Direct Line Group

Annual Report & Accounts 2012

Direct Line Insurance Group plc

Direct Line Group (the "**Group**") is the largest retail general insurer in the UK, the number one direct motor insurer in Italy and the number three direct motor insurer in Germany. We operate a multi-brand, multi-product and multi-channel business that covers the majority of customer segments in the UK for personal lines general insurance and small and medium-sized enterprise commercial insurance. Our brands offer the following products: motor, home, rescue, pet, travel and commercial.

Direct Line We have maintained the heritage of Direct Line in the UK by only selling its products directly to our customers through the phone and internet. We target customers who have a high brand affinity, with a focus on a quick and straightforward customer experience.

www.directline.com

Direct Line in Italy and Germany
In Italy and Germany, we distribute to customers through the phone and internet, including price comparison websites ("**PCWs**"). The brand is known for its excellent customer service and value.

www.directline.it / www.directline.de

direct line for business

Direct Line for Business ("DL4B")
DL4B, an extension of the Direct Line brand, is our direct commercial insurance brand for small and medium-sized enterprises ("**SMEs**") in the UK that have straightforward commercial insurance requirements.

www.directlineforbusiness.co.uk

Churchill, whose mascot has become a household name, markets its products in the UK through the phone and internet, including PCWs. We target customers who have a high brand affinity and value the need for support.

www.churchill.com

privilege®

Privilege targets customers who predominantly buy through PCWs, focusing on a quick customer experience at the best possible price.

www.privilege.com

GreenFlag
No Matter What

Green Flag is our roadside rescue and recovery product, which is sold both as a stand-alone service and as an optional add-on to motor insurance.

www.greenflag.com

NIG

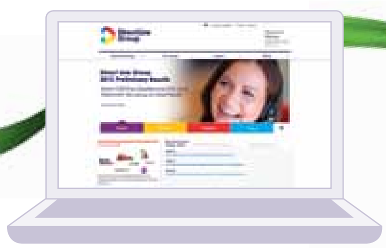
NIG is our specialist commercial insurance brand sold to SMEs in the UK through brokers; including an in-house intermediary that brokers all of the Royal Bank of Scotland ("**RBS Group**") and NatWest business.

www.nig.com

Brand Partners

Brand Partners is the business-to-business arm of Direct Line Group, specialising in providing personal lines insurance and roadside rescue and recovery products to some of the UK's biggest brands.

www.brand-partners.co.uk



For more information visit us online at
www.directlinegroup.com

Contents

Pages 10 to 95 of this Annual Report & Accounts 2012 constitutes the Directors' report for the purposes of section 415 Companies Act 2006. The Directors' report incorporates the Business review, on pages 10 to 51.

This Annual Report & Accounts 2012 contains statements which are not based on current or historical fact and are forward-looking in nature. Please refer to the 'Cautionary statement' on page 175.

Delivering our strategy

We have made good progress in our financial performance in 2012, increasing ongoing operating profit by 9.3% over the prior year. We continued to implement our transformation plan, as demonstrated by our return to underwriting profit. We successfully completed an Initial Public Offering on the London Stock Exchange in partial fulfilment of RBS Group's European Commission divestment obligation

Performance highlights

- Maintained our position as the UK's leading personal lines insurer
- New and extended partnership arrangements with Sainsbury's Bank, Nationwide Building Society, RBS and NatWest
- Extended the presence of Churchill and Privilege Motor and Home products to the four major UK PCWs
- Significant investment in pricing and claims capabilities, contributing to improved financial performance
- Balance sheet efficiency augmented through the issue of £500 million of subordinated debt following U K Insurance Limited, the Group's main underwriter, being assigned credit ratings of 'A' by Standard and Poor's and 'A2' by Moody's
- Successful separation from RBS Group and subsequent Initial Public Offering of 35% of Direct Line Group's Ordinary Shares in October 2012
- Announced targets of 98% combined operating ratio in 2013, £100 million of gross annual cost savings in 2014, and an overall target of a 15% return on tangible equity

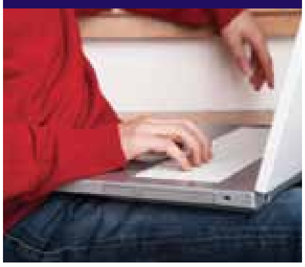
Customer focused business

Leading brands and significant scale

Quality products to meet customer needs

We have continued to invest in our leading brands, refreshing our brand advertising campaigns and sharpening the alignment of our brand portfolio to our target customer segments.

Multi-channel distribution



Ease of purchase

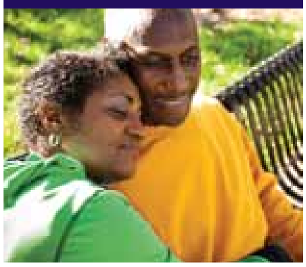
Our multi-brand, multi-channel distribution approach continues to be the central focus for us. Customers can choose from a variety of channels when purchasing our products.

Direct customer relationships

Good value and quality service

Our direct activity enables us to focus on providing high quality service to customers who value a direct relationship with their insurer.

Robust balance sheet and financial strength



Peace of mind

Our solid financial position means that we are in a position to provide protection for our customers.

Financial highlights

Return on tangible equity[1] (KPI)

11.5% 13.4% pro forma[1]

2012	11.5
2011	10.0
2010	(5.0)

In-force policies[2]

19.6m

2012	19.6
2011	19.4
2010	20.0

Gross written premium[2]

£3,991m

2012	3,991
2011	4,125
2010	4,095

Combined operating ratio[2] (KPI)

99.2% 2.6ppts improvement

2012	99.2
2011	101.8
2010	120.5

Operating profit/(loss)[2]

£461.2m

2012	461.2
2011	421.9
2010	(205.7)

Dividend per share (pence) (KPI)

8p

Adjusted earnings per share[3] (pence) (KPI)

21.8p

2012	21.8
2011	20.5
2010	(10.0)

Earnings per share (pence)

12.3p

2012	12.3
2011	16.6
2010	(18.1)

1. Return on tangible equity is adjusted profit after tax from ongoing operations divided by the Group's average tangible shareholders' equity. Profit after tax is adjusted to exclude Run-off operations, and restructuring and other one-off costs and is stated after charging tax (using the UK standard tax rate):
   – Pro forma return on tangible equity is based on the return on tangible equity but assumes that the capital actions taken by the Group (£1 billion dividend payment and £500 million long-term subordinated debt issue) occurred on 1 January 2012.
2. Ongoing operations. The profit before tax for the year to 31 December 2012 was £249.1 million (2011: £342.9 million).
3. Earnings adjusted to exclude restructuring and other one-off costs and the result of our Run-off operation.

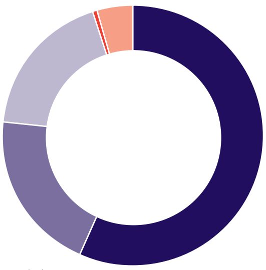
Leading the market

We use multiple brands, products and distribution channels to reach our customer segments for personal lines and commercial insurance in the UK, as well as multiple distribution channels for motor insurance in Italy and Germany

Our business divisions

We tailor our products to target specific market segments effectively.

Contribution to Group ongoing operating profit



- Motor
- Home
- Rescue and other personal lines
- Commercial
- International

Personal lines

Motor

We are the UK's leading personal motor insurer with a 16% share of the market's in-force policies. Mainly represented through our highly recognised brands, Direct Line and Churchill, we insure one in six cars on the road, representing 4.1 million in-force policies. We also sell motor insurance through partners such as Sainsbury's Bank.

Read more on p.31

Gross written premium	**£1,623.5m**
In-force policies (thousands)	**4,050**

Combined operating ratio

101.6%

Operating profit

£261.8m

Home

We are one of the UK's largest home insurers with an 18% market share of in-force policies. In addition to selling home insurance products through our own brands, we also distribute home policies through partners such as Sainsbury's Bank, RBS, NatWest, Nationwide Building Society and Prudential.

Read more on p.32

Gross written premium	**£989.0m**
In-force policies (thousands)	**4,239**

Combined operating ratio

96.6%

Operating profit

£93.3m

Multi-brand

We sell our products across a range of brands. Over 25 years, these brands have fundamentally changed Britain's insurance industry, making it easier for millions of customers to get good value cover.

Rescue and other personal lines

We are a leading provider of rescue and other personal lines insurance in the UK with 9.4 million in-force policies. This includes Green Flag, the UK's third largest roadside recovery provider. We also have an 11% share in both the pet and travel insurance markets.

Read more on p.33

Gross written premium	**£389.8m**
In-force policies (thousands)	**9,431**

Combined operating ratio

82.7%

Operating profit

£84.4m

Commercial

We provide commercial insurance, focused on SMEs and micro businesses, in the UK through our own brands NIG and DL4B, as well as through RBS and NatWest.

Read more on p.34

Gross written premium	**£435.6m**
In-force policies (thousands)	**466**

Combined operating ratio

108.2%

Operating profit

£2.2m

International

We are the largest direct motor insurer in Italy and the third largest in Germany, the two largest motor insurance markets in Europe. Private motor insurance is sold through the Direct Line brand and we have around 1.5 million in-force policies.

Read more on p.35

Gross written premium	**£552.7m**
In-force policies (thousands)	**1,462**

Combined operating ratio

103.3%

Operating profit

£19.5m

churchill™

privilege®

NIG

GreenFlag®
No Matter What

Brand Partners

Delivering value

We use a multi-brand, multi-product and multi-distribution channel business model, positioning each of our brands to offer different propositions to distinct customer segments. When combined effectively with our significant scale, we believe this allows us to achieve high performance in distribution, pricing, claims and cost, which in turn should position us to deliver value to customers and sustainable returns to our shareholders

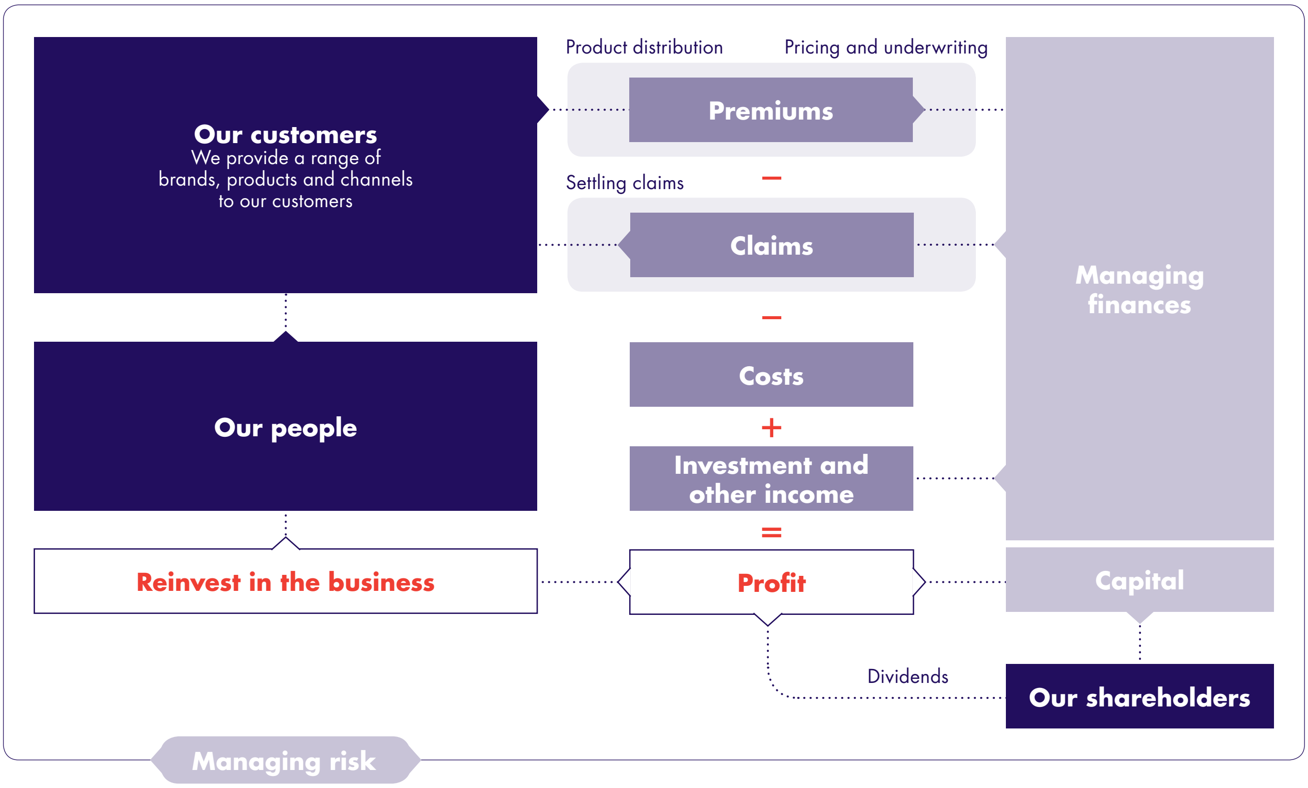
Delivering value to our customers through our people

Our customers

Our business model starts with our customers, who are the most important element in what we do. We aspire to give our customers the products that best suit their needs and encourage them to expect a high quality of service throughout their relationship with us. From the moment customers select our products, through to making a claim and resolving an unexpected event, we treat each phase of the journey as an opportunity to give our customers the best service and outcome.

Our people

Our people are essential to delivering products and services for our customers. Everyone from frontline staff, who directly engage with our customers, to the back office and central functions, who run all of the processes that sit behind our products and services, plays a part in ensuring we are meeting customers' needs. All of this will ultimately help to drive value for our customers and shareholders.



Through our focused processes

Product distribution

We give our customers what they need and make it easy for them to access our products in a way that suits them, ensuring they are appropriately covered when unexpected events happen.

We use a multi-brand, multi-product and multi-channel business model to sell our products and services to retail customers and businesses. Products can be purchased via the internet, phone, PCWs and indirectly via partners and brokers. Each brand represents products targeted at one or more of the insurance market segments: motor, home, rescue, pet, travel, commercial and international. By tailoring the distribution channel mix for each product, we can offer our customers a combination of brands, products and services that best suit their needs.

Pricing and underwriting

The scale of our business, which we have built over the last 25 years, enables deeper pricing insight, creating the potential for greater pricing accuracy. It also allows us to invest more heavily in data and achieve economies of scale, which means we are able to set the appropriate price for the risks we underwrite.

Settling claims

The point at which a customer needs to make a claim is when the value of their policy becomes apparent. Therefore, through active engagement with our customers, we aim to settle their claim as quickly and as easily as possible. Doing this the right way helps us to demonstrate the value of the products and services we provide.

Our low risk discipline

Managing finances

We manage our finances to maximise returns within agreed limits. This includes only spending money on items that add the most value to our customers, ensuring a well governed and controlled business, whilst balancing the need to generate a suitable and sustainable return to our shareholders. We also hold assets in excess of our expected liabilities in the form of capital, which is designed to absorb any unexpected losses that might occur.

Managing risk

Risk manifests itself in many ways and at each point of our business model it needs to be managed. We ensure that our products meet all of the regulatory standards and that customers fully understand what they are purchasing from us. We also make sure that we price our policies prudently and appropriately invest our assets to minimise the risk of creating a potential loss to the Group. We mitigate risks by agreeing policies and minimum standards that are regularly reviewed and updated to ensure we are in line with the risk appetite set by the Board. This internal control framework is supplemented with regular reviews by external experts.

Setting our direction

The Board is encouraged by the good progress made by the Group during 2012

"I believe the Company has a high quality Board that has the expertise and experience to provide excellent support and challenge to the business."

Mike Biggs, Chairman

This was a very important year for Direct Line Group. We made significant progress in delivering the objectives set out in our transformation plan, whilst also substantially separating operations from RBS Group. In October, we successfully listed on the London Stock Exchange in the UK's largest Initial Public Offering ("**IPO**") in 2012.

It was also an important year for the Board, which I joined as Chairman in April. We recruited three additional independent Non-Executive Directors, and I am pleased to report that the Board was at full strength prior to the IPO.

Strategy overview and results

The strategic plan to transform Direct Line Group into 'Britain's best retail general insurer' was launched in 2010 by our Chief Executive Officer, Paul Geddes and is now well established. We have made progress in many areas of our business including transforming our pricing and claims functions and improving our capital efficiency.

To supplement this plan, the Group announced a new set of targets in September 2012. These are for the Group to generate an overall return on tangible equity ("**RoTE**") of 15%; improve the combined operating ratio ("**COR**") to 98% in 2013; reduce the COR in Commercial to less than 100% in 2014; and achieve gross annual cost savings of £100 million in 2014.

The Board is encouraged with the progress made in 2012 as demonstrated by a pro forma RoTE of 13.4% and a COR for ongoing operations of 99.2%. Both outcomes show substantial improvement over 2011. Operating profit from our ongoing operations was up 9.3% at £461.2 million.

IPO

On 16 October 2012, Direct Line Group listed on the London Stock Exchange following the IPO by RBS Group of 35% of the Group's shares. The IPO was met with significant investor demand and the shares have subsequently performed well, rising by 24% from the IPO price of 175 pence per share to close the year at 216.4 pence per share.

As a result of receiving state aid, RBS Group is required by the European Commission to cede control of Direct Line Group by the end of 2013 and to divest itself of any remaining shares in the Group by the end of 2014.

Governance and Board changes

The year saw a number of changes to our Board's composition, which meant we were compliant with the UK Corporate Governance Code at the time of Admission to the Official List of the London Stock Exchange.

I joined the Board as Chairman in April and began by recruiting further Directors to build a Board suitable for the Group's ambitions and to join the existing independent Non-Executive Directors, Andrew Palmer and Jane Hanson. I am delighted that during the course of the year a further three independent Non-Executive Directors joined the Board – Glyn Jones, Clare Thompson and Priscilla Vacassin. Glyn also holds the position of Senior Independent Director. Glyn, Clare and Priscilla bring a variety of strengths and skills from their previous experience and these are discussed in the corporate governance section.

Furthermore, RBS Group currently has two nominated directors on the Company's Board, Bruce Van Saun and Mark Catton. RBS Group has the right to nominate up to two members of the Board as long as it remains a controlling shareholder of Direct Line Group and up to one member provided it owns between 20% and 50% of the shares.

Dividend

The Directors have proposed a final dividend of 8 pence per share. This proposal is in line with the policy set out at the time of the IPO. On the basis that the final dividend represents two-thirds of the total annual distribution, the full-year pro forma dividend of 12 pence per share would represent a payout ratio of 55% of earnings from ongoing operations.

The Group has adopted a progressive dividend policy which from 2013 will aim to raise the dividend annually in real terms to reflect the cash flow generation and the long-term earnings potential of the Group.

Relationship with RBS Group

Our ongoing relationship with RBS Group is set out in a number of agreements of which the Relationship Agreement and the Transitional Services Agreement ("**TSA**") are the most important.

The Relationship Agreement sets out that, notwithstanding the significant shareholding held by RBS Group, Direct Line Group is to carry on its business independently of RBS Group. The agreement ceases once RBS Group holds less than 20% of the shares of Direct Line Insurance Group plc (the "**Company**").

Under the TSA, RBS Group continues to provide IT and certain other services for a transitional period of up to 36 months.

Summary

2012 has been a year of very significant progress for Direct Line Group and the Board would like to acknowledge the effort and commitment of every member of staff in what has been an extremely busy and demanding year.

M N Biggs

Michael N Biggs, Chairman

For information on our corporate governance see p.52

Unlocking value

It has been a momentous year for Direct Line Group and our people have worked diligently to deliver good progress towards our strategic targets

Paul Geddes, Chief Executive Officer

Overview of financial performance

Welcome to our first Annual Report & Accounts as a listed company in our own right. I am pleased to report that we have made good progress against our business transformation plan and delivered an operating profit from ongoing operations of £461.2 million for 2012, an increase of 9.3% compared to 2011 (£421.9 million). All divisions were profitable in 2012. This was driven by a return to underwriting profit, demonstrating the effective use of our pricing and data, improved claims processes, as well as the strength of our distribution platform in serving our customers.

Helping our customers

As one of the leading motor and home insurers in the UK, our responsibility to motorists and homeowners is more than just processing a claim when an accident or loss has occurred. We consider road safety to be an important element of our work within the community. As such, we have developed partnerships with key road safety stakeholders, such as the charity, Brake, working with them to raise motorists' awareness of road safety issues.

Moving from the roads and into the home, some of our home insurance customers have had to endure another unprecedented year of rainfall and flooding. Our advisers were immediately on the ground in heavily affected areas to help customers through the claims process and provide them with alternative accommodation where needed.

Separation from RBS Group

Following the implementation of a comprehensive programme of initiatives, we are now operating on a substantially stand-alone basis from RBS Group. These initiatives included appointing the Direct Line Group Board of Directors, harmonising employee service contracts, developing a stand-alone risk and compliance department, and agreeing an arm's length TSA with RBS Group for residual services. We have also recently appointed Capgemini to support the migration of our IT as well as to design, deliver and run a new IT infrastructure to support the business.

"The flotation of Direct Line Group on the London Stock Exchange marked an important milestone in our history. Our strong business model and transformation plan proved attractive to the market despite considerable economic and market headwinds."

Paul Geddes, Chief Executive Officer

Listing on the London Stock Exchange

In October, we successfully completed our IPO on the London Stock Exchange. RBS Group sold 520.8 million Ordinary Shares in Direct Line Group, representing 35% of our issued share capital, generating gross proceeds of £911 million for RBS Group. In December, Direct Line Group became a constituent of the FTSE 250 Index.

The journey so far

In the midst of tough economic and competitive conditions, we have delivered a clear turnaround in performance, most visibly a £667 million improvement in operating profit from ongoing operations since 2010. We have maintained a focus on underwriting for profit by methodically reducing our level of risk, taking stringent steps to improve our pricing capability, and exiting lines of business that have proven unprofitable.

Since the beginning of our transformation plan in 2010, we have taken action to improve our capital efficiency and to benefit from our scale by consolidating four underwriting entities into one, U K Insurance Limited. We received an 'A' credit rating from Standard & Poor's and an 'A2' credit rating from Moody's, issued £500 million of long-term subordinated debt and prior to the IPO returned £1 billion in dividends to RBS Group.

As a result of these actions, we have strengthened and improved our business, making good progress towards achieving our strategic targets.

The strategic plan

With the first part of our transformation plan – to return to profit – complete, we have redefined our strategic plan through five key pillars: distribution, pricing, claims, costs, and Commercial and International.

Distribution

We renewed existing strategic partnerships, including Nationwide Building Society and RBS Group, and secured new ones, notably Sainsbury's Bank. We also launched our Churchill and Privilege motor and home products on comparethemarket.com, which means we have a presence on the four major UK PCWs.

Pricing

Since 2010, we have de-risked the motor portfolio and repriced to reflect the risk and cost of bodily injury claims, particularly with younger drivers and certain postcodes. We built capability through implementing a new pricing model and rating engine across the Motor and Home divisions, contributing to significant improvements in our loss ratio performance.

The right team to deliver the evolving customer agenda

We now have the right structure in place to help us specifically address our customers' needs and to protect their interests. In light of the new structure of the Financial Services Authority ("FSA") and the creation of the Financial Conduct Authority we are well placed to respond to the changing landscape of how businesses interact with their customers.

For more information see p.58

Claims
We have undergone a significant transformation in our claims function, including a strategic investment in a new claims system, ClaimCenter, which is now operational for the majority of Motor and Home claims. The benefits are being realised through improved claims processes, including shorter settlement times for customers and improved legal case management.

Costs
The first phase of our cost reduction programme focused on our operational cost base. We reduced the number of our sites from 32 locations to 16 and delivered 15% efficiency savings across our UK sales operations. In August 2012, we announced the target of gross annual cost savings of £100 million in 2014.

Commercial and International
We are working towards reducing our costs and improving operational efficiency in Commercial, targeting a COR below 100% in 2014. In International, we are leveraging our UK expertise in pricing and claims as well as driving through operational efficiencies to produce returns consistent with our strong market position as a leading direct insurer in both Italy and Germany.

Priorities for 2013
During 2013 we aim to make progress towards delivering the strategic financial targets we set out at the time of the IPO. In particular we aim to deliver a 98% COR in 2013 and to make progress towards our £100 million gross annual cost savings target.

We aim to achieve this by, for example, deploying the capability built in our pricing and claims functions over the last couple of years and, in 2013, we aim to supplement this by prioritising our distribution and cost initiatives.

To enhance our distribution, we are already fine-tuning our propositions with the implementation of new offers and pricing structures adapted to the evolving needs of our customers. We will continually monitor the business to ensure we are addressing the needs of our customers, the competitiveness of the markets in which we operate, the engagement of our staff and the returns expected by our shareholders.

Regulatory environment
We are operating in an industry that is preparing for substantial regulatory change. With the ongoing debates in the motor market surrounding referral and legal fees, the increase in whiplash claims and the implementation of the gender directive, we aim to be leaders through this period of change and lobby for reform to provide the best outcome for our customers and shareholders.

Outlook
The UK personal lines market remains competitive, particularly in the Motor division. In this environment, the Group will continue its strategy of disciplined underwriting that prioritises maintaining margin over volume. We expect to see improvements to the loss ratio in 2013 as investments in pricing and claims capabilities, together with the improved risk profile of the underwriting portfolio, especially in Motor and Commercial, are recognised. In 2014 we expect to have delivered the £100 million gross annual cost savings and we will continue to look at our expense base as market conditions evolve. Overall we continue to target a 98% COR for ongoing operations in 2013.

Investment markets remain tough with continued low reinvestment yields and therefore, within our risk appetite, we are planning various actions intended to mitigate pressures on investment returns. We will continue to invest in the business with the objective of both sustaining our leadership position and meeting our 15% RoTE.

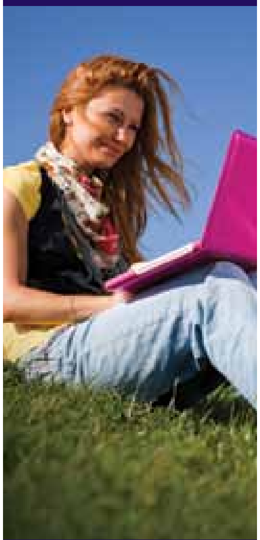
We have made great strides since the beginning of our transformation journey in 2010. I am extremely grateful for the hard work, dedication and expertise demonstrated by our people, and I am excited about developing the business even further for the next phase of our journey.

Paul Geddes, Chief Executive Officer

Transforming Direct Line Group

Our ambition is to be Britain's best retail general insurer. We focus on making it easy, while providing great value, for customers to fulfil more of their insurance needs with us

1 Distribution



Enhance effectiveness to improve customer value

See p.14

2 Pricing

Build superior pricing capabilities to utilise scale advantage in data

See p.16

3 Claims

Attain market leading position in claims management

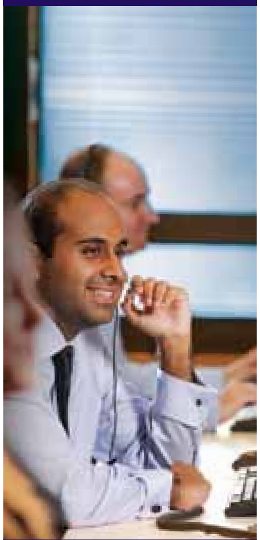
See p.18

4 Costs

Enhance cost efficiency

See p.20

5 Commercial and International



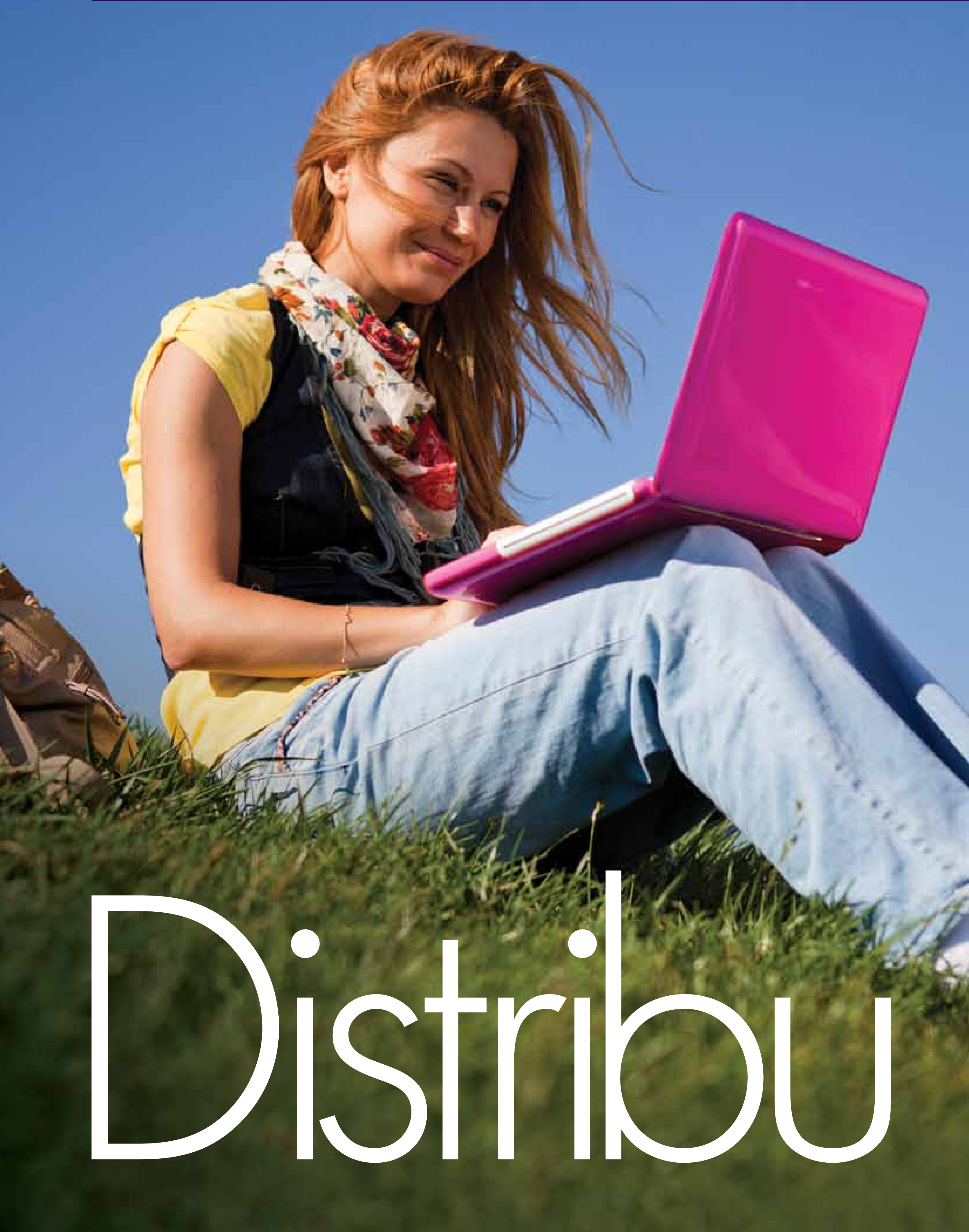
Leverage core skills to improve performance

See p.22

Financial targets

15%	98%	<100%	£100m	125%–150%
Return on tangible equity	COR for ongoing operations in 2013	COR for Commercial division in 2014	Gross annual cost savings in 2014	Maintain risk-based capital coverage consistent with credit rating in the 'A' range

For more information on our key performance indicators see p.24


Distribu

We aim to improve our distribution efficiency and effectiveness through a focus on digital capability and customer value

We employ a multi-channel distribution model and look to optimise the mix of these channels for each of our products and brands. This includes selling our products directly via the phone and internet, through the UK's four largest PCWs, and via partners and brokers.

This is a good foundation for us to build on. Our priorities for 2013 and beyond are to improve quote efficiency by developing our digital capability further and using our data and segmentation insight to target our customers better. We aim to increase customer lifetime value through a focus on improving retention and enhanced cross-product propositions that deepen customer relationships. We intend to continue to differentiate our brands to improve how we meet customer needs. For example, Direct Line "Together" rewards customer loyalty in a way that is unique to the sector, with a 10% discount offered on each and every additional Direct Line policy in the customer's household.

Motor in-force policies (thousands)

4,050

2012	4,050
2011	4,107
2010	4,807

Home in-force policies (thousands)

4,239

2012	4,239
2011	4,308
2010	4,327

Our strategy in action

Our launch on comparethemarket.com is one way that we reinforced our multi-brand, multi-channel model. We have given customers even more choice about how they access our Churchill and Privilege brands, as well as our partners, such as Sainsbury's Bank. Giving customers a variety of access points means they can buy in the way that best suits the level of interaction they need.

tion

Pricing

We aim to leverage our substantial data scale and the investments we have made to deliver leading technical and market pricing

We have been a leading retail general insurer for a long time. This gives us a significant scale advantage in data, with detailed customer level information from 49 million consumer records and eight million claims data points. Using this data more effectively has enabled us to improve profitability through pricing risks more accurately. By continuing to invest in our pricing capabilities we aim to offer our target customers competitive prices, while also continuing to manage value for our shareholders.

We have already enhanced the use of internal and external data, with twice as many risk factors tested as in 2009. We are building a new rating engine with faster links to external data and the real-time deployment of pricing changes. We aim to deliver industry leading technical pricing capabilities that will enable us to calculate the price implied by claims costs more accurately; and superior market pricing that will enable us to offer the right price to our target customers at any given point in time.

Motor current year loss ratio

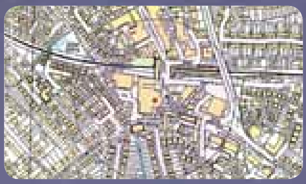
85.4% 4.1ppts improvement

2012	85.4
2011	89.5
2010	99.4

2

Our strategy in action

We understand the importance of price in consumer buying decisions. We therefore use our extensive data resources, such as the Geospatial tool, so that we can offer customers products at prices which accurately reflect their individual circumstances and risks, match their specific needs and offer good value for money.



Geospatial tool

Business review: Strategic review

Our strategy in action

For customers, the moment of truth comes when they make a claim. When many parts of the UK experienced severe flooding in 2012, our people were quickly at hand to provide assistance to the homes and businesses affected. Our Property Insurance Advisers assessed property damage, guided customers through the claims process and arranged temporary accommodation and cash advances to help with essential purchases where needed.

Claims

We aim to capitalise on our hard work and the strategic transformation to maintain top quartile claims performance

We have fundamentally redesigned our operating model, systems and processes in Claims, following extensive benchmarking against global best practice. We have launched our new claims system, ClaimCenter, across the majority of Motor and Home, enabling us to increase our claims handling efficiency. We have simpler processes in fewer sites, giving our people more control and giving our customers a better experience.

In Motor, we have put in place new processes to manage bodily injury claims proactively, bringing together legal, medical and insurance experts who are supported with specialist case management software. With the launch of our home estimating tool in April 2012, our Property Insurance Advisers can now use tablet computers to scope jobs accurately, apply our schedule of rates and deploy our revised builder network where required. This both improves customer service and controls claims spend.

In the next few years, we will aim to maintain momentum in our claims transformation programme. This will be extended to other business divisions in the UK, as well as applying lessons learnt to our International division. We expect to see further regulatory change in the coming years; we've been lobbying for it and we believe we are well placed to adapt to the changes when they come into effect.

Number of claims registered on new system

418,100

2012	418,100
2011	113,500

Costs

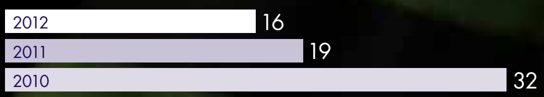
We aim to deliver on our cost saving target and continue to manage our expense base closely

We recognise the ongoing imperative to improve our expense position in this competitive market. In August 2012, we announced a target of £100 million gross annual cost savings in 2014. We have already taken steps to deliver the majority of the programme, including announcing the closure of our Teesside office as well as a reorganisation of the Executive team and the reduction of 70 senior leadership roles across the organisation.

The priority for 2013 and beyond is to deliver our cost saving programme while continuing to review the way we do business. We believe that making changes to our systems represents an important way of enhancing efficiency, while helping our people control the way services are provided to customers. We have signed a five-year contract with Capgemini to design, deliver and run our new IT infrastructure.

Number of sites

16



Our strategy in action

Having reviewed our cost base, we have made some fundamental changes to our organisation. We aim to continually operate at the most efficient levels, while maintaining excellent customer service. This means not just looking at the number of people and offices we need, but also challenging ourselves to reduce complexity and deliver better value to our customers and shareholders.

Commercial

Commercial

We have refocused our Commercial business to target the growing SME and micro segments, and are increasingly set to benefit as these customers move towards direct and e-trading distribution channels

We have successfully grown DL4B in these segments; it now represents 13% of our Commercial gross written premium having launched in 2007.

We have recently made a major investment in technology in our Commercial division, when we launched 'TheHub'. This is NIG's new, easy-to-use, full-cycle eTrading platform which is designed to capture the shift in broker distribution towards a high-volume low-cost model suitable for small business customers.

Having returned the business to operating profit in 2012, we are targeting a COR below 100% for the Commercial division in 2014. We aim to improve our loss ratio by managing our top-line growth and by enhancing our pricing sophistication through leveraging the Group's proprietary data. We have put in place robust plans to cut costs and deliver a better model for brokers, customers and shareholders.

Commercial combined operating ratio

108.2% 4.1ppts improvement

2012	108.2
2011	112.3
2010	121.6

and International

International in-force policies (thousands)

1,462

Year	Policies (thousands)
2012	1,462
2011	1,387
2010	1,082

International

We have 10 years of experience in Europe's two biggest motor insurance markets and are now getting to scale and profitability

In Italy, we are the leading direct motor insurer with one million policies, and are focusing on disciplined profit growth through targeted segmentation and cost initiatives. Our German business is number three in the direct motor market with around half a million policies and is targeting accelerated growth through PCWs and brand partnerships.

We are well positioned in these two markets that are gradually moving towards direct channels, and we have experienced local management teams in place to adapt to changes in the trading environment. Across both countries, we plan to improve operational efficiency and to leverage our UK expertise in pricing and claims systems.

Where we operate

Measuring our performance

We have defined seven key performance indicators that allow us to monitor our performance against our strategic priorities. These KPIs are supported by further more detailed performance indicators

Combined operating ratio[1]

99.2% 2.6ppts improvement

Definition
A measure of financial year underwriting profitability calculated by the sum of claims, commissions and expenses divided by net earned premium. This excludes instalment and other operating income and investment return.

Aim
We aim to make an underwriting profit and are targeting a COR of 98% in 2013.

Ongoing expenses (including claims handling)[1]

£1,145.1m

Definition
The cost of doing business including paying our people, marketing, infrastructure and IT. This includes the costs we incur in handling claims but excludes any commissions we pay to brokers or partners.

Aim
We aim to operate an efficient and effective organisation and are targeting £100 million gross annual cost savings in 2014 from the 2011 cost base.

Investment income yield

2.0%

Definition
The return generated by investing the assets we hold. These investments are held to pay out future claims and to support our capital base. It is calculated by dividing investment income (excluding net realised gains) by average investment assets under management.

Aim
We aim to maximise investment income subject to the risk appetite set by the Board. Our investment policy is conservative with assets currently invested in bonds, cash and property.

1. Ongoing operations.
2. Earnings adjusted to exclude restructuring and other one-off costs and the result of our Run-off operation.
3. RoTE is adjusted to exclude Run-off operations and restructuring and other one-off costs; based on average tangible equity, using UK standard tax rate.
4. Pro forma RoTE assumes that the capital actions taken by Direct Line Group (£1 billion dividend payment and £500 million long-term subordinated debt issue) occurred on 1 January 2012.

Adjusted earnings per share[2] (pence)

21.8p

Definition
We adjust earnings to exclude restructuring and other one-off costs and the result of our Run-off operation. These adjusted earnings, which reflect the ongoing operations, are divided by the average number of shares in issue.

Aim
We have not set a target for adjusted earnings per share given the cyclical nature of the insurance industry. Growing earnings per share is considered one indicator of a healthy business.

Return on tangible equity[3]

11.5% 13.4% pro forma[4]

Definition
The return generated on the capital shareholders have in the business. This is calculated by dividing adjusted earnings by average tangible equity. Pro forma RoTE assumes that the capital actions taken by the Group (£1 billion dividend payment and £500 million long-term subordinated debt issue) occurred on 1 January 2012.

Aim
We have set a target to achieve a 15% RoTE.

Dividend per share (pence)

8p

Definition
The amount of cash paid to shareholders out of the profits of Direct Line Group. The amount shown relates solely to dividends proposed post the IPO in October 2012.

Aim
We have adopted a progressive dividend policy and aim to grow the dividend in real terms each year.

Risk-based capital coverage

151.4%

Definition
A measure to show the level of capital held compared to the level that is required, taking into account the risks faced by the business.

Aim
We target risk-based capital coverage of 125% – 150% which we believe is equivalent to the level of capital required for a rating in the 'A' range from our credit rating agencies.

Direct Line Group is subject to a number of risks and uncertainties which could impact our KPIs and performance. Please refer to the following section.

Managing risk

We have a robust and integrated risk management framework. This framework sets out the responsibilities and accountabilities for risk management for the whole business

> "The risk and compliance strategy is focused on fully supporting the Group's goal to become Britain's best retail general insurer, delivering sustainable returns."
>
> **José Vazquez,** Chief Risk Officer

The Board has responsibility for setting and monitoring adherence to the risk strategy, risk appetite and risk framework. The Board has established a risk management model that separates the business's risk management responsibilities into three lines of defence as set out in the diagram below.

Risk strategy and risk appetite

The Board has set clear strategic risk objectives:

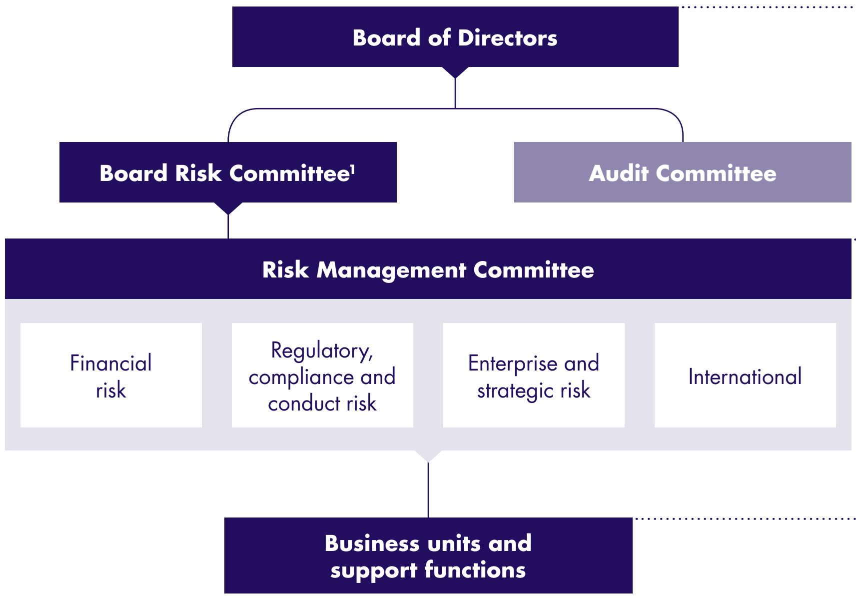
- To maintain capital adequacy
- To stabilise earnings volatility
- To ensure stable and efficient access to funding and liquidity
- To maintain stakeholder confidence

These objectives have been developed to recognise that, for long-term sustainability, we need to have sufficient economic capital and we need to protect our reputation and integrity in our relationships with customers and stakeholders.

Within the Group, a well-articulated risk appetite lies at the heart of effective enterprise risk management ("ERM") to support:

- Our strategic risk objectives, as outlined above
- Risk management
- Setting of boundaries for risk taking
- Stakeholder value optimisation

Our risk management structure



3rd Line defence Internal Audit function

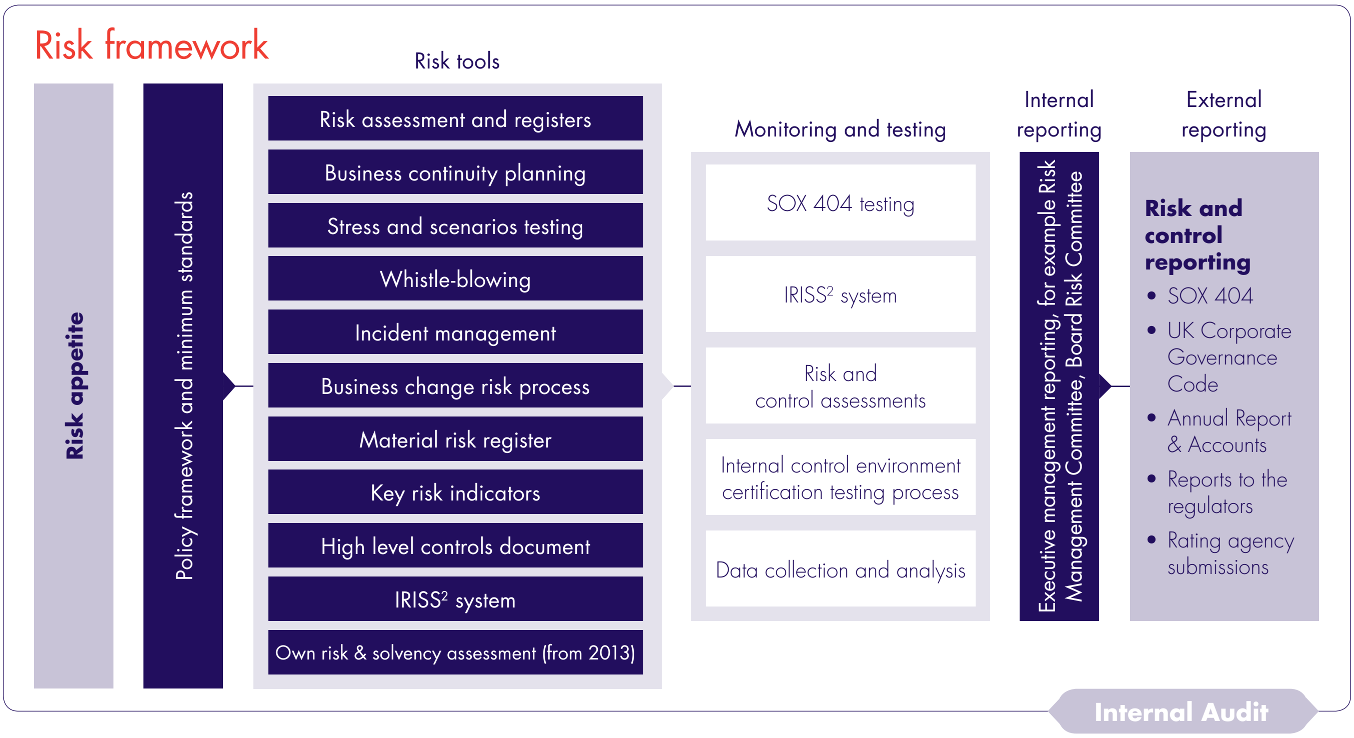
- Independent assurance on adequacy and effectiveness of risk framework

2nd Line defence Risk function

- Advise Board on risk strategy and risk appetite
- Advise Board on appropriate risk framework and risk tools
- Oversight, challenge and support of 1st line

1st Line defence business and support functions

- Adhere to risk strategy and risk appetite
- Own and manage risks
- Compliance with risk framework
- Assurance on adherence to policies



Notes:

1. The Chief Risk Officer is a member of the Executive Committee and reports to the Chief Executive Officer, with a right of access to the Board Risk Committee and the Audit Committee, assuring independence of the function. The Chief Risk Officer chairs the executive Risk Management Committee, which reviews material policies for the effective management of risk across the Group.
2. IRISS – Internal Risk Intelligence Software System is designed to facilitate a robust and consistent approach in the way we identify and capture risk information thereby significantly enhancing our ability to measure, report and manage our risks.

The risk appetite statements are expressions of the level of risk we are prepared to accept to achieve our business objectives. In order for these statements to be defined quantitatively as well as qualitatively, they are aligned to key metrics. These metrics are monitored regularly.

Risk appetite should not be static and the Group is committed to performing an annual review of the risk appetite framework to ensure its continued suitability to support a well-managed company.

The strategic risk objectives link to a set of risk appetite statements and key metrics.

The table below sets out these objectives and shows, at a high level, examples of corresponding appetite statements.

Strategic risk objective	Risk appetite statement
Maintain capital adequacy	Maintain sufficient economic capital to a defined target
Deliver stable earnings	Profitability over a defined period
Stable and efficient access to funding and liquidity	Cash outflows met under stress
Maintain stakeholder confidence	No appetite for material reputational, legal or regulatory risks

The aim of the risk framework is to provide a robust, proportionate, proactive and forward-looking process for risk management across the Group. A central component of this framework is the Group's policies and minimum standards, which inform the business as to how it is required to conduct its activities and risk management processes to remain within risk appetite. We employ a number of risk tools to manage and monitor risk. The output of our risk management activities is thoroughly tested and reported upon both internally and externally.

The policies and minimum standards cover all key risks to which the Group is exposed. Each policy is supported by minimum standards which set out the minimum level of risk management and other corporate and personal behaviours. The minimum standards are in turn supported by detailed guidance documents.

We incorporate the identification, assessment, management, control, reporting and mitigation of risk as part of our daily operations.

We believe the strengths of our risk framework are:

- Strong culture and risk leadership underpinned by training of our people
- Engagement with the business
- Embedded risk management processes, linking risk and capital
- Quantitative approach to risk analysis, for example, development of a robust economic capital model. Leveraging off our market leading position in home and motor provides access to a significant volume of data
- Risk assessment and management information through integrated risk systems
- Influencing decision-making and shaping behaviours, via the provision of accurate, timely and relevant risk advice and challenge

Principal risks and uncertainties

The Group writes products that are subject to a number of uncertainties and risks. It is a key role of the Risk function to ensure that these risks have been identified, measured and considered throughout the business.

Principal risks	Impact	Management and mitigation
Strategic risk The economic climate could put at risk our ability to meet our strategic objectives in the areas of distribution, pricing, claims, costs, Commercial and International. We may fail to execute our ongoing strategic transformation plan, and the expected benefits of that plan may not be achieved at the time or to the extent expected, or at all.	The value of the Group decreases, resulting in a lack of shareholder confidence.	• Constant monitoring and management of agreed strategic targets • Monitoring of cost savings to ensure they remain on track • Investment in brand awareness, and improved pricing and claims models • Upgrading and enhancement of numerous operational processes and systems
Underwriting and pricing risk We are subject to the risk that inappropriate business could be written (or not specifically excluded) and inappropriate prices charged. This includes catastrophe risk arising from losses due to unpredictable natural and man-made events affecting multiple covered risks particularly given the concentration of our home business in the UK.	Adverse loss experience impacting current year and future year business performance.	• Underwriting guidelines for all business transacted, restricting the types and classes of business that may be accepted • Exception reports and underwriting monitoring tools • Internal quality assurance programmes • Pricing policies by product line and by brand • Analysis of comprehensive data to refine pricing • Insurance governance forums whose remit include examination of data • Central control of policy wordings • Purchase of catastrophe reinsurance to limit the exposure • Quarterly analysis of all property portfolios to determine expected maximum losses • Investment in enhanced external data to mitigate exposures (for example, flood and individual underwriting risk through Geospatial)
Reserving risk Due to the uncertain nature and timing of the risks to which we are exposed, we cannot precisely determine the amounts that we will ultimately pay to meet the liabilities covered by the insurance policies written.	Adverse development in prior year reserves resulting in a financial loss.	• Technical reserves are estimated by: – A range of actuarial and statistical techniques, with projections of ultimate claims cost involving assumptions across a range of variables, including estimates of trends in claims frequency and average claim amounts based on facts and circumstances at a given point in time – Making assumptions on other variable factors including; the legal, social, economic and regulatory environments; Ogden discount rate and the process by which it is set; results of litigation; and the extent and terms on which periodical payment orders ("**PPOs**") are made by the Courts. Other factors considered include rehabilitation and mortality trends, business mix, consumer behaviour, market trends, underwriting assumptions, risk pricing models, inflation in medical care costs, future earnings inflation and other relevant forms of inflation, the performance and operation of reinsurance assets and future investment returns – Stress and scenario testing – Management's best estimate of reserves being equal to or in excess of the actuarial best estimate
Operational risk The risks of direct or indirect losses resulting from inadequate or failed internal processes, fraudulent claims or from systems and people, or from external events including changes in the competitor, regulatory or legislative environments. In particular we have IT systems risk, as the Group is highly dependent on the use of third-party information technology, software, data and service providers.	Adverse events with potential financial, reputational, legal and customer impacts.	• We have upgraded and enhanced many of our operational processes and systems, including the claims system and fraud detection system. This includes enhancing our ERM framework to integrate risk, business and capital strategies • We maintain a robust internal control environment • We have developed a bespoke risk capture, management and reporting system • Migration of IT onto a new enhanced platform

Principal risks	Impact	Management and mitigation
Investment risk **Market risk** – the risk of adverse financial impact due to changes in fair values of future cash flows of instruments held in the investment portfolio as a result of changes in interest rates, credit spread, foreign exchange rates and property values. **Credit risk** – the risk of exposure if another party fails to perform its financial obligations, including failing to perform them in a timely manner. **Liquidity risk** – the risk of maintaining insufficient financial resources to meet business obligations as and when they fall due.	Adverse movements due to asset value reduction, mismatch in assets and liabilities, and default of third parties. Inability to meet cash flows under stress.	• Our investment portfolio is managed and controlled through: – Investment strategy and guidelines proposed to the Board by the Investment Committee and monitored by the Asset and Liability Committee – Diverse holding of types of assets including geographies, sectors and credit ratings – Utilisation of risk reduction techniques, for example hedging – Stress testing and scenario analysis
Counterparty risk We partner with many suppliers and the failure of any of these to perform their financial obligations or perform them in a timely manner could result in a financial loss. The principal area of counterparty risk is our use of reinsurance against catastrophe risk.	Loss due to default of banks, reinsurers, brokers or other third parties.	• Credit limits are set for counterparties, particularly banks • Requirement for minimum credit ratings for reinsurers • Broker credit exposures are monitored by the business
Regulatory risk Changes in law and regulations are not identified, understood, or are inappropriately and incorrectly interpreted, or adopted, or business practices are not efficiently modified. Further, there is a risk that current legal or regulatory requirements are not complied with. For example, in the beginning of 2012, the FSA imposed a £2.17 million fine on the Group in relation to complaint file alterations.	Customer impact, financial loss and regulatory censure. Regulatory sanction, legal action or revenue loss.	• We have a constructive and open relationship with our regulators and other official bodies (for example the Ministry of Justice and the Office of Fair Trading), in addition to specific risk management tools and resources to minimise our exposure to regulatory risk
Conduct risk The risk of failing to deliver the appropriate treatment for our customers throughout all stages of the customer journey and that our people fail to behave with integrity.	Potential customer detriment, financial loss and regulatory censure and sanction.	• Our organisational culture prioritises a consistent approach towards customers and the interests of customers are at the heart of how we operate • We have developed a robust customer conduct risk management framework, to minimise our exposure to conduct risk
Brand and reputational risk We are dependent on the strength of our brands, our reputation with customers and distributors in the sale of products and services. We have entered into various strategic partnerships that are important to the marketing, sale and distribution of our products.	Loss of brand value negatively impacts our ability to retain and write new business.	• Our brand and reputation risk is regularly reviewed by various governance committees • A key focus for us is to build our brands business through marketing, whilst regularly monitoring performance using a range of brand metrics • We seek to offer a superior service to customers and to treat customers fairly in line with FSA principles

As long as RBS Group remains a significant shareholder, there are certain risks that apply to the RBS Group and, should they arise, may have an adverse impact on our business. For example, RBS Group will continue to exert substantial influence over us while it has a substantial shareholding; RBS Group could face the risk of full nationalisation or other resolution procedures; our contractual arrangements may be impacted by events that occur within RBS Group; and RBS Group is subject to a variety of risks as a result of implementing the state aid restructuring plan which could adversely affect us. RBS Group has a legal obligation to divest its controlling interest in the Group by the end of 2013 and completely divest by the end of 2014. The manner and exact timing of any divestment is uncertain.

Group performance

We continue to improve our financial performance, despite the backdrop of a competitive market and subdued investment returns

Operating profit for ongoing business improved by 9.3% to £461.2 million (2011: £421.9 million). This followed substantial management action to improve risk selection and claims management. Combined with the successful implementation of our 2012 capital plan, including returning £1 billion in dividends (2011: nil) to RBS Group and raising £500 million (2011: nil) of long-term subordinated debt, the Group has achieved, on a pro forma basis, a RoTE for ongoing business of 13.4%.

The Group's COR for ongoing business was 99.2% (2011: 101.8%), leading to a profitable underwriting result despite above average claims arising from major weather events and the impact of parallel running costs prior to the separation from RBS Group.

Summary income statement – ongoing operations

For the year ended 31 December	**2012 £m**	2011 £m
Gross written premium	**3,990.6**	4,124.9
Net earned premium	**3,708.7**	3,890.9
Underwriting profit / (loss)	**28.2**	(72.3)
Instalment and other operating income	**198.3**	255.5
Investment return	**234.7**	238.7
Operating profit	**461.2**	**421.9**
Adjusted earnings per share (pence)	**21.8**	20.5
Return on tangible equity (%)	**11.5**	10.0
Pro forma return on tangible equity (%)	**13.4**	n/a

The following table analyses ongoing operating profit / (loss) by division:

Divisional ongoing operating profit

For the year ended 31 December	**2012 £m**	2011 £m
Motor	**261.8**	254.8
Home	**93.3**	111.9
Rescue and other personal lines	**84.4**	63.3
Commercial	**2.2**	(12.4)
International	**19.5**	4.3
Total	**461.2**	**421.9**

On the following pages 31 to 35, the contribution of each division to the Group's operating performance is discussed in more detail.

Personal lines

"The UK Personal Lines business has maintained its focus on value within an increasingly competitive market. We are continuing to invest in pricing and claims excellence and are focused on delivering value for our customers."

Tom Woolgrove, Managing Director of Personal Lines

Motor

Highlights

- Retained position as the UK's leading motor insurer by in-force policies, stabilising the policy count after substantial de-risking in 2010 and 2011
- Operating profit up 2.7% despite significant reduction in other operating income
- Significant improvement in the COR, from 105.6% to 101.6%
- Continued to enhance our pricing and claims capability, contributing to a reduction of 7.1 percentage points in the loss ratio
- Extended our distribution reach through launching on comparethemarket.com with the Churchill, Privilege and Sainsbury's Bank brands

Performance highlights

	2012	2011
In-force policies (thousands)	**4,050**	4,107
Gross written premium	**£1,623.5m**	£1,734.8m
Loss ratio	**74.6%**	81.7%
Commission ratio	**2.0%**	1.5%
Expense ratio	**25.0%**	22.4%
Combined operating ratio	**101.6%**	105.6%
Operating profit	**£261.8m**	£254.8m

Our brands

direct line

privilege

churchill

Partners

Sainsbury's Bank

NatWest

PRUDENTIAL

RBS Group

Market

Following the significant increases in premium rates experienced in 2010 and 2011, the UK private motor insurance market has been broadly flat during 2012. Small bodily injury claims in particular have received considerable political and regulatory attention, with the prospect of a balanced package of reforms including:

- Banning solicitors' referral fees
- Reducing fixed legal costs for bodily injury claims to below £10,000
- Removing recoverability of conditional fee agreements offset by a 10% uplift to general damages

In addition, consultations regarding increasing the bodily injury small claims limit from £1,000 to £5,000 and reforming medical evidence for whiplash claims have begun.

Performance

We have continued to invest in our customer offerings, and have focused in particular on sharpening our multi-car proposition and pricing. We completed the roll-out of our new claims system to all brands, and are delivering improved claims performance, particularly in bodily injury cases. In July, we launched on comparethemarket.com, with the Churchill, Privilege and Sainsbury's Bank brands.

Gross written premium of £1,623.5 million fell 6.4% compared with 2011, due to the full-year effect of de-risking the portfolio in 2011 and a continued focus on disciplined underwriting. The in-force policy count stabilised at 4.1 million.

The underwriting loss in 2012 of £26.3 million improved by £72.3 million compared with 2011, and the COR fell from 105.6% to 101.6%. This was the result of continued improvements to claims performance arising from improved pricing, the ongoing effect of de-risking and the benefits arising from the transformation of the claims operation. These trends were reflected in both an improved current-year loss ratio and increased releases from prior years. Operating profit of £261.8 million in 2012 increased from £254.8 million in 2011.

Outlook

The UK motor market is expected to remain particularly competitive during 2013. The full effects of the move to gender neutral pricing, the package of upcoming legal reforms and the referral of the UK motor insurance market to the Competition Commission are still to be felt. We support the direction of the overall package of the legal reforms and continue to engage proactively with key stakeholders. Overall, we believe that, taken together, the effect of the package of civil justice reforms should be at least 'net neutral' for the Group in the medium term. However, there remains considerable uncertainty about the details and timing of the reforms. We will continue to prepare for a range of outcomes.

Home

Highlights

- Operating profit of £93.3 million, 16.6% lower than 2011 primarily due to adverse weather in 2012
- In-force policies broadly stable, reflecting competitive market conditions for new business
- Partnership extended with Sainsbury's Bank, signing an arm's length distribution agreement with RBS Group and renewal and extension of Nationwide Building Society partnership

Performance highlights

	2012	2011
In-force policies (thousands)	**4,239**	4,308
Gross written premium	**£989.0m**	£1,031.3m
Loss ratio	**58.4%**	57.4%
Commission ratio	**16.2%**	17.5%
Expense ratio	**22.0%**	20.2%
Combined operating ratio	**96.6%**	95.1%
Operating profit	**£93.3m**	£111.9m

Our brands

direct line

churchill

privilege

Partners

Sainsbury's Bank

Nationwide

PRUDENTIAL

NatWest

RBS Group

Market

The size of the UK home insurance market has been relatively stable in recent years with limited growth in the housing stock and competitive pressure through the growth of the PCW distribution channel. These constraints have remained in 2012, with little observed new business premium inflation from major market players. This competitive environment is expected to continue.

Performance

We continue to focus on improving our product options to meet customer needs and increase customer value. New product ranges were launched in 2012 for our Sainsbury's Bank and Nationwide Building Society partnerships.

During 2012, we implemented a new rating capability for Home. This allowed us to make a step change in our ability to set renewal prices more accurately and, at the end of 2012, resulted in a material improvement to our peril level risk pricing.

In addition, our new claims system and operating model, launched for Churchill in 2011, has been extended to our remaining own brands, with the roll-out plan for our partner brands continuing into 2013. In December 2012, we launched home insurance on comparethemarket.com, with our Churchill, Privilege and selected partner brands.

Total gross written premium was £989.0 million, 4.1% lower than 2011, with a COR of 96.6% and an operating profit of £93.3 million. Rainfall figures for 2012 were among the highest on record, with claims from weather events totalling £105 million, £25 million above the expected level for a normal year.

In-force polices reduced by 1.6% from 2011, due mainly to pressure on new business sales. This was partly offset by our ongoing retention initiatives as we continued to focus on a balanced approach of ensuring existing customers were retained, whilst investing in rating capability and insight to maintain our competitiveness in the market.

Outlook

The Home division continues to enhance its pricing and claims capabilities with a focus on deploying these in key customer segments. With a balanced distribution footprint, we believe the Home division is well positioned to maintain its position in a competitive market.

Rescue and other personal lines

Highlights

- Operating profit up 33.3% to £84.4 million
- Increase in in-force policies relating to growth in packaged bank accounts
- Increased Green Flag branded presence at roadside and new marketing campaign

Performance highlights

	2012	2011
In-force policies (thousands)	**9,431**	9,151
Gross written premium	**£389.8m**	£350.2m
Loss ratio	**50.9%**	44.4%
Commission ratio	**6.0%**	22.5%
Expense ratio	**25.8%**	19.4%
Combined operating ratio	**82.7%**	86.3%
Operating profit	**£84.4m**	£63.3m

Our brands

direct line

privilege

churchill

GreenFlag No Matter What

Partners

Sainsbury's Bank

Nationwide

NatWest

RBS Group

Market

The UK breakdown market is well established with three major providers; AA, RAC and Green Flag. The market has historically displayed strong returns, although the total market premium has been impacted in recent years by lower car ownership, due to the economic climate.

The pet and travel markets continue to be competitive, with the growth in PCWs acting to diversify distribution. Customer numbers are expected to remain broadly stable.

Performance

The division has delivered gross written premium of £389.8 million which is 11.3% higher than 2011. This was driven by the growth in travel partnership accounts and premium inflation in the pet market. In-force policies increased by 3.1% during 2012. Gross written premium for the rescue business reduced by 3.6% compared with 2011, with growth in the Green Flag direct business offset by lower linked sales as the Motor business de-risked.

Underwriting profit of £66.2 million was 23.1% higher than 2011, the increase being largely attributable to one-off releases and adjustments relating to the run-off of our creditor business. Overall operating profit increased by 33.3% compared with 2011.

A distribution agreement has been signed with RBS Group for the provision of rescue and travel insurance through packaged bank accounts, strengthening our partnership relationship as we separate from RBS Group. A new strategic service partner agreement with external recovery agents, embedded in 2012, has created an increased Green Flag branded presence at the roadside and we have launched a new marketing campaign for the brand.

Outlook

In 2013 we expect to enhance our customer propositions through refreshed marketing initiatives and improved distribution capabilities. The positive results in 2012 from the run-off of our creditor business are not expected to be repeated in 2013.

Commercial

"Thanks to a strong focus on pricing and disciplined underwriting we are back in profit. We have established a momentum over the last two years which gives us confidence in delivering our targets."

Jonathan Greenwood, Managing Director of Commercial

Highlights

- Return to operating profit in 2012
- Significant improvement in COR to 108.2%
- Action taken to improve expense ratio
- Roll-out of eTrading platform commenced

Performance highlights

	2012	2011
In-force policies (thousands)	**466**	422
Gross written premium	**£435.6m**	£438.6m
Loss ratio	**63.1%**	65.4%
Commission ratio	**21.6%**	21.0%
Expense ratio	**23.5%**	25.9%
Combined operating ratio	**108.2%**	112.3%
Operating profit / (loss)	**£2.2m**	(£12.4m)

Our brands

direct line for business

NIG

Partners

NatWest

RBS Group

Market

This year was another challenging year for the UK commercial market as overall premium rates remained under pressure. Motor experienced increasing rates in response to bodily injury claims, whereas liability rates struggled to keep up with underlying claims inflation. This, together with depressed investment returns, has been countered by a number of cost reduction initiatives across the market.

Performance

Gross written premium of £435.6 million was broadly unchanged as growth in DL4B was offset by the exit of unprofitable business. The loss ratio improved by 2.3 percentage points reflecting improvements in underlying business, particularly from the motor account, and continued releases from prior year reserves. This was despite a number of larger than normal fire claims in the first half of 2012, as well as weather events. The expense ratio improved by 2.4 percentage points reflecting improved cost management.

Outlook

We have set a target to deliver a COR below 100% in 2014 and expect to make progress towards this target in 2013. Through 2013 we aim to rationalise our regional and head office operating model, to complete the roll-out of the new Commercial eTrading platform in the broker channel and to continue the development of our brands.

International

"The International business has continued to strengthen its position in the two markets in which we operate. We have delivered a substantial increase in profits, contributing to the improvement in the Group result."

Jamie Brown, Managing Director of International

Highlights

- Significant improvement in operating profit to £19.5 million
- 3.9% increase in gross written premium in local currency terms
- 5.4% increase of in-force policies to around 1.5 million

Performance highlights

	2012	2011
In-force policies (thousands)	**1,462**	1,387
Gross written premium	**£552.7m**	£570.0m
Loss ratio	**78.1%**	81.4%
Commission ratio	**12.1%**	7.9%
Expense ratio	**13.1%**	18.3%
Combined operating ratio	**103.3%**	107.6%
Operating profit	**£19.5m**	£4.3m

Our brands

direct line
L'ASSICURAZIONE A PORTATA DI MOUSE

direct line
Versichern kann so einfach sein.

Market

In Italy the economic environment deteriorated further in 2012 with depressed GDP growth. The downturn put pressure on the insurance market which contracted by 1%. The pricing cycle remained positive with market rates increasing by 2.5%. However, there was a decrease in the number of insured vehicles of 1.5% year on year. Despite adverse conditions the direct market increased by 10% in comparison with 2011.

In Germany, economic growth slowed in the second half of the year but remains largely positive compared with the rest of Europe. The motor insurance industry reached €22 billion gross written premium with growth of 5.1% above 2011 levels mainly driven by a positive pricing cycle.

Performance

Despite a challenging year within the Eurozone, our International business performed strongly in 2012.

Both the Italian and German businesses have generated strong profits in 2012, making operating profits of £14.0 million and £5.5 million respectively.

In-force policies increased by 5.4% to around 1.5 million and gross written premium increased 3.9% in local currency terms. Due to adverse exchange rates, reported gross written premium reduced by 3.0% to £552.7 million compared with 2011.

The COR improved from 107.6% to 103.3% as the business focused on operating efficiencies following strong growth in 2011.

Outlook

The outlook for Direct Line Italy is mixed. The Italian economy continues to experience lower new car sales and the volume of cars in Italy is expected to shrink in 2013. Offsetting this, fewer miles driven is resulting in lower claims frequency. The Italian government has announced a number of initiatives to liberalise the market and although these have yet to be finalised we consider this may provide an opportunity for Direct Line Italy.

The German environment has remained positive for direct market growth and has seen premium rates increase in 2012 and a benign economic backdrop. Direct Line Germany experienced strong growth in year end business which we expect will help it build further scale in 2013.

Improving efficiencies

We continue to experience improvements in our financial performance, despite a backdrop of a competitive market and subdued investment returns. Our balance sheet remains strong and we have taken actions to improve its efficiency

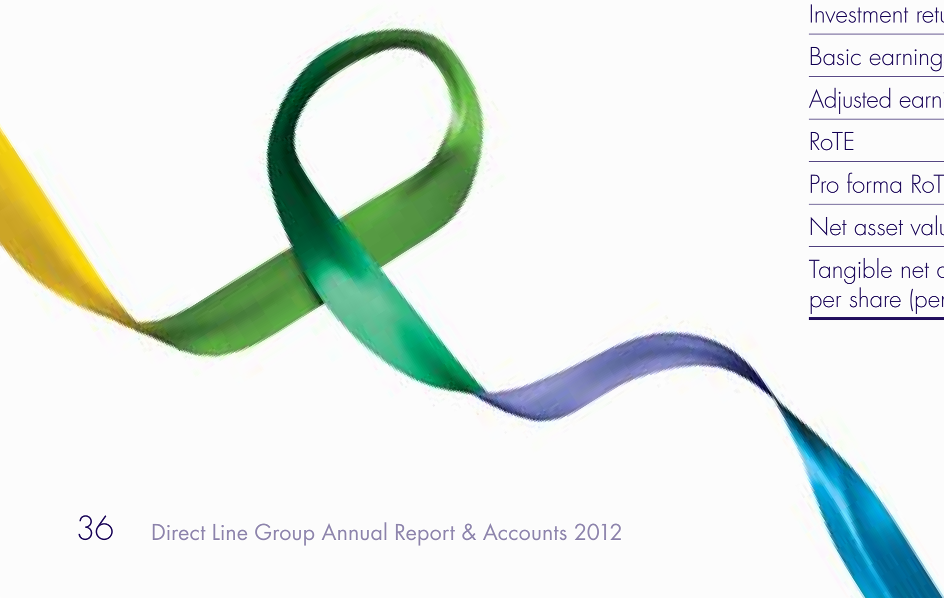
John Reizenstein, Chief Financial Officer

Highlights

- Operating profit from ongoing operations of £461.2 million up 9.3%
- COR for ongoing operations of 99.2%
- RoTE of 11.5% and pro forma RoTE of 13.4%
- Final dividend proposed of 8 pence per share

For the year ended 31 December	**2012 £m**	2011 £m
In-force policies (thousands)	**19,648**	19,375
Gross written premium – ongoing operations	**3,990.6**	4,124.9
Net earned premium – ongoing operations	**3,708.7**	3,890.9
Underwriting profit / (loss)	**28.2**	(72.3)
Instalment and other operating income	**198.3**	255.5
Investment return	**234.7**	238.7
Operating profit – ongoing operations	**461.2**	**421.9**
Run-off	**6.1**	(23.9)
Restructuring and other one-off costs	**(189.5)**	(54.0)
Operating profit	**277.8**	**344.0**
Finance costs and other	**(28.7)**	(1.1)
Profit before tax	**249.1**	**342.9**
Tax	**(64.8)**	(93.9)
Profit after tax	**184.3**	**249.0**
Of which ongoing operations	**326.5**	308.1

Key metrics		
Loss ratio	**67.1%**	70.2%
Commission ratio	**9.1%**	10.1%
Expense ratio	**23.0%**	21.5%
Combined operating ratio	**99.2%**	101.8%
Investment income yield	**2.0%**	2.3%
Investment return	**2.8%**	2.6%
Basic earnings per share (pence)	**12.3**	16.6
Adjusted earnings per share (pence)	**21.8**	20.5
RoTE	**11.5%**	10.0%
Pro forma RoTE	**13.4%**	n/a
Net asset value per share (pence)	**189.1**	240.9
Tangible net asset value per share (pence)	**161.0**	216.5



"In 2012 we demonstrated good earnings momentum coupled with active capital management. We aim to continue to focus on producing strong, sustainable returns for shareholders."

John Reizenstein, Chief Financial Officer

Income statement

Operating profit – ongoing operations

For the year ended 31 December	2012 £m	2011 £m
Underwriting profit / (loss)	**28.2**	(72.3)
Instalment and other operating income	**198.3**	255.5
Investment return	**234.7**	238.7
Operating profit	**461.2**	**421.9**

Overall operating profit from ongoing operations of £461.2 million was a 9.3% increase on 2011 (2011: £421.9 million). A significant improvement in the underwriting result, primarily relating to pricing actions, improvements to risk mix and the Group's claims transformation plan more than offset lower instalment and other operating income. Investment return was broadly in line with 2011 and was supported by higher realised investment gains.

In-force policies and gross written premium

In-force policies (thousands)

As at 31 December	2012	2011
Motor	**4,050**	4,107
Home	**4,239**	4,308
Rescue and other personal lines	**9,431**	9,151
Commercial	**466**	422
International	**1,462**	1,387
Total	**19,648**	**19,375**

In-force policies for ongoing operations increased by 1.4% during 2012 to 19.6 million. The increase related primarily to Rescue and other personal lines and arose mainly from travel policies from packaged bank accounts. Motor and Home in-force policies were broadly stable during the period.

Commercial continued to grow in-force policies through DL4B which focuses on SME and micro businesses. After a period of strong growth in 2011, International's growth rate slowed to 5.4% with growth coming from both the Italian and German operations.

Gross written premium

For the year ended 31 December	2012 £m	2011 £m
Motor	**1,623.5**	1,734.8
Home	**989.0**	1,031.3
Rescue and other personal lines	**389.8**	350.2
Commercial	**435.6**	438.6
International	**552.7**	570.0
Total	**3,990.6**	**4,124.9**

Gross written premiums of £3,990.6 million fell 3.3% compared with the prior year (2011: £4,124.9 million). This was predominantly driven by Motor, due to the full-year effect of de-risking the portfolio in 2011 and a continued focus on disciplined underwriting. Home gross written premium fell 4.1% compared with 2011, due primarily to increased competition for new business volumes.

Gross written premium for Commercial was broadly flat, reflecting the growth of lower average premium business through DL4B, partially offset by the exit of a number of unprofitable schemes.

International gross written premium of £552.7 million was 3.0% lower than the previous year (2011: £570.0 million) as a result of adverse exchange rate movements during 2012. Gross written premium in local currency terms increased by 3.9%, broadly in line with the increase in in-force policies.

Underwriting profit

The Group's COR improved by 2.6 percentage points to 99.2% (2011: 101.8%), resulting in an increase in underwriting profit to £28.2 million (2011: loss of £72.3 million). This was primarily the result of a 3.1 percentage points improvement in the loss ratio, reflecting actions taken to improve risk selection and the implementation of the claims transformation programme. In addition, a lower commission ratio reflected the non-repeat of a payment made to RBS Group in 2011 under a historic profit share arrangement. Offsetting these improvements was a modest increase in the expense ratio as a result of lower net earned premium and a number of one-off items. These included an increase in the final recharge from RBS Group in the first half of the year and parallel running costs reflecting the build out of corporate functions prior to separation from RBS Group on 1 July 2012.

The improvement in the loss ratio was despite the wettest year in England and the second wettest in the UK since records began and a number of larger than normal fire claims in Commercial in the first half of 2012. Claims relating to weather events in Home totalled to £105 million (2011: £20 million) and were £25 million more than would be expected in a normal year.

Current-year attritional loss ratio

For the year ended 31 December	2012	2011
Reported loss ratio	**67.1%**	70.2%
Prior year reserve releases	**8.7%**	4.9%
Weather events – Home	**(2.8%)**	(0.5%)
Current-year attritional loss ratio	**73.0%**	**74.6%**

The Group views the current-year attritional loss ratio as a good indicator of underlying performance as it excludes prior-year reserve movements and claims from weather events in the Home division.

Overall, the current-year attritional loss ratio improved by 1.6 percentage points in 2012 reflecting progress made in improving the underlying performance of the Group.

Combined operating ratio

	Reported basis		Current year basis	
For the year ended 31 December	2012	2011	2012	2011
Motor	**101.6%**	105.6%	**112.3%**	113.4%
Home	**96.6%**	95.1%	**100.5%**	90.1%
Rescue and other personal lines	**82.7%**	86.3%	**88.9%**	99.8%
Commercial	**108.2%**	112.3%	**122.2%**	122.1%
International	**103.3%**	107.6%	**112.1%**	109.8%
Total	**99.2%**	**101.8%**	**107.9%**	**106.7%**

On a segmental basis, the COR improved in all divisions compared with 2011, with the exception of Home, which was impacted by worse than average claims from weather events.

In Motor, the 4.0 percentage points improvement in COR reflects management actions to improve the risk profile of the book as well as higher releases of reserves from prior years. These releases were driven by favourable bodily injury experience for recent accident years partly attributable to improved pricing, better risk selection and benefits arising from the Group's claims transformation programme. Following these actions, inflation rates for small bodily injury claims continue to be favourable relative to actuarial expectations.

The Home COR of 96.6% was 1.5 percentage points higher than full year 2011 as a result of a number of offsetting items. Overall, the Home loss ratio was stable with higher weather related claims being offset by reserve releases from prior years. The attritional current-year loss ratio was broadly in line with 2011. The expense ratio was higher reflecting the trends seen at the Group level.

The Rescue and other personal lines COR improved by 3.6 percentage points compared to 2011, driven by a reduction in the commission ratio following the non-repeat of a profit commission payment in 2011. The 2012 result continued to benefit from prior-year reserve releases related to the run-off of the legacy creditor book. Future results of the division are not expected to benefit from similar reserve releases.

The Commercial COR improved by 4.1 percentage points to 108.2% for 2012. This was driven by a reduction in the expense ratio together with loss ratio improvements. The improvements in loss ratio reflect underwriting actions taken to improve attritional performance as well as the continued release of prior-year reserves. This was partially offset by a number of larger than normal fire claims in the first half of 2012.

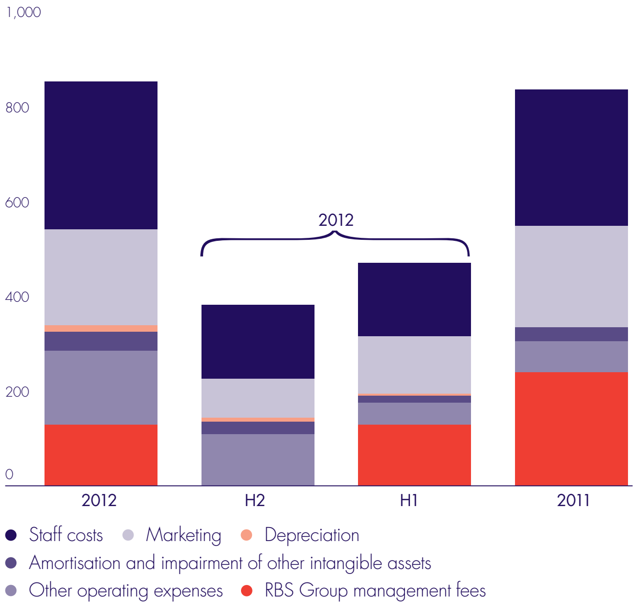
International's COR improved by 4.3 percentage points compared with 2011 as a result of an improved loss ratio reflecting reserve releases from prior years, particularly in respect of large bodily injury claims in Italy. An improved expense ratio, partly reflecting higher reinsurance commissions received in 2012, was offset by a higher commission ratio attributable to a change in mix towards PCW and partnership business.

Prior-year reserve releases / (additions)

For the year ended 31 December	2012 £m	2011 £m
Motor	**174.3**	138.2
Home	**37.4**	(48.5)
Rescue and other personal lines	**23.9**	52.8
Commercial	**56.2**	38.4
International	**30.2**	7.9
Total	**322.0**	**188.8**

Prior-year reserve releases increased to £322.0 million (2011: £188.8 million) equivalent to 8.7% of net earned premium (2011: 4.9% of net earned premium).

Ongoing operating expenses (£m)



The expense ratio increased by 1.5 percentage points to 23.0% due to lower net earned premium and a modest increase in operating expenses.

Ongoing operating expenses rose by £17.2 million from the prior year (2011: £837.6 million), with the increase principally driven by a number of one-off items including an increase in the final recharge from RBS Group in the first half of 2012 and parallel running costs reflecting the establishment of corporate functions prior to separation from RBS Group on 1 July 2012.

From 1 July 2012 the Group no longer paid a recharge to RBS Group and this was replaced by directly paying third-party suppliers for the majority of services previously provided by RBS Group. Consequently, expenses previously reported under management fees are now reflected within their relevant line items. The Group continues to pay RBS Group for transitional IT infrastructure, the costs of which are included within other operating expenses.

Staff costs and other operating expenses increased in 2012 as a direct result of separation from RBS Group, whereas RBS Group management fees fell by 46.2%, all of which were incurred in the first half of 2012.

Operating expenses including claims handling costs increased by 1.0% to £1,145.1 million. The Group is targeting gross annual savings of £100 million in costs and claims handling expenses in 2014 relative to the level in 2011 (2011: £1,134.0 million). Plans relating to 70% of the target have been announced, with advanced plans in place for the remainder of the savings. Savings associated with this plan are expected to begin to be recognised in 2013.

Instalment and other operating income

Ongoing operations

For the year ended 31 December	**2012 £m**	2011 £m
Instalment income	**125.4**	138.5
Other operating income	**72.9**	117.0
Instalment and other operating income – ongoing	**198.3**	255.5
TPF tariff income (non-repeatable)	**–**	(21.9)
Underlying instalment and other operating income	**198.3**	233.6

Instalment and other operating income from ongoing operations reduced by 22.4% primarily as a result of the cessation of fee income in Motor relating to managing certain elements of the run-off of Tesco Personal Finance ("TPF") business. All policies relating to TPF have now expired and this income will not be repeated. On an underlying basis instalment and other operating income fell 15.1%.

Instalment income of £125.4 million reduced by £13.1 million compared to the prior year (2011: £138.5 million) as a result of lower average in-force policies during 2012 and changes to risk mix from previous years. Penetration rates for instalment income remain good.

Breakdown of underlying other operating income – ongoing

For the year ended 31 December	**2012 £m**	2011 £m
Solicitors' referral fee income	**21.1**	27.9
Vehicle replacement referral income	**17.2**	21.9
Revenue from vehicle recovery and repair services	**25.9**	39.3
Fee income from insurance intermediary services	**1.9**	3.4
Other income	**6.8**	2.6
Underlying other income	**72.9**	95.1
TPF tariff income (non-repeatable)	**–**	21.9
Other operating income	**72.9**	117.0

Reductions in solicitors' referral fee income and vehicle replacement referral income primarily reflect a reduction in non-fault claims volumes. This is due to reduced accident frequency, which has also benefited claims costs over the period. The reduction in revenue from vehicle recovery and repair services has resulted from fewer repairs relating to third-party claims and lower revenues at the tracker recovery business.

Investment return

Total investment return was £281.8 million, in line with 2011 as an increase in realised gains and reduction in impairments offset lower investment income. For ongoing operations, investment return was £234.7 million, 1.7% lower than 2011.

During 2012, total funds under management decreased by 13.8% to £9.4 billion. Key reasons for the reduction include the payment of dividends and repayment of intra-group loans totalling £1,235.2 million to RBS Group and the acquisition of Direct Line Germany from RBS Deutschland for £120 million. This was partially offset by the issuance of £500 million of long-term subordinated debt.

Investment return

For the year ended 31 December	Total Group 2012 £m	Total Group 2011 £m	Ongoing operations 2012 £m	Ongoing operations 2011 £m
Investment income	199.3	243.6	**179.9**	210.9
Net realised and unrealised gains	82.5	38.3	**54.8**	27.8
Total investment return	**281.8**	**281.9**	**234.7**	**238.7**

Investment income was £199.3 million, an 18.2% decrease on 2011, mainly as a result of the decrease in assets under management, low reinvestment yields in the UK and higher cash holdings during the year. Elevated cash holdings during the year arose from extensive portfolio restructuring and the need to hold cash in advance of the capital management activities.

Net realised and unrealised gains recognised in 2012 were £82.5 million compared with £38.3 million in 2011.

Investment yields – total Group

For the year ended 31 December	2012	2011
Investment income	**2.0%**	2.3%
Investment return	**2.8%**	2.6%

The investment income yield on the total portfolio for 2012 was 2.0%, a decrease from the 2.3% earned in 2011. The investment return was 2.8% compared with 2.6% in 2011.

Income on invested assets

For the year ended 31 December	2012 Asset allocation	2012 Income	2011 Asset allocation	2011 Income
Corporate bonds	**48.4%**	**2.8%**	41.5%	3.2%
Government bonds	**28.2%**	**1.6%**	32.1%	2.0%
Cash and cash equivalents	**22.0%**	**0.8%**	25.8%	0.7%
Investment property	**1.4%**	**4.4%**	0.6%	8.6%
Total	**100.0%**	**2.0%**	**100.0%**	**2.3%**

Reinvestment rates on corporate bonds remain low with current reinvestment yields of 1.6%. Taken with current yields on cash and government bonds and expected yields on property, the blended reinvestment rate at the target asset mix is 1.6%. This does not take into account the effect of forward yields or a number of management actions which are expected to augment returns.

Run-off

The Run-off segment, which includes the exited personal lines broker and TPF businesses, made a profit of £6.1 million in 2012 compared with a loss of £23.9 million in 2011. Reserve releases for 2012 were £67.5 million, the majority of which were due to TPF.

The Group agreed with TPF the level of final reserves to be retained by the Group in respect of the run-off of remaining claims under TPF policies and finalised certain other matters arising out of the expiry of the distribution arrangements. Following determination of the reserves, the risks and rewards of the run-off for this line of business were transferred to the Group and subsequently, the £258.5 million loan was repaid to TPF on 8 January 2013.

Restructuring and other one-off costs

Restructuring and other one-off costs rose to £189.5 million in 2012, up from £54.0 million in 2011. Costs associated with the Group's separation and divestment from RBS Group were £148.9 million, with the remainder relating mainly to the Group's cost savings programme.

Restructuring and other one-off costs for 2013 are estimated to be approximately £140 million. Approximately £70 million relates to one-off costs associated with the cost savings programme and a further £70 million relates to IT migration. The total one-off cost of IT migration continues to be estimated at around £100 million, with the remaining £30 million expected to be incurred in 2014.

Finance costs

Finance costs increased to £28.7 million (2011: £2.7 million), primarily reflecting interest on the £500 million of long-term subordinated debt issued in April 2012.

Taxation

The effective tax rate for 2012 was 26.0% (2011: 27.4%) and benefited from lower UK corporate tax rates. The effective tax rate was 1.5 percentage points higher than the UK standard tax rate due to higher earnings from the International operations, which have a higher corporation tax rate, and higher levels of disallowable expense, in part relating to separation and divestment. This was partially offset by a credit in International for prior periods.

The Group's direct and indirect contribution to the Exchequer is significantly higher than the UK corporation tax that the Group pays on its profits. During 2012, the sum of taxes either paid or collected was in excess of £650 million. This included insurance premium tax, income tax and national insurance but excluded irrecoverable VAT.

Profit for the year and return on tangible equity

Profit for the year amounted to £184.3 million (2011: £249.0 million).

RoTE increased to 11.5% (2011: 10.0%) as a result of both the improved operating result from ongoing operations and the capital actions taken to improve the efficiency of the Group's capital position. Had the £1 billion dividend to RBS Group and issue of £500 million long-term subordinated debt taken place prior to the start of the year, the RoTE, on a pro forma basis, would increase to 13.4%.

Earnings per share

Basic and diluted earnings per share of 12.3 pence fell 25.9% compared with 2011, reflecting the increase in restructuring and other one-off costs which more than offset the increase in operating profit from ongoing operations.

Adjusted basic and diluted earnings per share, which excludes Run-off and restructuring and other one-off costs, increased by 6.3% to 21.8 pence.

Dividends

Prior to the IPO in October 2012, £1 billion of dividends were paid to RBS Group. These dividends formed part of the actions taken to improve the capital efficiency of the Group.

A final dividend of 8 pence per share (2011: nil) has been proposed. On the basis that the final dividend represents two thirds of the total annual distribution, the full-year pro forma dividend of 12 pence per share would represent a payout ratio of 55% of earnings from ongoing operations, in line with the policy set out at the time of the IPO. From 2013, the Group aims to raise the dividend annually in real terms.

Cash flow

Net cash from operating activities before investment of insurance assets was an outflow of £966.0 million in 2012 principally due to cash used by operations of £731.4 million, reflecting higher payments of current and prior-year claims relative to declining premium income, and significant payments relating to restructuring and separation in the first half of the year. Tax of £232.4 million was also paid. Net cash from operating activities before investment of insurance assets was an outflow of £359.8 million in 2011, principally due to cash used by operations of £378.0 million, reflecting higher payments of current and prior-year claims relative to declining premium income. Net cash released from investment of insurance assets was £2,004.8 million in 2012 and £38.8 million in 2011. The increase in 2012 reflects a net liquidation of investments in available-for-sale financial assets and a net decrease in investment balances held with credit institutions in 2012 relative to a net increase in 2011.

Cash flows from investing activities were an outflow of £154.2 million in 2012, comprising £63.7 million for the purchase of property, plant and equipment, £96.6 million of investment in software development costs and £6.1 million cash inflow relating to net investment hedges of foreign subsidiaries. Cash flows from investing activities were a cash outflow of £126.2 million in 2011 due largely to investment in software development costs of £119.8 million.

During 2012, the Group paid dividends totalling £1 billion to RBS Group, repaid loans to RBS Group of £246.4 million and received net proceeds of £493.0 million from the issue of long-term subordinated debt. Finance costs in relation to this debt resulted in cash outflows of £16.1 million. Altogether, the net outflows from financing activities during the period amounted to £774.5 million.

Balance sheet and financial management

Net asset value

The net asset value at 31 December 2012 was £2,831.6 million (31 December 2011: £3,612.8 million) with tangible net asset value of £2,410.1 million (31 December 2011: £3,247.0 million). This equates to 189.1 pence and 161.0 pence per share respectively as at 31 December 2012 (31 December 2011: 240.9 pence and 216.5 pence, respectively).

The reduction in net asset value and tangible net asset value primarily relates to the £1 billion of dividends paid to RBS Group during 2012. Adding back these dividends, net asset value per share rose by 6.3% in 2012 and tangible net asset value per share rose by 5.2% in 2012.

Reserving

Estimation of claims reserves is a central aspect of financial management. Insurance is inherently uncertain requiring the use of judgement in estimating the ultimate claims liability. The factors that must be considered when assessing the level of outstanding liabilities include class of business, timeliness of notification of claims, validity of claims made against a policy and validity of the amount of the claim. At any time there is a range of possible outcomes at which the claims reserves could ultimately settle and as time passes the uncertainty surrounding likely claims settlement reduces. The uncertainty is greater for bodily injury claims due to time it takes for these claims to settle. This is particularly true for PPOs awarded to settle some bodily injury claims, in which annually indexed payments could be awarded over the lifetime of the injured party.

Given this uncertainty, the Group adopts a prudent approach to the assessment of liabilities. This prudent approach is supported by historical claims reserve releases. These can be observed in the gross and net ultimate claims cost development triangles shown on pages 147 and 148. The triangles demonstrate that, for all accident years, the estimated ultimate claims cost has reduced over time. Reductions in ultimate claims cost have fluctuated over the period with the years from 2003 to 2006 and 2010 showing the largest decreases. The 2009 accident year has shown the lowest reduction following a significant increase in claims relating to motor over the 2009 and 2010 financial years in response to the market-wide adverse development in bodily injury claims. This resulted in part from the rise of claims management companies, an increase in no-win no-fee litigation, and an increase in PPOs.

Actuarial reviews are carried out quarterly with over 95% of all claims reserves being reviewed at least annually. Actuarial best estimates are produced internally, and are subject to independent external review at least annually. Reserves are based on management's best estimate set by the Group, which will be at least equal to the actuarial best estimate at a legal entity level. The Group will set reserves informed by a range of actuarial outputs including percentiles and scenarios. It will consider the level of historic variability inherent in the claims data and other short- and long-term risks not reflected in the actuarial data.

The Group's reserves are particularly susceptible to potential retrospective changes in legislation and new court decisions, for example, a change in the Ogden discount rate. This is the discount rate set by the relevant government bodies and used by courts to calculate lump sum awards in bodily injury cases. The rate is currently 2.5% per annum but is currently under review by the Ministry of Justice. From 2010, the Group has calculated its estimated reserve based on an assumed Ogden discount rate of 1.5% in recognition of the uncertainty regarding the future rate. Applying an Ogden discount rate of 2.5% would reduce the estimated reserves by £184.7 million as at 31 December 2012. Applying an Ogden discount rate of 0.5% would increase the estimated reserves by £259.3 million.

Most of the Group's technical reserves are held on an undiscounted basis and, therefore, do not allow for the investment income which will be earned on the technical reserves after the balance sheet date until the claims are fully settled. The one exception is the technical reserves held in respect of PPOs which are held on a discounted basis, in line with the ABI Statement of Recommended Practice ("SORP"), and where the Group assumes an investment return of 4.0% (2011: 4.5%). Claims for PPOs are also assumed to inflate at 4.0% (2011: 4.5%) per annum resulting in a real discount rate of 0.0% (2011: 0.0%).

As the Group has moved to operating on a stand-alone basis there have been substantial changes to the reserving practices and processes including:

- Increased focus on reporting to the Group and Audit Committee reflecting additional reserving governance
- Claims reserves are based on internal estimates, supported by independent external review

Claims reserves net of reinsurance

For the year ended 31 December	**2012 £m**	2011 £m
Motor	**3,026.6**	3,148.9
Home	**403.8**	375.8
Rescue and other personal lines	**77.1**	92.7
Commercial	**588.3**	605.3
International	**429.7**	439.9
Total – ongoing operations	**4,525.5**	4,662.6
Run-off	**856.4**	1,148.7
Total	**5,381.9**	5,811.3

Investment portfolio

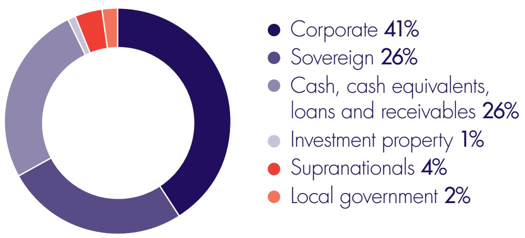
Our investment strategy is conservative and primarily comprises investments in sovereign bonds, investment grade fixed income securities and cash. The strategy is to ensure adequate liquidity, to appropriately match asset and liability durations (with specific focus on PPOs) and to diversify risk and maximise return relative to the Group's risk appetite.

During 2012, the key achievements included:

- Establishing an in-house investment capability to enable the Group to manage and oversee its investment holdings. The in-house team's responsibilities include managing cash, government bonds and 'AAA' credit portfolios for the UK business, with specialist external asset managers employed to manage other asset holdings
- Investing in US Dollar investment grade credit (hedged back to Pounds Sterling) to enable wider debt issuer diversification
- Building a UK commercial property portfolio to diversify returns and provide asset returns with a correlation to inflation
- Realigning investment holdings to new risk appetite statement
- Transferring the management of the International operations credit investment portfolios to an external asset manager

Investment portfolio as at 31 December 2012

Investment portfolio as at 31 December 2011



Derivatives are permitted for risk management purposes within the investment portfolio including interest rate swaps to align asset and liability durations and forward currency contracts to manage currency risk.

During 2012, the portion of investment portfolio backing the Run-off operations was converted to cash prior to settlement with TPF. Post final settlement, residual cash retained is being reinvested in line with asset benchmarks for the UK portfolio.

The total value of the investment portfolio at 31 December 2012 was £9.4 billion, 13.8% lower than at 31 December 2011. Assets under management remain liquid with 22.0% of the funds held in cash and cash equivalents at year end. This is a transitory position and it is planned that cash holdings will reduce significantly during it 2013.

Corporate, sovereign, local government and supranational debt securities account for 76.6% of the portfolio, of which 41% are rated as 'AAA' and a further 49% are rated as 'A' or 'AA'.

The average duration of total investment assets was 1.8 years, with the breakdown being UK 1.7 years, Italy 2.8 years and Germany 2.5 years (2011: average on total assets 2.2 years, UK 2.1 years, Italy 2.3 years and Germany 2.6 years).

Exposure to European economies such as Spain, Italy and Ireland is minimal, with these countries accounting for only 1.0% of the aggregate bond portfolio. There are no investment holdings in Portugal or Greece.

Investment property holdings shown as at 31 December 2011 comprised three properties which were sold to RBS in the first half of 2012. Investment property held at the end of 2012 has been purchased since August 2012 and relates to commercial premises.

Asset allocation and benchmarks

	UK			Germany			Italy		
	Current benchmark holding	2012 Year end	2011 Year end	Current benchmark holding	2012 Year end	2011 Year end	Current benchmark holding	2012 Year end	2011 Year end
Cash[1]	10%	23%	27%	10%	8%	8%	10%	7%	15%
Credit	60%	54%	44%	85%	67%	70%	90%	93%	85%
Sovereign	25%	21%	28%		8%	6%			
Investment property	5%	2%	1%						
Pfandbrief[2]				5%	17%	16%			
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%

Notes:

1. Awaiting investment into credit and property accounts.
2. Pfandbrief holdings in the German portfolio are overweight as a result of legacy holdings, which are in the process of being run down.

Investment holdings and yields

	2012		2011	
As at 31 December	**Asset allocation**	**Income**	Asset allocation	Income
Corporate bonds[3]	**4,528.6**	**125.2**	4,509.5	150.6
Government bonds[4]	**2,635.7**	**50.4**	3,481.2	66.0
Cash and cash equivalents	**2,062.5**	**19.3**	2,799.2	20.4
Investment property	**128.9**	**4.4**	69.5	6.6
Total	**9,355.7**	**199.3**	10,859.4	243.6
Corporate bonds	**48.4%**	**2.8%**	41.5%	3.2%
Government bonds	**28.2%**	**1.6%**	32.1%	2.0%
Cash and cash equivalents	**22.0%**	**0.8%**	25.8%	0.7%
Investment property	**1.4%**	**4.4%**	0.6%	8.6%
Total	**100.0%**	**2.0%**	100.0%	2.3%

Notes:

3. Asset allocation at 31 December 2012 includes investment portfolio derivatives, which have been netted and have a mark-to-market value of £7.8 million.
4. Government bonds include sovereign, supranational and local government bonds. Sovereign bonds account for 19.7% of the total investment holdings as at 31 December 2012 as per the following:
   – sovereign £1,843 million, supranational £521 million and local government £271 million as at 31 December 2012; and
   – sovereign £2,795 million, supranational £489 million and local government £198 million as at 31 December 2011.

Capital management

Capital management policy

The Group seeks to manage its capital efficiently and maintain an appropriate level of capitalisation and solvency in line with its risk appetite. The Group determines the appropriate level of capital on the basis of a number of criteria, including a risk-based capital requirement, holding a prudent capital buffer above regulatory requirements, and the objective of maintaining a credit rating in the 'A' range. The Group manages its subsidiaries to ensure that capital resources exceed regulatory minima.

Risk-based capital

The Group uses its own risk-based capital model, as part of its individual capital assessment ("**ICA**") for the UK general insurance underwriter, to determine how much capital is required to operate within its risk appetite and strategy. The Group has an overall target of holding capital resources in the range of 125% to 150% of the risk-based capital requirement.

The UK regulated entities carry out an assessment of the adequacy of their overall financial resources in accordance with the FSA's ICA methodology. This is based on an internal capital model, which is calibrated, as required by the FSA, to a 99.5% confidence interval over a one-year time horizon.

The International entities hold capital in excess of that required by their local regulators.

Capital management actions

In 2012, Direct Line Group paid three dividends totalling £1 billion to its parent company, RBS Group, as part of a number of capital actions aimed at creating a more efficient capital structure ahead of its IPO in October 2012.

On 27 April 2012 the Group issued £500 million of long-term Tier 2 subordinated debt. The increase in debt and financial leverage was partially offset by the repayment of long-term borrowings of £246.4 million to RBS Group in 2012. Undated loan capital of £258.5 million provided by TPF was repaid in January 2013.

Capital position

The Group presents its solvency information on a regulatory reporting basis. The Group is well capitalised with an estimated Insurance Group Directive ("**IGD**") coverage ratio of 279.4% (31 December 2011: 319.0%). The Group also has an estimated risk-based capital coverage ratio of 151.4% as at 31 December 2012 (31 December 2011: 169.5%).

As at 31 December	**2012**	2011
Consolidated statutory solvency capital		
Shareholders' equity	**2,831.6**	3,612.8
Goodwill and other intangible assets	**(421.5)**	(365.8)
Regulatory adjustments	**(73.5)**	(25.6)
Total Tier 1 capital	**2,336.6**	**3,221.4**
Upper Tier 2 capital[1]	**–**	258.5
Lower Tier 2 capital[2]	**495.5**	–
Regulatory adjustments	**(23.7)**	(37.2)
Total regulatory capital	**2,808.4**	**3,442.7**
Insurance Group Directive		
IGD required capital[3]	**1,005.0**	1,079.1
IGD excess solvency	**1,803.4**	2,363.6
IGD coverage ratio	**279.4%**	319.0%
Risk-based capital coverage ratio	**151.4%**	169.5%

Notes:

1. Includes the undated subordinated loan from TPF of £255 million and £3.5 million of solvency capital provided by TPF in relation to the TPF life insurance business, both of which the Group repaid in January 2013. As such, it has been excluded from Tier 2 capital as at 31 December 2012.
2. Includes that element of the subordinated dated notes applicable for regulatory capital purposes.
3. Based on the IGD for the Group and adjusted to include the capital requirement for Direct Line Versicherung AG acquired on 2 April 2012.

The above regulatory numbers are estimated, based on preliminary regulatory returns for 31 December 2012.

The table below sets out the Group's financial leverage ratio:

As at 31 December	2012	2011
Shareholders' equity	**2,831.6**	3,612.8
Undated subordinated loan[1]	**258.5**	258.5
Subordinated dated notes	**529.0**	–
Long term borrowings	**–**	246.4
Total financial debt	**787.5**	**504.9**
Total capital employed	**3,619.1**	**4,117.7**
Financial leverage ratio[2]	**21.8%**	12.3%

Notes:

1. Repaid in January 2013.
2. Total financial debt as a percentage of total capital employed.

Following the repayment of the undated subordinated loan, the financial leverage ratio on a pro forma basis, excluding the undated subordinated loan, as at 31 December 2012 would have been 15.7%.

Credit ratings

Standard & Poor's and Moody's Investors Service provide insurance financial strength ratings for U K Insurance Limited, the Group's UK general insurance underwriter. U K Insurance Limited is currently rated 'A' (strong) with a stable outlook by Standard & Poor's and 'A2' (good) with a stable outlook by Moody's.

Standard & Poor's and Moody's currently link the financial strength ratings of U K Insurance Limited to the overall rating of RBS Group. As a consequence, Standard & Poor's has indicated that, while RBS Group has a majority shareholding in Direct Line Group, its rating for U K Insurance Limited could be affected by future rating actions on RBS Group. Moody's has indicated that its rating for U K Insurance Limited could be negatively impacted by a material weakening of RBS Group's credit profile as reflected in any further downgrade in RBS Group's ratings or any delay to the completion of the divestment of Direct Line Group from RBS Group.

Solvency II

The FSA has extended its planning horizon to 31 December 2015 in response to delays in Solvency II legislation. The Group's Solvency II programme is being reshaped in the light of these delays and the application date for internal model approval revised. The Group's internal model produces Solvency II, enhanced ICA and economic capital numbers for the UK general insurance business. The Group's new risk management system has significantly improved and automated risk management activity and the Solvency II data warehouse implementation is progressing. As an interim measure, the FSA is expected to regulate the Group via an enhanced ICA regime until Solvency II is implemented in the UK.

Acting responsibly

One of the most exciting elements of building a new corporate brand is being able to take a fresh look at everything we do

"I feel passionately about Direct Line Group playing an important role in contributing to UK growth, jobs and taxes. Building a strong, successful and sustainable business is integral to achieving this.

"As a leading retail general insurer, our responsibility is not only to our customers, shareholders and staff, but also to the wider society.

"Our values are a first step in reflecting that responsibility and embedding sustainability into our business."

Jane Hanson, Chair of the Corporate Social Responsibility Committee

Four core elements

We have worked closely with Business in The Community ("**BITC**") and identified four core Corporate Social Responsibility ("**CSR**") elements: Employee Experience; Business Practices; Community; and Energy and Environment. Each has its own distinct strategy, developed with the help of our employees – volunteers from across the business who are passionate about doing the right thing.

Employee experience

Strategy

People matter. They do much more than their jobs; they help us achieve our vision to be the best.

We must recognise how far we have come and what we still need to change in order to be the best. Our focus is on evolving our strategy to provide a better employee and customer experience. We are using all information channels available, linking the analysis and interpreting the results to develop our people, their talents, create the right culture and build sustainable engagement.

Challenges and opportunities

As we continue with our transformation programme, it is vital that we continuously monitor our employee engagement levels and behaviours through various channels. We will focus on measures of their experiences before, during and after their time with us.

We seek to understand how best to enable a company culture that is collaborative, empowering, and innovative, so that our people are able to influence the customer experience positively and achieve superior customer and shareholder value.

The Group's diversity network aims to represent the multiple minority groups within our business and aspires to have a workforce reflective of the outside world and our customer base. The network has just been established and we hope to encourage up to 10% of our workforce to become members by the end of 2014.

Achievements in 2012

1) Involve and consult our people

To make the Group a great place to work, we know it is important to involve and consult our people on the design and delivery of all our major transformational initiatives. We do this through: our business-wide employee representative body ("ERB"), which ensures all employees have a voice; an in-house social media platform called 'Best-Quest', used by more than 30% of our employees to discuss improvement ideas and initiatives; and an intranet-based comment and feedback facility. This has proved to be a popular channel through which they are embracing our values. A key achievement of the programme was the distillation of the ideas received from employees to arrive at a set of values to govern the way the Group operates.

2) Invest in our leadership

We recognise it is critical to have a strong and diverse leadership team that recognises the technical, people and general business leadership skills required to achieve our vision. A new leadership group has been identified, which has collective accountability for and ownership of our strategy. We have introduced a new leadership programme in partnership with Ashridge Business School, and have worked with Henley Business School to identify emerging talent to become future senior managers. A new leadership competency framework has been designed to help our leaders become best in class.

3) Maintain people's engagement

Recognising the importance of people's engagement through organisational transformation, we have worked on proactively identifying where there are employee engagement issues across the organisation and put in place supporting activities to mitigate these, such as outplacement support, redeployment and career fairs. Benchmarking against the Towers Watson 2012 surveys, our engagement index shows that we have maintained employee engagement throughout our transformation journey to date at 73%, which is in line with industry norms.

This is reflected in the Global Transitional Companies Norm Group[1], which we outperform in 13 of 15 categories including:

- 14% higher for treating each other with respect
- 13% higher for innovation and empowerment
- 8% higher for customer focus
- 9% higher for strategic leadership

We exceed in the following key areas:

- 7% higher for people leadership
- 7% higher for managing change
- 4% higher for the extent to which our people feel the values have been embedded

In areas where we do not outperform, such as personal development, we are taking a number of initiatives. These include our new Leadership Framework, People Managers Transformation Programme and the new people development and succession planning processes.

Importantly, we know that our people leaders have faith in the future: 82% are optimistic about developments, and we are rated 7% higher than other financial services organisations for managing change.

Business practices

Strategy

Embedding CSR in our day-to-day business operations is critical if we are to build a sustainable business – one which our customers, shareholders and employees value and respect. Our strategy is to encourage and reward behaviour which makes the communities we impact safer places to be through product innovation, customer education and working with government and other bodies.

Note:

1. Data Source: Towers Watson; Employee Opinion Survey 2012.

Ideas from employees helped to arrive at a set of values to govern the way the Group operates.

Our aim is to create a culture of volunteering, giving all our employees one paid day off a year.

Challenges and opportunities

Making our communities safer, through reducing vehicle collisions and crime, aligns both insurance risk and our CSR thinking, helping us maintain operational effectiveness in the long term. Reducing the number of claims our customers experience not only provides us with commercial benefit, but more importantly reduces the distress and inconvenience our customers face when they are involved in a road traffic accident, or household incident, or when they are the victims of crime.

We are already involved in a number of important areas, for example: road safety through our sponsorship programmes with Brake; industry initiatives on uninsured drivers; and combating the increase in fraudulent claims. There is a clear opportunity for us to expand these programmes and deepen our support through product innovation and customer education.

Through our supplier network, we have a clear opportunity to develop best practice further. For example, through our 'Repair not Replace' programme, we are reducing our environmental impact.

Achievements in 2012

- We chaired an industry seminar called 'Steering Young Drivers in the Right Direction', which brought together the Government, the insurance industry and researchers to discuss how to reduce the number of collisions involving young drivers who have recently passed their test.
- We launched a range of severe weather guides to help our customers prepare their homes for bad weather and to minimise any damage caused.
- Our severe weather response vehicle (mobile office), helps us to reach more customers in areas that have been extremely badly affected. It is a local base where our customers and suppliers can come and speak to us.
- We established Health & Safety ("**H&S**") governance procedures including an H&S Executive Committee and elected representatives from across the business.

Direct Line Group is proud to be involved in educating young children about road safety.

Community

Strategy

We are committed to helping make communities safer – safer for our customers, safer for our people and safer for the areas in which we operate. To help do this, our aim is to create a culture of volunteering across our business, giving all our employees one paid day off a year to get actively involved with one of our new national charity partners or local community charities.

Our three main areas of focus are:

- Road safety education
- Helping out in a crisis
- The reduction of crime and anti-social behaviour in our communities

Our four national charity partners are:

- Brake
- RoadSafe
- The Prince's Trust
- Catch22

Road safety

We see it as a duty and an important issue to campaign to make our roads safer for all users. The Direct Line brand has fostered a nine-year working relationship with road safety charity **Brake**. An ongoing sponsorship of Brake's Parliamentarian of the Year Awards takes place every January to recognise MPs who campaign on road safety issues.

Education is key to making our roads safer. The Group has signed up to the European Road Safety Charter, an initiative that shares good practice to resolve road safety issues across the European Union. In Westminster, we sponsor policy debates by way of panel discussions on subjects such as the impact of uninsured drivers, how to reduce the risk to young drivers and combating fraud. Our new public policy focus is on helping young drivers through improved education and technology. Beep-Beep Days are sponsored in schools across the UK, teaching children the rules of the road in a fun way.

We have further strengthened our relationship with Brake by making it a national charity partner. Under this arrangement, all our employees now have the opportunity to become involved in educating young children.

RoadSafe has also been chosen as one of our national charity partners. Its mission is to reduce road deaths and injuries through a variety of road safety initiatives. In collaboration with local police and road safety managers, our employees have the opportunity to become involved in local Community Speedwatch campaigns, monitoring the speed of vehicles in areas of concern to the public. This is the first of a number of RoadSafe initiatives we are planning.

Helping out in a crisis

We are there to help people in their time of need, whether that be when their home has been flooded or when they are involved in a car crash. Our customer service teams are trained to deal with the worst cases and our technical teams and loss adjustors are deployed all over the country to help our customers recover. Our aim is to get people's lives back on track as easily as possible. When major events affect our communities, we aim to deploy our people to help and advise in these communities, not just our insured customers. We have also built a specialist mobile office that helps us base ourselves right in the heart of communities that are in crisis.

The reduction of crime and anti-social behaviour in our communities

We are building a programme to enable us to interact more closely with our communities and to use our knowledge, people and presence to draw attention to crime and anti-social behaviour and the impact this has on our communities. Our aim is to make our communities safer by raising awareness of the issues amongst employees and the wider community, and to work with relevant community partners to help prevent people slipping into crime and anti-social behaviour.

We have chosen to partner with:

The Prince's Trust – this charity specialises in helping disadvantaged young people. In collaboration with The Prince's Trust, we ran a 'Get into car repairs' pilot at our Wakefield accident repair centre. Over a four-week period, 15 disadvantaged young people received technical car repair training, work readiness skills – including CV writing and interview experience – and soft skills such as communication and team building. A number of people from our Leeds sites volunteered as mentors, offering ongoing support to the participants. Following its success, we aim to assess the feasibility of how we develop the programme further.

Catch22 – this organisation is a forward-looking social business with many years' experience of providing services that give young people an alternative to getting into trouble, crime and anti-social behaviour. Through the Catch22 Community Space Challenge project, our employees volunteer to work alongside local young people to transform neglected public spaces.

Supporting our employees in charitable giving

We also support our employees in their charitable giving through our payroll giving scheme, matching their monthly contributions by up to £50 per person per month. Our Community Cashback scheme gives employees the opportunity to apply for an annual award of £250 for their charitable endeavours. We also recognise the great things that our employees do to support local communities, both within and outside work, through our Chief Executive Awards scheme.

Challenges and opportunities

There are many ways in which we get involved in programmes, sponsorships and volunteering with a number of organisations that work in and for the community. If we spread this activity too wide, we will dilute our impact. To counter this challenge we chose to partner with four charities whose activities are aligned with our commitment to make communities safer.

Achievements in 2012

- Through our Community Cashback scheme our employees were able to donate an additional £48,000 to the charities in which they are involved or are close to their heart.
- Through our payroll giving scheme, by matching employee donations we were able to contribute £112,000 to the charities that matter to our people.
- Through utilising our call centre network we were able to support Children in Need and Comic Relief, with over 900 employees taking pledge telephone calls.

In collaboration with The Prince's Trust, we're helping disadvantaged young people get back into the workplace.

Our specialist mobile office helps us base ourselves right in the heart of communities that are in crisis.

Energy and environment

Strategy

We intend that our operations will be managed sustainably and with environmental considerations at the heart of the way we run the business. We will manage our operational impact and aim to reduce our carbon footprint.

We have defined our ambitions as follows:

- Buildings – the high profile of our portfolio provides a very visible opportunity to demonstrate our practical commitment to CSR. We aim to encourage recycling and biodiversity to consume less energy, water and to produce less waste.
- Business – we aim to reduce the impact of our travel, both to the office and to business meetings; to promote flexible working arrangements; to consume less energy and paper; and to use existing assets more efficiently.
- People – we aim to connect people in ways that benefit the environment, from car pools to volunteer groups.

We aim to achieve all this by:

- Creating and maintaining healthy workplaces by physical upgrade; maintaining suitable environmental conditions; targeting and reducing high energy usage by improving plant efficiency; introducing new technologies; and encouraging change from our employees.
- Introducing a range of agile working practices and technological improvements to enhance flexibility, minimise travel, and reduce printing, accommodation and resource impacts.
- Undertaking water and waste audits; seeking to minimise waste at source and disposal to landfill and to maximise re-use, recycling and energy from waste. We will look to minimise water use and recycle where appropriate.
- Encouraging reduction in car travel through improved travel planning, facilities and agile working practices, and by promoting car sharing and cycling to work.

We aim to monitor performance metrics across the business and by site, and track our progress in each of these areas. We also aim to submit to external regulation as required, and expect to operate in compliance with Energy, Environmental and Pollution Prevention Regulations.

Challenges and opportunities

Climate change is a very real commercial risk to our business. The landmark climate change risk assessment study by the Department for Environment, Food and Rural Affairs in January 2012 cited flooding as one of the key risks faced by Britain and estimated that flood risks to buildings and infrastructure were anticipated to rise to between £2 billion and £12 billion by the 2080s. As a leading home insurer, we are in discussion with the Government on how to address these future risks, as well as sharing our data and insight.

A key challenge for our environment strategy is to obtain all relevant information to gain a clearer view of our current impacts and position, and enable us to monitor our CSR KPIs, as a business and by site.

In 2007, we were one of the founding members of ClimateWise, an industry-wide membership group, which works with the University of Cambridge to analyse the effects of climate change and how the industry can combat them.

Achievements in 2012

- 100% renewable rate on contracted electricity sourced for our UK offices and our default office paper has 100% recycled content.
- We have improved our paper sourcing and for marketing and customer documents we use Forest Stewardship Council certified, vegetable and water-based inks with the ability to track from source. We are also actively working on reducing the volume of paper mailed and archived through electronic and alternative delivery channels.
- We were one of the first insurers to provide insurance for electric vehicles and have committed to supporting the move towards more sustainable vehicles.
- We recycled 76% of the waste generated by our Accident Repair Centres, saving 1,517 tonnes of CO_2.

Committed to high standards in governance

Our pursuit of strong governance is based on the conviction that it is good for our business

Mike Biggs, Chairman

Dear shareholders and other stakeholders
I am pleased to be writing this report at an exciting time for Direct Line Group. We became a listed company on 16 October 2012, a point which represents a significant milestone in the development of our business.

More than 27 years after the Group was originally launched in partnership with RBS Group in 1985, subsequently becoming a wholly-owned subsidiary in 1988, we achieved substantial operational separation last summer.

A year of transformation

Significant changes and events affecting the Group during 2012 and until the date of this report.

2012

14 Feb: The new Direct Line Group corporate identity was launched.

27 March: The Company declared and paid an interim dividend of £300m to RBS Group.

25 April: £500m Fixed/Floating Rate Guaranteed Subordinated Notes due 2042 issued by the Company with the Notes being guaranteed by U K Insurance Limited.

27 April: The Company announced that Mike Biggs had been appointed as Chairman and that Bruce Van Saun, Group Finance Director of RBS Group, had been appointed as a Non-Executive Director.

28 May: The Company declared an interim dividend in an aggregate amount of £500m to be paid on 6 June 2012 to RBS Group.

1 July: Operationally separate from RBS Group.

3 August: The Group announced a cost reduction plan targeting gross annual cost savings of £100m in 2014.

The scale of organisational change in the business during 2012 was also significant. In addition to the separation from RBS Group, Direct Line Group continued a process of business transformation at the same time as executing the IPO which has allowed us to become a listed company.

Leadership

As a Board we are focused on strong governance. This first Annual Report & Accounts as a listed company allows us to set out the steps we have taken to deliver against our stated objective of achieving good practice governance.

"As Chairman of Direct Line Group, I am responsible for the leadership of the Board."

Mike Biggs, Chairman

I am pleased to report that we reached compliance with the UK Corporate Governance Code in relation to key Board structure and processes by the time of the IPO.

3 September: The Company declared and paid a further interim dividend of £200m to the RBS Group. The Company also announced that Clare Thompson had been appointed as a Non-Executive Director.

14 September: The Company announced its intention to proceed with an IPO. The Company also announced that Priscilla Vacassin had been appointed as a Non-Executive Director.

24 September: The Company announced that Glyn Jones had been appointed as Senior Independent Director and Mark Catton, CEO of RBS Corporate and Institutional Banking in the UK, as a Non-Executive Director.

28 September: The Company published the IPO price range.

16 October: 1,500m shares were admitted to trading on the London Stock Exchange under the ticker 'DLG'.

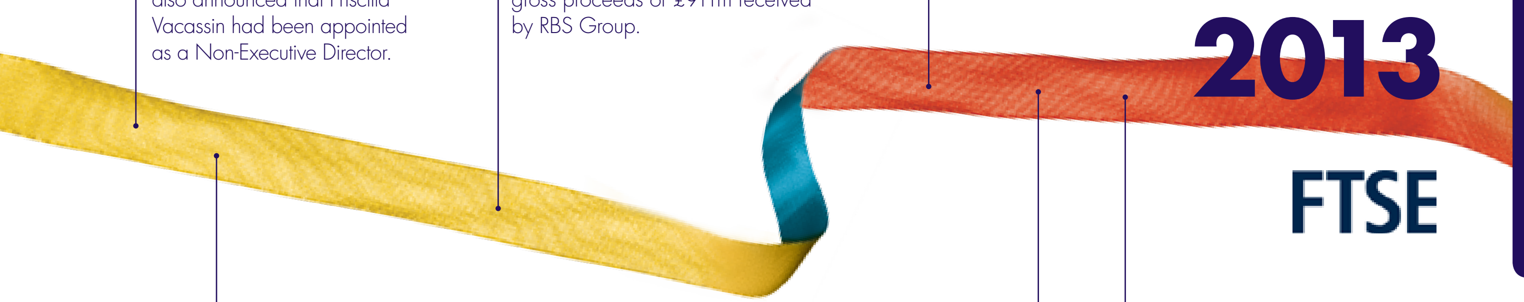
17 October: Following the exercise of an over-allotment option in respect of a further 67.5m Ordinary Shares to be sold on the market, RBS Group sold 520.8m Ordinary Shares in the Company. The sale represented 35% of the total share capital and generated gross proceeds of £911m received by RBS Group.

2 November: The Company announced that operating profit from ongoing operations of £347.9m for the nine months to 30 September 2012 had increased by 3% over the prior period.

13 December: The Company won 'IPO of the Year' at the 2012 FT and mergermarket European M&A Awards.

24 December: The Company became a constituent of the FTSE 250.

15 January 2013: The Company announced the award to Capgemini UK plc of a five-year contract to design, deliver and run a new IT infrastructure for the Group whereby our corporate and business applications will be migrated from RBS Group IT infrastructure to an independent platform.



Before and after the IPO the Board was instrumental in initiating projects to assure an integrated approach to governance. Further details of our approach are set out on pages 60 to 68.

Our pursuit of strong governance is based on the conviction that it is good for our business. By adopting structures and systems designed to help us operate with maximum effectiveness and efficiency, we aim to optimise our competitive positioning and instil trust and confidence in our stakeholders that we intend to deliver against our objectives and create long-term sustainable value.

Effectiveness

Following my appointment as Chairman in April last year, my first priority was to establish an effective Board able to guide Direct Line Group as a newly-listed company. Unusually for a subsidiary group, Direct Line Group had already had independent Non-Executive Directors on its Board for over nine years. In the approach to the IPO, we embarked on a programme of reviewing the Board composition and produced detailed candidate profiles specifying the skills and qualities required of our Directors. The profiles included requirements for a diversity of experience to match the range of the Group's businesses, as well as deep experience of the financial services sector and significant Board experience in major listed businesses. By September 2012, we had appointed five independent Non-Executive Directors, in addition to two RBS Group-nominated representatives.

A fuller description of how the Board was set up to respond to the business's needs and the challenges it faces is provided on page 64.

Following appointment, the Directors commenced induction programmes designed to familiarise them with the operation of the Group and its management and to provide updates regarding significant developments affecting listed companies and our business sector.

We intend to continue to build on these inductions by arranging site visits and training during 2013. We will review the effectiveness of the Board as a whole and of individual Directors by annual evaluations.

Accountability

An overriding focus in 2012 was to ensure our policies, processes and systems are fit for Direct Line Group to operate as a listed company, meeting all relevant statutory, regulatory and compliance obligations.

One of the first challenges we met during 2012 was to revisit the existing governance infrastructure and devise a framework appropriate for a stand-alone listed insurance group. It was particularly important, during a time of significant organisational change, to ensure that the outputs of various work streams were subjected to robust systems of challenge and independent oversight, with material decisions being escalated to the Board.

What has the Board achieved?

Highlights of 2012

- Refreshed the membership of the Board to meet the requirements of best practice relating to a majority of Non-Executive Directors on the Board (excluding the Chairman).
- Provided oversight of the Fit for Listing project.
- Considered matters relating to Solvency II.
- Launched initiatives targeting £100 million of gross annual cost savings in 2014.
- Carried out a successful inaugural capital markets transaction with £500 million of Tier 2 subordinated debt issued in April 2012.
- Substantially completed separation from RBS Group with independent corporate functions and governance from 1 July 2012.
- Set financial targets for the Group, including COR and RoTE.
- Continued to deliver the Group's transformation plan and is making progress towards its target of a 15% RoTE.
- Achieved a successful IPO in October 2012.
- Awarded a five-year contract to Capgemini UK plc to design, deliver and run a new IT infrastructure for the Group whereby our corporate and business applications will be migrated from RBS Group IT infrastructure to an independent platform at a cost of approximately £100 million.

In addition, the Company refreshed its committees during 2012 to ensure the Board has adequate support to provide assured oversight of the business. The composition, attendance, role and focus of each committee are described later in this report.

Remuneration

The subject of Directors' remuneration continues to receive attention from shareholders, regulators and the public. It is clear to me that transparency in reporting on remuneration is key to obtaining the confidence of investors. Although the result of the Department of Business, Innovation and Skills' consultation on revisions to the remuneration reporting regulations is not expected until later in 2013, Direct Line Group intends to adopt the recommendations, where practicable, within the confines of current regulatory and legislative requirements.

We have designed our remuneration strategy to attract, retain and motivate executives of the highest quality, incentivising them to deliver exceptional performance aligned with the interests of shareholders and the delivery of our business plan.

We have determined a policy of setting pay by reference to median market pay in the context of FTSE 31 to FTSE 100 listed companies and insurance peers. We determined the remuneration levels and structures for Executive Directors in line with that policy. Further information is available in the Directors' remuneration report on page 78.

Relations with shareholders and other stakeholders

We value open, constructive and effective communication with our shareholders. We had regular dialogue with our major shareholder, RBS Group, throughout the year. In the run-up to and following listing, we held numerous meetings with actual and potential shareholders. I am available to meet our major shareholders to discuss Directors' remuneration and other matters going forward.

In summary

Your Board is hardworking and committed, well placed to challenge robustly the proposals put before it and to provide independent oversight. In addition the Group has implemented a governance framework which provides it with a firm foundation for the future. This is aimed at ensuring that the outputs of our various work streams are subjected to robust systems of challenge and independent oversight, with material decisions on the items specifically reserved to the Board being promptly escalated to it.

MN Biggs

Michael N Biggs, Chairman

27 February 2013

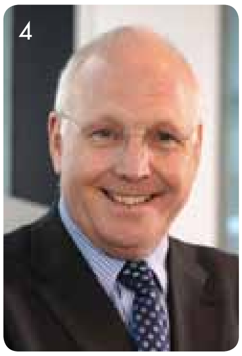
What will the Board focus on?

Our objectives for 2013

The Board's main priorities are to embed the significant changes made to the governance of the Group, with specific actions focused on key areas of activity:

- Supporting the vision of becoming Britain's best retail general insurer.
- Overseeing the Group's progress in pursuit of its stated targets, including those relating to COR and RoTE.
- Reviewing the main elements of governance architecture to ensure that they are fit for purpose for the newly-listed entity.
- Conducting a full Board evaluation, since the Board will have been in place for sufficient time to make such a review appropriate.
- Reviewing the Group's policy on gender diversity to consider how more women can be promoted to senior and executive management roles.
- Setting the tone and culture of the Group focusing on behaviours to help achieve the strategic objectives and to deliver fair outcomes to our customers.

Board of Directors



1 Michael N Biggs (N and R)

Chairman of the Board

Appointment
Mike joined the Board and became Chairman of the Group in April 2012 and is Chair of the Nomination Committee.

Experience and qualifications
Mike has almost 40 years' experience of the UK and international financial services sector. He was Chief Executive Officer and Group Finance Director of Resolution plc, the FTSE 100 UK life assurance business and is currently Chairman of Resolution Limited. He was previously Group Finance Director of Aviva plc. He has a Masters degree in History from the University of Oxford and is an Associate of the Institute of Chartered Accountants of England and Wales. Mike is 60.

External appointments
Chairman of Resolution Limited (but will step down later in the year).

Key strengths and contribution
Mike is a respected figure in the insurance industry and is well regarded by City investors. He brings the Group extensive insurance industry experience and a successful track record of flotations in this sector.

2 Paul Geddes (C)

Chief Executive Officer

Appointment
Paul was appointed as Chief Executive Officer in August 2009.

Experience and qualifications
Paul was the Chief Executive Officer of RBS Group's mainland UK retail banking business, having joined in 2004 as Managing Director with responsibility for products and marketing.

Before joining RBS Group, Paul held a number of senior roles in multi-channel retailing in businesses that were then parts of the GUS and Kingfisher groups. Paul started his career in marketing, with UK and European roles at Procter & Gamble. Paul read Philosophy, Politics and Economics at the University of Oxford. He is a fellow of the Chartered Institute of Bankers in Scotland. Paul is 43.

External appointments
Paul is a member of the ABI Board, a member of the Financial Ombudsman Service's insurance industry steering group, and a member of the FSA Practitioner Panel.

Key strengths and contribution
Paul's experience in leading one of the UK's largest retail banking businesses during a challenging period for the industry and improving its customer and financial performance against peers singled him out in 2009 as the Chief Executive able to lead the turnaround of Direct Line Group and its divestment from RBS Group.

3 John Reizenstein

Chief Financial Officer

Appointment
John joined as Chief Financial Officer in December 2010.

Experience and qualifications
John was previously Managing Director, Corporate and Markets at Co-operative Banking Group (CBG, the group that brings together The Co-operative Bank, Co-operative Insurance Society and CIS General Insurance). He was Chief Financial Officer at CBG from 2003 to 2007. Prior to joining CBG, John spent more than 20 years in investment banking with UBS and Goldman Sachs. John is an Economics graduate of the University of Cambridge. He is 56.

External appointments
None

Key strengths and contribution
John is an experienced Chief Financial Officer and former banker with extensive City and financial services experience. He is accordingly well placed to provide strong support to Paul Geddes in leading the Group.

4 Glyn Jones (A, N and *)

Senior Independent Non-Executive Director

Appointment
Glyn joined the Board in September 2012.

Experience and qualifications
Glyn was Chairman of Towry Holdings Limited between 2006 and 2011. He also served as Chairman of Hermes Fund Managers from 2008 to 2011 and was Chairman of its sister company, BT Pension Scheme Management, for a part of this period. Glyn was Chief Executive Officer of the independent investment group, Thames River Capital, from 2005 to 2006. From 2000, he served as Chief Executive Officer of Gartmore Investment Management in the UK for four years. Before this, Glyn was Chief Executive Officer of Coutts NatWest Group and Coutts Group, having joined in 1997. Glyn joined Standard Chartered in Hong Kong in 1990 where he became the General Manager of Global Private Banking. He was a consulting partner with Coopers & Lybrand/Deloitte Haskins & Sells Management Consultants from 1981 to 1990. He is a graduate of the University of Cambridge and a Fellow of the Institute of Chartered Accountants in England and Wales. Glyn is 60.

External appointments
Glyn is Chairman of Aspen Insurance Holding Limited, a New York listed specialty lines insurer, and also Chairman of Aspen Insurance UK Limited, a principal operating subsidiary of the Aspen Group.

Key strengths and contribution
Glyn has undertaken a number of senior roles within the financial services industry. He brings knowledge of insurance from his time as Chairman of Aspen. As a former Chief Executive Officer in the asset management industry he also understands the City and shareholders well.

5 Mark Catton

Non-Executive Director

Appointment
Mark joined the Board in September 2012.

Experience and qualifications
Mark rejoined RBS Group in August 2007 as a Managing Director in corporate banking, having previously worked for NatWest. Prior to joining RBS Group, Mark was a senior executive at Barclays from 2001 to 2007, responsible for a number of its client and product businesses. He was latterly Managing Director in European investment banking and debt capital markets at Barclays Capital. He is an associate of the Chartered Institute of Bankers and the Association of Corporate Treasurers. Mark is 46.

External appointments
Mark sits on The Royal Bank of Scotland Group plc's management committee and is Chief Executive Officer of UK Corporate and Institutional Banking at RBS Group, a position he has held since 2008.

Key strengths and contribution
Mark is one of two Non-Executive Directors nominated by The Royal Bank of Scotland Group plc as the majority shareholder. He has 20 years' experience in corporate banking and financial markets to add to the perspectives around the boardroom table.

6 Jane Hanson (A, B, C, I and *)

Non-Executive Director

Appointment
Jane joined the Board in December 2011 and is Chair of the Board Risk and Corporate Social Responsibility Committees.

Experience and qualifications
Jane spent 12 years with KPMG, where she worked in the financial sector, becoming the director responsible for delivery of corporate governance, internal audit and risk management services in the North of England. Jane has also

held executive roles as Director of Audit, and Risk and Governance Director at Aviva's UK Life business. Jane is a graduate of the University of York with a degree in music and is a Fellow of the Institute of Chartered Accountants in England and Wales. Jane is 45.

External appointments
Jane is Chair of the Audit and Risk Committee and Non-Executive Director at Reclaim Fund Ltd. She is an Independent Member of the Fairness Committee at ReAssure Ltd; and Chair of the Audit and Risk Committee and Senior Independent Director at Calderdale and Huddersfield Foundation Trust. Jane has her own financial sector consulting business, delivering audit, enterprise risk management and corporate governance advisory and consulting services to the financial sector. She is also a magistrate.

Key strengths and contribution
Jane has undertaken a number of senior roles in financial services, including in the UK life insurance sector and has extensive experience of risk management, corporate governance and internal control. She also has extensive experience of developing and monitoring customer frameworks. This experience led to Jane's appointment as Chair of the Board Risk and Corporate Social Responsibility committees. She also provides a customer focus on the Board.

7 Andrew Palmer (A, B, I, N, R and ⋆)
Non-Executive Director

Appointment
Andrew joined the Board in March 2011 and is Chair of the Audit Committee and Chair of the Investment Committee.

Experience and qualifications
Andrew retired from Legal & General Group plc, where he was the Group Finance Director, in 2009. He is a Fellow of the Institute of Chartered Accounts in England and Wales. Andrew is 59.

External appointments
Andrew is currently the Senior Independent Director at Segro plc, the British and European Industrial Real Estate Investment Trust Company (he will step down in April 2013), a trustee of the Royal School of Needlework, a Non-Executive Director of RSN Enterprises Limited and Royal London Mutual Insurance Society Limited and a member of the Financial Reporting Review Panel of the Financial Reporting Council.

Key strengths and contribution
Andrew has undertaken a number of senior roles within the financial services and insurance industries. In addition, he has insight into corporate governance developments and best practice in financial reporting through his membership of the Financial Reporting Review Panel of the Financial Reporting Council. Accordingly, he is able to advise the Group on its governance framework and financial reporting policies and can draw on his experience in our industry sector.

8 Clare Thompson (A, B, C, R and ⋆)
Non-Executive Director

Appointment
Clare joined the Board in September 2012.

Experience and qualifications
Clare was a partner at PricewaterhouseCoopers (PwC) from 1988 to 2011. During her 23 years as a partner of PwC, she held several senior and high profile roles, particularly within the insurance sector. She is a graduate of the University of York with a degree in Mathematics and is a Fellow of the Institute of Chartered Accountants in England and Wales. Clare is 58.

External appointments
Clare is currently a Non-Executive member of the Partnership Board of Miller Insurance Services LLP and is Treasurer of the Disasters Emergency Committee.

Key strengths and contribution
Clare brings with her extensive experience and knowledge gained from roles across the professional services industry including as Lead Audit Partner at PwC where she guided companies through change and acted as an adviser to insurance companies. She gained significant experience of both general and life insurance in the latter role.

9 Priscilla Vacassin (B, R and ⋆)
Non-Executive Director

Appointment
Priscilla joined the Board in September 2012 and is Chair of the Remuneration Committee.

Experience and qualifications
Priscilla was most recently Group Human Resources Director at Prudential plc and a Non-Executive Director and member of the Audit Committee at the Ministry of Defence. Priscilla has previously held senior human resources positions across a number of financial services and customer facing industries including roles at Abbey National plc, where she was Executive Director, Human Resources; BAA plc, where she was Group Human Resources Director and Kingfisher plc. She graduated in Law (with Honours) from the University of North East London. Priscilla is 55.

External appointments
Priscilla has her own search and consultancy business.

Key strengths and contribution
Priscilla has great knowledge and experience of developing organisational values, and creating the leadership, succession, development and remuneration structures required to support corporate strategy. She has worked both as a practitioner and as an adviser and therefore understands the complexity around remuneration in both technical and market terms.

10 Bruce Van Saun
Non-Executive Director

Appointment
Bruce joined the Board in April 2012.

Experience and qualifications
Bruce has over 25 years of financial services experience. From 1997 to 2008 he held a number of senior positions with Bank of New York and later Bank of New York Mellon, most recently as Vice-Chairman and Chief Financial Officer, before which he was responsible for Asset Management and Market-Related businesses. He has held senior positions with Deutsche Bank, Wasserstein Perella Group and Kidder Peabody and Company. He has served on several corporate boards as a Non-Executive Director and has been active in numerous community organisations. He graduated summa cum laude (with the highest distinction) from Bucknell University in Lewisburg, Pennsylvania, with a Bachelor of Science in Business Administration. He also gained an MBA at the University of North Carolina. Bruce is 55.

External appointments
Bruce is currently the Group Finance Director for The Royal Bank of Scotland Group plc.

Key strengths and contribution
Bruce is one of two Non-Executive Directors nominated by The Royal Bank of Scotland Group plc as the majority shareholder. As Group Finance Director at The Royal Bank of Scotland Group plc, Bruce has extensive experience of the activities and markets in which the Group operates.

Key

(A) Audit Committee
(B) Board Risk Committee
(C) Corporate Social Responsibility Committee
(I) Investment Committee
(N) Nomination Committee
(R) Remuneration Committee
(⋆) Independent

Executive Committee

1 Robert Bailhache
Director of Communications

Appointment
Rob joined as Director of Communications in February 2012.

Experience and qualifications
Rob has 19 years' experience in international capital markets as a communications specialist and financial journalist. Rob was previously a Managing Director and Head of Group Press Office at HSBC Holdings. Prior to this he was Managing Director, Financial Services and a Partner of Financial Dynamics, a subsidiary of FTI Consulting Inc. Rob began his career in business media where he held senior journalist roles in the UK and Asia. Rob is a graduate of the University of Nottingham where he gained a Bachelor of Arts (Honours) in Politics and the University of London where he gained a Master of Arts in South Asia Studies. He holds a Certificate in Investor Relations awarded by The Investor Relations Society.

2 Jamie Brown
Managing Director of International

Appointment
Jamie joined the Group in 1997.

Experience and qualifications
Jamie joined as part of the Motor team, initially setting up Direct Line Rescue. In 1999 he was responsible for the acquisition and integration of Green Flag. In 2001 he moved to Italy to lead the development of the Direct Line business in that market, and in 2007 took broader responsibility across the Group's other European businesses. Previously Jamie followed a career both inside and outside the insurance industry in the UK and overseas. He is a Chartered Accountant and has spent six years in the accountancy profession, 23 years in the insurance industry with AIG, Churchill and Direct Line and six years in other industries.

3 Darrell Evans
Chief Customer Officer

Appointment
Darrell joined the Group in October 2009.

Experience and qualifications
Before his current role, Darrell was Managing Director, Sales, Services and Partnerships. Prior to this, he was Director of Products at RBS Group before assuming responsibility for mortgage brands and the retail telephony centres at the retail bank at RBS Group. Darrell began his career with RBS Group when he joined NatWest in 1986 where he undertook a variety of strategy, finance, marketing and product management roles. Darrell holds an MBA from Aston Business School.

4 Jonathan Greenwood
Managing Director of Commercial

Appointment
Jonathan joined the Group in 2001.

Experience and qualifications
Previously, Jonathan held various senior Group positions in Personal Lines and Partnership divisions including Managing Director Home and Product and pricing Director Partnerships. Immediately prior to joining the Group, Jonathan was Vice President of Insurance for MBNA Europe and prior to that General Manager for a joint venture between Commercial Union and BNP Paribas. Jonathan started his career at Halifax, later HBOS, where he held a variety of senior product and operational roles in the general insurance division.

5 Steve Maddock
Managing Director of Claims

Appointment
Steve joined as Managing Director of Claims in February 2010.

Experience and qualifications
Previously, Steve held the position of Director of Strategic and Technical Claims at RSA, a role he assumed in 2004. He has over 20 years' insurance industry experience, including roles as Director of Claims and Customer Service at Capita and Director of Operations at AMP. Steve holds an MBA from the University of Reading and is a Non-Executive Director of the Motor Insurers' Bureau and the Insurance Fraud Bureau.

6 Mark Martin
Human Resources Director

Appointment
Mark joined as Human Resources Director in February 2010.

Experience and qualifications
Previously he was Human Resources Director and a member of the Board at T-Mobile Limited. Before this, he held a number of human resources, general management and marketing roles in the food manufacturing, fast moving consumer goods, telecoms and public sectors. He holds a BSC (Honours) degree in Management and Personnel Practice from Aston University, and is a Fellow and Graduate of the Chartered Institute of Personnel and Development.

7 Angela Morrison
Chief Information Officer

Appointment
Angela became Chief Information Officer (CIO) in 2010.

Experience and qualifications
Prior to her current role, Angela was CIO at J Sainsbury's and a member of their Operating Board. She previously worked for ASDA/Wal-Mart where she held a number of roles including European Strategy Director, CIO through the ASDA/Wal-Mart integration and e-Commerce Director which included establishing ASDA's home grocery business. Angela started her career as a consultant and holds a degree in Electrical and Electronic Engineering from the University of Bristol.

8 Humphrey Tomlinson
General Counsel and Company Secretary

Appointment
Humphrey joined the Group in November 2011.

Experience and qualifications
Humphrey has had more than 20 years' experience since qualifying as a solicitor in 1989, and has advised on corporate and commercial matters, a wide range of corporate transactions across many countries, legal risk management and corporate governance issues, with RSA Insurance Group, where he was Group Legal Director, and City law firm Ashurst Morris Crisp. He is a graduate of the University of Oxford.

9 José Vazquez
Chief Risk Officer

Appointment
José joined as Chief Risk Officer in March 2012.

Experience and qualifications
José was previously Global Chief Risk Officer at HSBC Insurance, where he had responsibility for the Group Chief Actuary, and was a Board member of its captive insurance company. Prior to joining HSBC, José held various roles over 10 years at Zurich Insurance, initially in London Market Operations, then as Chief Actuary International Business Division and finally as Chief Actuary of the UK. José started his career as a consulting actuary, including six years as a consultant with KPMG in London where he worked on a wide range of domestic and European engagements. José is a Maths graduate from Brunel University and a Fellow of the Institute of Actuaries.

10 Thomas Woolgrove
Managing Director of Personal Lines

Appointment
Tom joined as Managing Director, Personal Lines in April 2010.

Experience and qualifications
Tom previously held various Managing Director roles with HBOS and Lloyds Banking Group, including UK Private Banking, General Insurance and Motor Finance. Before that, he was a strategy consultant with Gemini Consulting, part of the Capgemini Group, and a graduate engineer with Rolls-Royce Aerospace. He is a member of the Association of British Insurers General Insurance Committee and the Chartered Insurance Institute Professionalism Taskforce. He was elected Deputy President of the Chartered Insurance Institute in July 2012. Tom holds a Masters Degree in Engineering and Management from the University of Oxford, and an MBA from the University of Chicago, Booth School of Business.

Corporate governance is at the core of what we do

Contents

"As a Board we are collectively responsible for leading the business and targeting long-term success. We are all fully committed to acting in the Company's best interests to take the Company along this journey."

Mike Biggs, Chairman

The UK Corporate Governance Code

The following report details how the Board has applied the principles and provisions in the Financial Reporting Council's UK Corporate Governance Code 2010 (the "**Code**"), as required by the UK Listing Rules. The report fulfils the requirements of the Corporate Governance statement for the purposes of the Disclosure and Transparency Rules.

The Company was not listed and therefore not subject to the Code until 16 October 2012. However, the Board considers that the Company had achieved the required level of compliance with the Code by the time it listed. The Company is compliant with the Code with the exception that the Company's Directors, some of whom joined the Board in the run-up to the IPO, are yet to be subject to an annual assessment. It is intended that such an assessment will take place for all Directors during 2013.

A copy of the Code is available from www.frc.org.uk.

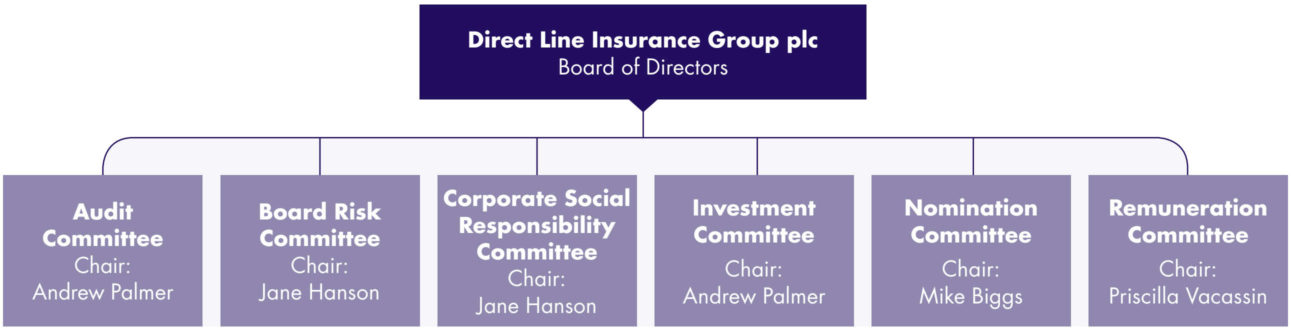
Leadership

What is our integrated approach to corporate governance?

The Group undertook a significant programme of work to establish a governance system appropriate for a stand-alone listed company. This included the adoption of a new set of high-level controls, risk management policies and minimum standards. The Group also observed examples of good governance practice and emerging legal and regulatory developments to anticipate and meet the expectations of its investors and other stakeholders.

The Group's integrated approach to governance is demonstrated by the way in which the various projects undertaken during the year were managed, chief among which was the Fit for Listing project. Each project involved consultation and regular meetings with stakeholders, and accountability for delivery was cascaded throughout the business.

The Board and Committee governance structure



Fit for Listing
Given the scale of organisational change which was to take place during 2012, a Fit for Listing work stream was created that brought together the interests of relevant stakeholders. The purpose was to establish a framework for delivering the transition of Direct Line Group from 'limited' to 'listed' status, as well as to establish and confirm management and operational focus, given the other work streams also underway.

Robust governance was established, with strong technical and project management input. This involved all the main business stakeholders and the Executive Committee with appropriate escalation to and oversight by the Board and the participation of the RBS Group and Direct Line Group Divestment Steering Group where appropriate.

The primary aim of the Fit for Listing work stream was to deliver the compliance, regulatory and governance obligations of the FSA, the UK Listing Authority and the Financial Reporting Council ("**FRC**"). It was also to embed this work within an overall philosophy of achieving good governance.

Relationship Agreement
An element of achieving independence and substantial operational separation from RBS Group was to enter into a Relationship Agreement setting out the terms of the relationship between Direct Line Group and RBS Group following the listing.

The Relationship Agreement makes explicit the independence of Direct Line Group from its major shareholder, RBS Group, whilst making express provision for RBS Group to be entitled to the information it needs from Direct Line Group in order to meet its legal, regulatory and accounting obligations. It also sets out RBS Group's rights to nominate Directors depending on the proportion of its shareholding in the Company. This is an important piece of governance architecture.

High level controls
Under the provisions of the Group's governance framework, the Group operated a system of high level controls, covering areas relating to the Board, Board Committees, strategic planning, risk management, internal audit, delegated authorities, monitoring and reporting on internal control, and the policy framework. This document was revised during the year to reflect the separation from RBS Group and the Company's own premium listing.

Policies and minimum standards
The Group operates under a system of policies and supporting minimum standards. In addition to covering areas across the business such as risk, internal controls, finance and operational policies and minimum standards, these include Stock Exchange announcements; registrar processes; the control of inside information; share dealing; disclosure requirements and the requirements under the ongoing obligations of the Listing Rules and the Disclosure and Transparency Rules.

Transformation plan
The Transformation plan launched in 2010 consisted of three phases:

Phase 1: Recover profitability

Phase 2: Rebuild competitive advantage

Phase 3: Deliver a disciplined, profitable business

Following the return to profit in 2011, the Group redefined its strategic plan through five pillars: distribution, pricing, claims, costs and Commercial and International businesses. The Group is making good progress as it targets a 15% RoTE.

Customer conduct
A working group was set up to assess our conduct towards our customers during transactions, to highlight potential failures of delivering appropriate customer outcomes. This includes how our entire business thinks about interactions with our customers.

The working group manages customer conduct across Direct Line Group. It assesses and reports our performance, while consulting on improvements and emerging conduct themes.

Culture and behaviours
The organisational and governance changes made in 2012 were accompanied by a corresponding programme to reinforce the culture and behaviours we require to enable Direct Line Group to achieve its strategic objectives. See page 47 for more information on this initiative.

Three Lines of Defence

The Board has adopted a 'Three Lines of Defence' operating model as part of our approach to risk management. The model addresses:

- the roll-out of our risk strategy and wider risk framework throughout the business;
- a risk function to implement and develop the policy framework; and
- the provision of independent assurance by our internal audit function over the adequacy and effectiveness of our governance, risk and control framework.

We provide further information on this model in the Risk Management report on page 26.

How are we structured to ensure good, strong governance?

The Group started 2012 with a structure appropriate to the needs of a wholly-owned subsidiary of our parent, RBS Group. The appointment of new Directors helped enable the restructuring of our Board Committee architecture, leading to the creation of a Remuneration Committee (in April), a Corporate Social Responsibility Committee and a Nomination Committee (when we listed). Under the provisions of RBS Group's governance framework, Direct Line Group's risk and audit functions were overseen at Board level by a combined Risk and Audit Committee. Following the principles set out in the Walker Report, this Committee was separated on listing into a Board Risk Committee and an Audit Committee. We also have an Investment Committee.

The governance structure illustrating the relationship between the Board and its Committees is set out on page 61.

The Board has established its Board Committees to assist it in delivering its responsibilities. Each Committee plays a vital role in ensuring that the Board operates efficiently and gives appropriate consideration to matters. The composition, attendance, role and focus of each Committee are set out on pages 68 to 76.

What is the role of the Board and what are its members' key responsibilities?

The specific duties of the Board are clearly set out in its terms of reference. These address a wide range of corporate governance issues and list those items that are specifically reserved for consideration and decision by the Board.

The role of the Board is to organise and direct the affairs of the Group in a manner that is most likely to promote its long-term success for the benefit of its members as a whole.

The Board is the main decision-making forum for the Group. It has overall responsibility for managing the business and affairs of the Group, the establishment of the Group's strategy and the raising and allocation of capital. The main responsibilities of the Board include:

- Ensuring that the necessary financial and human resources are in place for the Group to meet its objectives.
- Managing risk effectively through setting, approving and monitoring the Group's strategic aims with regard to risk appetite, stress scenarios, mitigating actions and longer-term strategic threats.
- Monitoring and overseeing the Group's operations to ensure competent and prudent management and sound planning.
- Scrutinising the performance of management in meeting agreed goals and objectives.
- Monitoring the reporting of performance.
- Satisfying itself as to the integrity of financial information and that financial controls and systems of risk management and internal control are robust and defensible.
- Determining appropriate levels of remuneration for the Executive Directors.
- Taking a prime role in succession planning and appointing and, where necessary, removing Executive Directors.
- Discharging its responsibilities in accordance with relevant legislation and guidance.

Board roles and responsibilities

Role	Responsibilities
Chairman	• To provide leadership of the Board and ensure its effectiveness in all aspects of its role.
Chief Executive Officer	• To develop and deliver the Group's strategy within the policies and values established by the Board.
Non-Executive Director	• To provide constructive challenge and to help to develop proposals on strategy.
Senior Independent Director	• To provide a sounding board for the Chairman and to serve as an intermediary for the other Directors when necessary. • To be available to shareholders if they have concerns which contact through the normal channels of Chairman, Chief Executive or other Executive Directors has failed to resolve or for which such contact is inappropriate.

How often does the Board meet?

The Board met regularly during 2012; in addition to the 11 scheduled meetings a further 11 ad hoc meetings were held. Not all the Directors were available to attend the ad hoc meetings. Details at attendance of Board and Board Committee meetings by Directors during the year are set out below and on pages 68 to 77.

	Prior to listing on 16 October 2012		After listing on 16 October 2012	
	Scheduled meetings[1]	Ad hoc meetings[1]	Scheduled meetings[1]	Ad hoc meeting[1,8]
Chairman				
Andrew Palmer[2]	8 of 8	9 of 10	2 of 3	0 of 1
Mike Biggs[3]	4 of 4	5 of 5	3 of 3	1 of 1
Senior Non-Executive Director				
Glyn Jones[4]	1 of 1	–	3 of 3	0 of 1
Non-Executive Directors				
Mark Catton[4]	1 of 1	–	2 of 3	0 of 1
Jane Hanson	8 of 8	9 of 10	3 of 3	1 of 1
Clare Thompson[4]	1 of 1	2 of 2	3 of 3	1 of 1
Priscilla Vacassin[4]	1 of 1	1 of 1	3 of 3	0 of 1
Bruce Van Saun[3]	1 of 4	5 of 5	3 of 3	0 of 1
Ian Falconer[5]	2 of 2	1 of 1	–	–
Christopher Sullivan[6]	1 of 1	0 of 1	–	–
Executive Directors				
Paul Geddes	8 of 8	10 of 10	3 of 3	1 of 1
John Reizenstein	8 of 8	10 of 10	3 of 3	1 of 1
Sheree Howard[7]	2 of 2	3 of 3	–	–

Notes:

1. Attendance is expressed as the number of meetings attended out of the number of meetings possible or applicable for the Director to attend.
2. Acting Chairman from 27 January 2012 to 27 April 2012.
3. Mike Biggs joined the Board as Chairman and Bruce Van Saun was appointed to the Board on 27 April 2012.
4. Clare Thompson and Priscilla Vacassin joined the Board on 3 and 13 September respectively. Mark Catton and Glyn Jones joined the Board on 24 September 2012.
5. Resigned from the Board on 23 February 2012.
6. Resigned from the Board on 27 January 2012.
7. Resigned from the Board on 26 March 2012.
8. Although half the Board attended this meeting, all Directors were provided with papers and given the opportunity to comment ahead of the meeting.

Who are the Directors?

The Board currently comprises the Chairman, who was independent on his appointment to the Board, two Executive Directors, five independent Non-Executive Directors and two non-independent Non-Executive Directors nominated by The Royal Bank of Scotland Group plc.

The names of the Directors who served as at the end of the year, together with their biographical details and other information, are shown on pages 56 to 57.

Mike Biggs, Glyn Jones, Mark Catton, Clare Thompson, Priscilla Vacassin and Bruce Van Saun all joined the Board during the year, and Chris Sullivan, Ian Falconer and Sheree Howard left the Board. The respective dates are shown in the notes to the table.

How are the roles of the Chairman and Chief Executive Officer distinct?

The roles and responsibilities of the Chairman and the Chief Executive Officer are clearly differentiated. The division of responsibilities at the top of a Company is required by the Code to ensure that no one person may exert absolute control. The role statements of both the Chairman and the Chief Executive Officer were reviewed during the year and approved by the Board on 21 September 2012. These statements for the Chairman and the Chief Executive Officer, which explain their responsibilities, are available on the Group's website.

What is the governance framework below Board and Board Committee level?

Although the Board is ultimately responsible for the success of the Company, Paul Geddes, the Chief Executive Officer, has received delegated authority from the Board to manage the Group's day-to-day operations.

In turn, the senior executives who report to him take responsibility for managing the businesses and functions within the Group, and each member of the Executive Committee has the financial and other authorities needed to manage their respective areas.

Paul Geddes and these senior executives are supported by the functional departments of the Group.

The diagram 'Direct Line Group's Executive Committee' below illustrates the management governance framework.

What is the role of the Executive Committee?

The Executive Committee is the principal management committee that assists the Chief Executive Officer in the day-to-day management of the business as a whole. It supports him in setting performance targets and in implementing the Group's strategy and direction as determined by the Board. The Committee assists him to monitor key objectives and commercial plans to deliver the Group's targets. It also helps him to evaluate new business initiatives and opportunities, and receives and considers reports on operational matters, where these are material to the Group or have cross-company implications.

Board effectiveness

"At Direct Line Group we have worked hard to ensure that the Board has the appropriate mix of skills, experience, independence and knowledge to help deliver our long-term strategy. It is vitally important to us that we have the right combination of people to support our ambitions for the future and we spent considerable time building a Board which we believe has the capabilities to do this."

Mike Biggs, Chairman

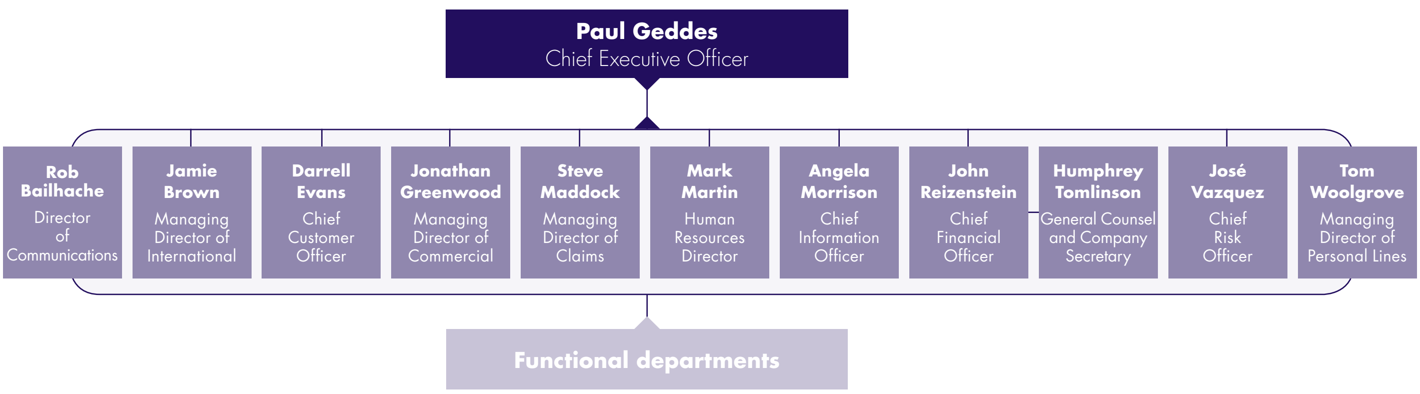
How do you ensure the Board of Directors is balanced and the majority of Directors are independent?

As part of the process of creating a Code-compliant Board, the Company focused on obtaining the elements considered necessary to maximise the Board's effectiveness (see the process for appointing new people to the Board overleaf). Consequently, the Board and its committees have been constructed in a way that ensures that an appropriate balance of skills, experience, independence, knowledge of the sector and diversity exists to enable the Directors to discharge their duties and responsibilities effectively.

In assessing the independence of each Director we considered whether each was independent in character and judgement and particularly whether there were relationships or circumstances which were likely to affect his or her judgement.

The individuals' attributes were established as part of the selection procedure. (Please see the section "What is the process for appointing new people to the Board?" for the desired attributes of our Directors and a description of the selection process.)

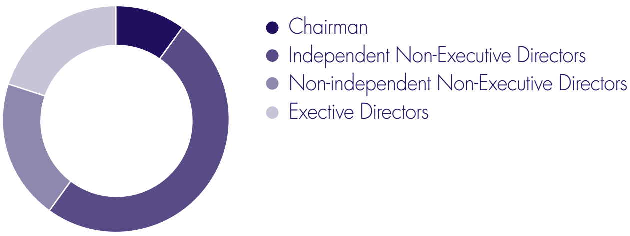
Direct Line Group's Executive Committee



In addition, the Company employs a continuous process of reviewing independence from management and invites the declaration of any conflict of interest that could interfere with each Director's ability to act in the best interests of the Group. UK company law allows the Board to authorise a situation in which there is, or may be, a conflict between the interests of the Group and the direct or indirect interests of a Director or between the Director's duties to the Group and to another person. The Board has adopted procedures for ensuring that its powers to authorise conflicts operate effectively. For this purpose a register of conflicts, and of any authorisation of a conflict granted by the Board, is maintained by the Company Secretary and regularly reviewed by the Board.

Mark Catton and Bruce Van Saun are non-independent Non-Executive Directors by virtue of being nominated for appointment to the Board by RBS Group, the Company's majority shareholder. RBS Group has committed to the European Commission to sell Direct Line Group as a condition of its receipt of state aid in 2009. To comply with this requirement, RBS Group must cede control of Direct Line Group (that is, reduce its shareholding to below 50%) by the end of 2013 and must have divested its entire interest by the end of 2014. Mark Catton and Bruce Van Saun will step down in stages as RBS Group's holding in the Company diminishes. Please refer to page 82 for further information.

Balance of Board members



Experience of Board members

In addition, all 10 have experience of working in the financial services sector.

What is the process for appointing new people to the Board?

The Company spent considerable time on recruiting its new Directors during 2012. Assisted by selection consultants JCA Group, and deploying skills matrices to identify desired attributes, the Directors pursued a formal, rigorous and transparent selection procedure. Separate requirements were developed for Non-Executive Directors, the Senior Independent Director and the Chairman. Our target search criteria for Board members included:

Experience

- Significant Board experience in major listed businesses.
- Extensive knowledge and operational experience in insurance at a senior level.
- Experience and appreciation of businesses with customer service at their core (perceived as advantageous).
- Likely to have had executive experience.

Attributes

- Widely recognised as an individual of high repute and integrity who can rapidly gain Executive and Non-Executive colleagues' respect and trust.
- An independent thinker who is able to engage constructively and add real value to Board discussions.
- Well organised and committed, an individual who takes their Non-Executive role seriously.
- Robust, straight talking, open and approachable with a non-emotional and calm demeanour.
- Supportive of the executive team while being able to challenge constructively.
- A team player and a good listener with the style and ability to be a highly constructive member of the Board.
- A sound understanding of the requirements of good public reporting and the ability to identify whether what is being presented in meetings stands up against reporting standards.
- Strong communication and presentation skills, with the ability to get under the skin of the business and a strong desire to gain a deep understanding of what is going on in and around the Group.

The selection procedure included a number of interviews with JCA Group and meetings with existing Board members. The Company also obtained a range of references for each candidate.

The Nomination Committee will adopt an approach modelled on this selection procedure for future appointments.

How long are the Directors appointed for?

The Directors may appoint additional members to the Board during the year. Subsequently, in accordance with a provision of the Code and the Company's Articles of Association, Direct Line Group submits Directors for re-election on an annual basis, subject to the Group's independence criteria (where appropriate), ongoing commitment to Group activities and satisfactory performance.

In line with these arrangements, all 10 Directors will be subject to re-election by shareholders at our Annual General Meeting ("**AGM**") on 6 June 2013.

Non-Executive Directors are normally expected to serve two fixed terms of three years, but may be invited to serve a third term of three years.

What level of commitment is expected from our Board members?

All our Directors, including the Chairman, have indicated that they are able to allocate sufficient time to the work of Direct Line Group to enable them to discharge their respective duties and responsibilities effectively. Directors' appointment letters contain a condition to this effect, and Directors were made fully aware, and accepted, that the time commitment would be greater than normal in 2012 given the need to deliver the IPO transaction and associated restructuring activities.

Our Directors have had a considerable work load during 2012 and showed great commitment to meeting the requirements of the business in a year of transformation. In all, 22 Board meetings were held during the year, 11 of which were scheduled and a further 11 ad hoc.

How do we ensure that Board members have adequate resources and training to undertake the role effectively?

The Company believes it is crucial to provide Directors with adequate resources and training and devoted considerable time during the year to ensure that all Directors, many of whom were new to the business, received induction to help them understand their duties and responsibilities and develop knowledge of the business as quickly as possible. These sessions were based on a comprehensive technical acclimatisation programme, developed specifically to meet the needs of Direct Line Group Directors, with individual Directors provided with specific training in such areas as reserving, including reinsurance.

Further training and updates are provided to the Board and its Committees as appropriate.

How do we ensure we have an effective Board?

The Board significantly changed over 2012. It was not at full complement until September, prior to the listing of the Company in October.

For these reasons, the Board did not undertake a formal evaluation of its performance in 2012. We intend to conduct a comprehensive review in 2013, when individual Directors will be subject to a performance evaluation, and the Chairman will meet with each Director and provide feedback on a one-to-one basis. Committee chairmen will also receive feedback on the performance of their committees. Feedback on the Chairman's performance will be provided directly to the Senior Independent Director, who will discuss this with the other Non-Executive Directors before their one-to-one meetings with the Chairman.

The Group also intends to engage the services of an external consultant to facilitate the evaluation of the Board and its committees within three years of listing on the London Stock Exchange.

Our induction process[1]

The Group provides Directors with formal induction sessions, including the following matters:

- Overview of business
- Reserving, including reinsurance
- Accounting, including capital and investments
- Risk – regulatory and other risks
- Solvency II – overview
- Complaints and treating customers fairly
- Claims
- Strategy and change
- International
- Categories and products
- Marketing
- Communications
- Human Resources
- Competition law
- Anti-bribery and corruption
- Anti-money laundering

Note:

1. Further sessions are taking place in 2013.

What is the Direct Line Group's approach to diversity?

The Board considered carefully the diversity of its Board members from a variety of perspectives and sought to ensure that Directors had the relevant range of knowledge, skills, experience and, where necessary, independence to help the Company deliver its strategy.

With three women out of 10 Directors, the Government's guidelines, the recommendations of Lord Davies's report (Women on Boards) and related initiatives such as the work of the 30 Percent Club have been met in respect of gender diversity.

To further governance of our gender-diversity programme we have included an appropriate remit in the terms of reference of the Nomination Committee. In this, diversity, including gender diversity, features as one of the criteria for the selection of Directors to the Board. Also, the Corporate Social Responsibility Committee intends to consider the issue in the context of ensuring the diversity of the Group talent pipeline for future requirements, with mentoring schemes for high-potential candidates and associated training and development programmes.

As an organisation we are committed to ensuring that diversity is promoted across our business and that everyone is treated fairly irrespective of their racial or ethnic origin, gender, age, disability, religion, belief or sexual orientation. This will apply during our day-to-day activities at work through to our recruitment process for external candidates and the selection for promotion of internal employees, ensuring that we employ only the best people for the role based on merit and evidence of their qualifications, skills and experience. We also consider 'diversity' as including diversity of thought and approach.

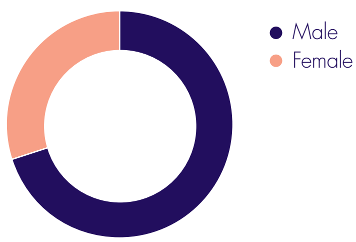
Building a working environment where all our employees can develop to their full potential is important to us and we work hard to broaden the range of approaches available to our people, ensure our policies and processes support them and encourage divergent thinking.

We need a wide range of talented people to deliver great service to our diverse customers. Our commitment to valuing diversity is reflected in our Diversity Policy. It is the responsibility of everyone to demonstrate our commitment through how we treat others. Some of the benefits of a diverse workforce include:

- Greater access to different perspectives and sources of information.
- Improved ability to respond and change through creativity and innovation; innovative approaches to products.
- Increasing employee engagement, which helps attract new staff and retain those already here, reduces recruitment costs and can increase productivity.
- Building and tapping into a deeper pool of talent.

In a competitive and challenging business environment, diversity is a necessity and an advantage. It helps us retain business, identify new markets and attract new customers. Our customers collectively represent a variety of backgrounds and nationalities and we need to understand their particular needs. When our workforce mirrors the diversity of our customers we are better placed to understand, anticipate and meet those needs through innovative products and services.

Gender diversity of Board members



Accountability

"At Direct Line Group we are determined to present a fair, balanced and understandable insight into our business for our stakeholders. We endeavour to make this assessment as clear as possible."

Mike Biggs, Chairman

What is the Board's responsibility in relation to the financial and business reporting in this Annual Report & Accounts?
The Board is responsible for providing shareholders with a fair, balanced and understandable assessment of the Company's position and prospects.

An explanation from the Directors of their responsibility for preparing the financial statements is set out in the statement of Directors' responsibilities on page 95. This is complemented by the statement by our auditors explaining their reporting responsibilities on page 97.

We meet specific responsibilities placed on the Board under the provisions of the Code as follows:

- An explanation of how the Company generates value over the long term within the business model and the strategy for delivering Company objectives is on pages 6 to 23.
- How the Board has concluded that the business remains a going concern is discussed on page 94.
- The arrangements established by the Board for the application of risk management and internal control principles are detailed on pages 67 to 68.
- The Board has delegated to the Audit Committee oversight of the management of the relationship with the Company's auditors. A separate Audit Committee report is set out on pages 68 to 71 and provides details of the role and activities of the Committee and its relationship with the internal and external auditors.

What action has the Board taken to determine the nature and extent of the significant risks it is willing to take in achieving its strategic objectives?
The Board acknowledges it has overall responsibility for the Group's risk management and internal control system, and has complied with the Code by establishing a continuous process for identifying, evaluating and managing the significant risks the Group faces. This process includes risks arising from social, environmental and ethical matters.

The Group's risk assessment process includes output from a system for reporting on all the significant risks that stand in the way of achieving Group objectives. The system also reports on the nature and effectiveness of the controls and other management processes that manage these risks. The system also sets risk appetites for key categories of quantifiable risk. It additionally encompasses self-assessment of controls by risk owners throughout the business, whose assertions are independently challenged by the Risk Management Committee.

The Board Risk Committee regularly reviews significant risks, their potential impact on the Group's financial position, variations from agreed risk appetites and the actions taken to manage those risks.

How does the Board ensure that internal systems of control are effective?

The Board has put in place a management structure with defined lines of responsibility and clear delegation of authority. This control framework cascades down through the business units and central functions, showing clear responsibilities for ensuring that appropriate controls are in place at an operational level, including those that relate to the financial reporting process.

The internal audit function supports the Board by providing an independent and objective assurance of the adequacy and effectiveness of the Group's operations. It brings a systematic and disciplined approach to evaluating and improving the effectiveness of its risk management, control and governance frameworks and processes.

The Directors are aware that any system of internal control is designed to manage, rather than eliminate, the risk of failure to achieve business objectives and can only provide reasonable, and not absolute, assurance against material misstatement or financial loss.

The Board regularly reviews the effectiveness of the Group's risk management and internal control systems. Its monitoring covers all material controls and is based principally on reviewing reports from management and the Internal Audit function so that the Board may consider whether significant weaknesses are promptly remedied and if they indicate a need for more extensive monitoring. During the course of the reviews, the Board has not identified or been advised of any failings or weaknesses which it has determined to be significant.

Remuneration

The Board has delegated responsibility to the Remuneration Committee for the remuneration arrangements of the Executive Directors and any applicable senior executives of the Group. Please refer to the Directors' remuneration report on pages 78 to 90.

Committee reports

Audit Committee report

Andrew Palmer,
Chair of the Audit Committee

Role and focus

The Committee is responsible for the oversight and challenge of the effectiveness of the Group's systems of financial control, financial regulatory reporting and other internal controls. It monitors the work of internal and external auditors and actuaries.

The Audit Committee's terms of reference are available on our website at: **www.directlinegroup.com**.

Membership and attendance[1]

	Scheduled meetings[2]	Ad hoc meetings[2]
Committee Chair		
Ian Falconer[3]	1 of 1	n/a
Jane Hanson[4]	5 of 5	2 of 2
Andrew Palmer[5]	5 of 5	2 of 2
Non-Executive Directors		
Mike Biggs[6]	1 of 1	1 of 2
Glyn Jones[7]	2 of 2	n/a
Christopher Sullivan[8]	n/a	n/a
Clare Thompson[7]	2 of 2	n/a

Other attendees include

- Chief Executive Officer
- Chief Financial Officer
- Chief Risk Officer
- General Counsel and Company Secretary
- Head of Internal Audit
- External auditors

Minimum number of meetings per annum

The Committee is to meet at least four times a year at appropriate times in the financial and regulatory reporting and audit cycle and otherwise as required.

Notes:

1. The attendance shown above includes attendance of the Audit and Risk Committee until it was split into distinct Audit and Board Risk Committees with effect from 16 October 2012.
2. Attendance is expressed as the number of meetings attended out of the number of meetings possible or applicable for the Director to attend.
3. Resigned from the Committee on 23 February 2012.
4. A member from 16 February 2012 and Chair between 23 February and 16 October 2012. Continues as a member.
5. A member throughout the year and appointed Chair on 16 October 2012.
6. A member between 28 May 2012 and 16 October 2012.
7. Appointed members from 16 October 2012.
8. Resigned from the Committee on 27 January 2012.

The Group's Audit Committee was established by the Board on 21 September 2012 to be effective from admission to listing. Prior to the establishment of this Committee, the Group had a combined Risk and Audit Committee, the last meeting of which took place on 31 August 2012. References to the activities of the Audit Committee in this report include those carried out by the Risk and Audit Committee during 2012.

What did the Committee do in 2012?

- Reviewed the constitution, membership and terms of reference of the Committee.
- Agreed the scope of the audit work to be undertaken by the external auditors and the Internal Audit function.
- Monitored Internal Audit's independent and objective reports regarding the appropriateness, effectiveness and sustainability of the Group's system of internal controls.
- Reviewed regular reports of the work conducted by the auditors and noted mitigating actions proposed by management where required.
- Received quarterly risk reports until the formation of the Board Risk Committee in September and, in the light of the IPO, ensured that the auditors' focus was aligned with the areas of greatest risk facing the Group.
- Reviewed: the interim results for the half year ended 30 June 2012 issued in September; the interim management statement issued in November; and the Annual Report & Accounts for the year ended 31 December 2012, with particular focus on accounting policies and critical estimates and judgements.
- Considered plans and key assumptions relating to the Group's actuarial reserves, received regular updates regarding movements and emerging trends, and recommended the level of reserves to the Board each quarter.
- Provided oversight of the Fit for Listing work stream and monitored progress towards the target operating model.
- Key control issues reported by Internal Audit were monitored on a quarterly basis until the Group's risk exposure had been properly mitigated.
- Monitored the Group's compliance with statutory and regulatory requirements and recommendations within the scope of the Committee's terms of reference.
- Assessed the external auditor's performance.

What have we achieved?

- Facilitated the Group's separation from RBS Group by supervising the various work streams focusing on the creation of the Group's target operating model.
- Effected the creation of separate Audit and Board Risk Committees, wholly constituted of independent Non-Executive Directors and with distinct terms of reference.
- Obtained independent reviews from Towers Watson of the Group's actuarial reserves at the first and second quarters of 2012 to support the proposed IPO.
- Rolled out and monitored the Group's system of internal controls appropriate to an independent listed insurance company.
- Reviewed documentation relating to the listing of £500 million of Tier 2 subordinated debt, issued in April 2012 and the IPO documentation.
- Established the parameters of the services provided by the external auditors in line with the requirements of the relevant minimum standard.
- Reviewed and challenged key assumptions, judgements, analysis of emerging trends and movements on internal and external actuarial best estimates and management best estimate reserves, and recommended the associated levels of reserves to the Board each quarter.
- Approved an internal controls manual as a guide to the businesses and to the auditors.

What will we be focusing on?

- Providing oversight of the actuarial reporting process; a review of the Group's control environment and processes.
- Providing oversight of the Internal Audit strategic review, that is, the programme of activity being delivered to ensure that the Internal Audit function can continue to meet the expectations of the Board and satisfy emerging regulatory and industry standards for internal audit.
- Ensuring the provision of training and development, particularly in relation to new legislation and regulation.

Frequency of meetings

During 2012, the Committee (and its predecessor, the Risk and Audit Committee) met on seven occasions, five of which were scheduled and two were additional ad hoc meetings. The members' attendance record is set out above.
In addition to the formal meetings, the Committee held:

- Separate meetings to discuss relevant issues with members of senior management and the Head of Internal Audit.
- Meetings with the external auditors to discuss issues relating to the Committee and for the purpose of training.
- Private meetings with the Head of Internal Audit and the external audit partner to discuss the general control environment and culture of the Group.

Committee expertise

Committee members bring considerable financial and accounting experience to the Committee's work. All members have past employment experience in either finance or accounting roles, or comparable experience in corporate activities, and are members of the Institute of Chartered Accountants in England and Wales.

The Board is satisfied that each of these members has recent and relevant financial experience, as recommended by the Code.

Reports to the Board

The Chair of the Committee submits a report to the subsequent meeting of the Board on the Committee's work.

Internal control

The Group's Internal Audit function carries out independent internal audit work.

The Head of the Internal Audit function reports to the Chair of the Audit Committee and the Chief Financial Officer. The Chief Risk Officer reports to the Chair of the Board Risk Committee and to the Chief Executive Officer.

The Internal Audit function provides the Committee with independent and objective reports on the appropriateness, effectiveness and sustainability of the Group's risk management, systems of internal control, governance frameworks and processes. The Group's statement of internal controls can be found on page 68.

The key control issues that Internal Audit reports to management and to the Committee are monitored on a quarterly basis until the related risk exposures have been properly mitigated.

More details of the management of risk are contained in the Board Risk Committee report on page 71 and the Risk Management report on page 26.

Reserves

The Committee approves annual plans for reviews of reserves, informed by internal and external emerging issues. It also considers an appropriate balance between internal actuarial review and external peer review. Consultants appointed to provide validation of actuarial reviews are subject to approval by the Committee.

At least half-yearly, the Committee reviews and challenges the key assumptions and judgements, the emerging trends, movements and analysis of uncertainties underlying the assessment of the actuarial best estimate reviews where appropriate.

Simultaneously with this review, the Committee also considers and challenges the appropriateness of proposals made by the Chief Financial Officer for management best estimate reserves for booking, informed both by actuarial analysis, wider commercial insights and principles of consistency from period to period.

Following their review of actuarial best estimate and management best estimate reserves, the Committee proposes the respective reserves to the Board for booking.

Financial reporting

The review process undertaken by the Committee prior to the publication of the Group's financial statements focuses on our critical accounting policies and practices, and on any changes and decisions that require a major element of judgement, unusual transactions, clarity of disclosures and significant audit adjustments. In addition, the Committee reviews the going concern assumption, compliance with accounting standards and obligations under applicable laws, regulations and governance codes and makes appropriate recommendations to the Board.

External audit

The Committee plays a key role in managing the relationship with the Group's external auditor, Deloitte LLP. The Group's Audit/Non-Audit Services Minimum Standard ensures that the independence and objectivity of the external auditor are not impaired.

Both audit and non-audit services provided by Direct Line Group's external auditor are closely monitored:

- The Audit Committee formally approves a list of audit and non-audit services and an associated budget in advance of each financial year in line with the Auditing Practices Board's Ethical Standard 5.
- All permitted services must be approved before any work commences and applications for approval must be submitted on a prescribed form, signed by the relevant member of the Executive Committee.
- The Audit Committee Chair approves services costing less than £100,000 whilst the Audit Committee approves services costing in excess of £100,000.
- At each meeting, the Audit Committee reviews and, if approved, ratifies all services approved since its previous meeting.
- On an annual basis, the Audit Committee receives a report on all services provided during the year and their related costs.

The Audit Committee will regularly review and where appropriate update the Minimum Standard to ensure alignment with the latest standards and practice in establishing, maintaining and monitoring the independence and objectivity of auditors.

Fees payable to the auditor

During the year ended 31 December 2012, Deloitte LLP's fees for audit services and other services supplied were £6.1 million.

In accordance with the Group's Audit/Non-Audit Services Minimum Standard, all services were approved prior to work commencing and each of the non-audit services was confirmed to be permissible for the external auditor to undertake. The Audit Committee approved fees of £4.5 million payable to Deloitte LLP for services not related to audit work, which accounted for 74% of total fees paid to the external auditor in the year. The majority of non-audit fees relate to the Group's IPO, for which Deloitte LLP provided additional services as Reporting Accountants.

A summary of fees payable to the auditor for the year ended 31 December 2012 is provided in note 10 to the Group financial statements.

The Audit Committee and Board remained satisfied that the provision of non-audit services by Deloitte LLP has not compromised Deloitte's independence as the Company's external auditor.

Auditor performance and independence

The performance of the external auditors is assessed every year, including their independence and objectivity and the effectiveness of the external audit process. The effectiveness review includes regular questioning of the external auditor during Audit Committee meetings. The Committee reviews the external audit strategy and receives reports from Deloitte LLP on its own policies and procedures regarding independence and quality control, including an annual confirmation of independence in line with industry standards. The Committee concluded that the performance of the external auditor and the effectiveness of the audit process were satisfactory.

Re-appointment of auditor

The Committee intends to undertake a formal review on a regular basis to assess whether the external audit should be re-tendered. Deloitte LLP has been the Group's auditor since 2000, during which time the Group was audited as a division of RBS Group. Following the Company's listing on the London Stock Exchange on 16 October 2012, Deloitte remained the Group's external auditor.

The Committee is recommending to the Board that Deloitte LLP be re-appointed as auditor of the Company. A resolution for the re-appointment of Deloitte LLP as auditor of the Company will be put to a shareholder vote at the AGM on 6 June 2013.

This report was reviewed and approved by the Board on 27 February 2013.

Andrew Palmer, Chair of the Audit Committee

Board Risk Committee report

Jane Hanson,
Chair of the Board Risk Committee

Role and focus

The Board Risk Committee provides oversight and advice to the Board in relation to current and potential future risk exposures of the Group and future risk strategy. It determines risk appetite and tolerance and promotes a risk awareness culture within the Group.

The Board Risk Committee's terms of reference are available on our website at: **www.directlinegroup.com**.

Membership and attendance[1]

	Scheduled meetings[2]	Ad hoc meetings[2]
Committee Chairs		
Ian Falconer[3]	1 of 1	n/a
Jane Hanson	5 of 5	2 of 2
Non-Executive Directors		
Mike Biggs[4]	1 of 1	1 of 2
Andrew Palmer	5 of 5	2 of 2
Clare Thompson	2 of 2	n/a
Priscilla Vacassin	2 of 2	n/a

Other attendees include

- Chief Executive Officer
- Chief Financial Officer
- Chief Risk Officer
- General Counsel and Company Secretary
- Head of Internal Audit

Minimum number of meetings per annum

The Risk Committee is to meet at least four times a year at appropriate times in the risk and regulatory reporting cycle.

Notes:

1. The Board Risk Committee was constituted on 16 October 2012. The attendance shown above includes attendance of the Risk and Audit Committee until it was split into distinct Audit and Board Risk committees with effect from 16 October 2012.
2 Attendance is expressed as the number of meetings attended out of the number of meetings possible or applicable for the Director to attend.
3. Resigned from the Committee on 23 February 2012.
4. A member between 28 May 2012 and 16 October 2012.

The activities of the Risk and Audit Committees were combined and managed by a joint Risk and Audit Committee until 16 October 2012. References to the activities of the Board Risk Committee below include those activities carried out by the Risk and Audit Committee.

What did the Committee do in 2012?

The Committee (and its predecessor, the Risk and Audit Committee) considered and monitored the following matters during 2012:

- The Group's key risks and risk appetite, including regulatory and conduct risks.
- The high level risk-based policies throughout the Group, including the risk appetite framework, policy framework, and associated tools and processes. These included, but were not limited to, the business change risk process, material risk assessment and business continuity planning.
- The detailed planning for the Group's internal Solvency II model. The Committee also received regular progress reports on the development of the models used to calculate economic capital requirements and the stress and scenario-testing techniques used to validate the results.
- Risks identified as outside appetite resulting from Internal Audit and other assurance reviews of the Group's system of internal control and the action taken by management to mitigate them.
- The Group's economic capital and liquidity positions, particularly in light of the evolving Eurozone uncertainty. The Committee also considered in detail the management actions being taken to address the impact of the economic environment.
- The arrangements by which our staff may, in confidence, raise concerns regarding possible improprieties regarding financial reporting or other matters.
- Monitored the Group's compliance with SOX 404 and other statutory and regulatory requirements and recommendations within the scope of the Committee's terms of reference.

What have we achieved?

- Revised the constitution and membership of the Committee to meet the requirements of a listed company.
- Approved of a comprehensive ERM framework.
- Oversight of the Solvency II programme.
- Ensured the risk governance framework was fit for purpose.

What will we be focusing on?

- Fostering a culture which is aligned to appropriate outcomes for the customer.
- Delivering a mature and embedded conduct risk framework.
- Considering and recommending for approval by the Board:
  - the design and implementation of risk management and measurement strategies across the Group; and
  - the Group's risk appetite, framework and tolerance levels for current and future strategy.

Frequency of meetings

During 2012, the Committee (and its predecessor the Risk and Audit Committee) met on seven occasions; five were scheduled meetings and two of which were additional ad hoc meetings. The members' attendance record is set out on page 71.

This report was reviewed and approved by the Board on 27 February 2013.

Jane Hanson, Chair of the Board Risk Committee

Corporate Social Responsibility Committee report

Jane Hanson,
Chair of the Corporate Social Responsibility Committee

Role and focus

The remit of the Corporate Social Responsibility Committee is to ensure Direct Line Group conducts its business in a responsible manner (including in relation to health and safety, environmental, corporate social responsibility, social and ethical matters). The Committee also oversees the allocation of donations and community involvement.

Membership and attendance

	Scheduled[1] meetings	Ad hoc[1] meetings
Committee Chair		
Jane Hanson	1 of 1	n/a
Committee members		
Paul Geddes	1 of 1	n/a
Clare Thompson	1 of 1	n/a
Tom Woolgrove[2]	1 of 1	n/a

Other attendees include

- Human Resources Director
- General Counsel and Company Secretary
- Director of Communications
- Head of Public Affairs and Sustainability

Minimum number of meetings

The Committee is to meet at least four times a year.

Notes:

1. Attendance is expressed as the number of meetings attended out of the number of meetings possible or applicable for the Director to attend.
2. Appointed as a member on 13 December 2012.

What did the Committee do in 2012?

The Corporate Social Responsibility Committee was constituted as part of the Fit for Listing programme and held its first meeting in December 2012. At that meeting, the Committee considered:

- The constitution of the Committee, its membership and terms of reference.
- The priorities and targets on key issues.
- Health and safety policies and procedures and compliance with them.

What have we achieved?

- Approved the constitution and membership of the Committee to meet the requirements of a listed company.
- Produced the Corporate and Social Responsibility Plan for 2013 including priorities, policies and community engagement activities.
- Launched the Company's 'One Day' volunteering initiative for employees.

What will we be focusing on?

- Reviewing the Group's overall Corporate Social Responsibility strategy, measures, policies and compliance.
- Reviewing performance and priorities against both internal targets and relevant external benchmarking indices.
- Reviewing the extent, effectiveness and transparency of external reporting.
- Considering and recommending the Group's positioning on relevant emerging Corporate Social Responsibility issues.
- Overseeing the Group's compliance with its health and safety statutory and regulatory requirements and embedding a health and safety culture across the Group.

This report was reviewed and approved by the Board on 27 February 2013.

Jane C Hanson.

Jane Hanson, Chair of the Corporate Social Responsibility Committee

Investment Committee report

Andrew Palmer,
Chair of the Investment Committee

Role and focus

The role of the Investment Committee is to propose investment policies and guidelines for the management of Group funds for approval by the Board and to oversee the management and performance of the investment strategy of the Group. The International and Life boards independently review and approve the investment guidelines of those entities.

Membership and attendance

	Scheduled meetings[1]
Committee Chair	
Andrew Palmer	2 of 2
Committee members	
Ian Falconer[2]	1 of 1
Jane Hanson	2 of 2
Christopher Sullivan[3]	0 of 1

Other attendees include

- Chief Executive Officer
- Chief Financial Officer
- Director of Investment Management and Treasury
- General Counsel and Company Secretary

Minimum number of meetings per annum

The Committee is to meet at least three times a year.

Notes:

1. Attendance is expressed as the number of meetings attended out of the number of meetings possible or applicable for the Director to attend.
2. Resigned from the Committee on 23 February 2012.
3. Resigned from the Committee on 27 January 2012.

What did the Committee do in 2012?

- Reviewed its membership, constitution and terms of reference.
- Considered plans and monitored progress in delivering a stand-alone Investment and Treasury function prior to operational separation from RBS Group.
- Monitored the delivery of in-train changes to the existing portfolio strategy.
- Reviewed the return on funds invested, having regard to existing investment policies and guidelines.
- Reviewed and monitored exposures of concern, in particular sovereign and bank exposure to Eurozone countries, and legacy positions outside the tolerance limits set in the risk exposure framework.
- Received updates on collateral management plans, the closure of legacy investment portfolios, changes to the asset manager for the International portfolios and recommendations to adjust credit durations for the Group's investment portfolios.
- Reported as appropriate to the boards of the regulated companies within the Group on our investment management performance.

What have we achieved?

- Monitored the successful creation of a stand-alone Investment and Treasury function.
- Reviewed the significant progress made by the Investment and Treasury function in reshaping the investment portfolios.

What will we be focusing on?

- Considering changes to the existing asset benchmark composition for the Group's investment portfolio to improve the expected risk-adjusted returns, respecting the Group's investment risk appetite set by the Board.
- Using the internal capital model to support asset strategy decisions by understanding the capital and solvency implications.
- Reviewing the liquidity requirements of the business and considering the adequacy of liquidity available to meet such needs from the investment portfolio.
- Reviewing the merits of any derivative and asset strategies proposed to mitigate risks associated with long-term liabilities.
- Monitoring the selection and implementation process for any new asset classes approved for the investment portfolio.

This report was reviewed and approved by the Board on 27 February 2013.

Andrew Palmer, Chair of the Investment Committee

Nomination Committee report

Mike Biggs,
Chair of the Nomination Committee

Role and focus

The Nomination Committee is responsible for considering and making recommendations to the Board regarding the appointment of Directors. It will make recommendations regarding the membership and chairmanship of the Board Committees.

The Nomination Committee's terms of reference are available on our website at: **www.directlinegroup.com.**

Membership

Committee Chair
Mike Biggs
Non-Executive Directors
Glyn Jones
Andrew Palmer

Other attendees include

- Chief Executive Officer
- General Counsel and Company Secretary

Minimum number of meetings per annum

As required, but not less than once a year.

Frequency of meetings

As the Board was up to full complement prior to listing on 16 October 2012, the Committee did not need to meet between listing and the year end. It has subsequently met to determine Directors' independence or non-independence for the purpose of recommending to the Board the re-appointment of Directors at the AGM.

The Committee is to meet at least once a year to consider the Board composition and membership of the principal Committees and to consider the suitability of all Directors standing for re-election at the AGM. The Committee will also meet as required to consider candidates for appointment to the Board. The Chief Executive Officer is closely involved in the work of the Committee and is invited to attend and contribute to meetings.

Appointments

During 2012, Mike Biggs, Mark Catton, Glyn Jones, Clare Thompson, Priscilla Vacassin and Bruce Van Saun were appointed to the Board. The appointment of Mike Biggs was managed by RBS Group as it wholly owned Direct Line Group at that time. Messrs Van Saun and Catton were nominated by the Company's majority shareholder, RBS Group. We recruited the remaining Non-Executive Directors appointed in 2012 with the help of external search consultants JCA Group, who have no other connection with the Company. As part of the process, those newly-appointed Directors met the Chairman, the Chief Executive Officer and a number of other Directors before being appointed.

Please refer to pages 66 to 67 for the Group's approach to diversity, including gender diversity.

This report was reviewed and approved by the Board on 27 February 2013.

Michael N Biggs, Chair of the Nomination Committee

Remuneration Committee report

Priscilla Vacassin,
Chair of the Remuneration Committee

Role and focus

The Committee is responsible for setting and oversight of the Group's remuneration policy. It also makes recommendations to the Board regarding the remuneration arrangements of the Company's Executive Directors and any applicable senior executives.

The Remuneration Committee's terms of reference are available on our website at: **www.directlinegroup.com.**

Membership and attendance

	Scheduled meetings[1]	Ad hoc meetings[1]
Committee Chairs		
Mike Biggs[2]	4 of 4	5 of 5
Andrew Palmer[3]	4 of 4	4 of 5
Priscilla Vacassin[4]	1 of 1	2 of 2
Non-Executive Directors		
Jane Hanson[5]	3 of 3	3 of 4
Clare Thompson[6]	1 of 1	1 of 1

Other attendees include

- Chief Executive Officer
- Chief Financial Officer
- Chief Risk Officer
- Human Resources Director
- Director of Performance and Reward
- General Counsel and Company Secretary
- FIT Remuneration Consultants LLP[7], independent adviser

Meeting frequency

The Committee is to meet at least four times a year.

Notes:

1. Attendance is expressed as the number of meetings attended out of the number of meetings possible or applicable for the Director to attend.
2. Chair until 21 September 2012. Continues as a member.
3. Acted as Chair for meetings held on 18 July, 13 August, 3 September and 21 September 2012. Continues as a member.
4. Chair from 21 September 2012.
5. Resigned from the Committee on 21 September 2012.
6. Appointed to the Committee on 21 September 2012.
7. Attends by invitation as the Committee's independent adviser.

What did the Committee do in 2012?

- Reviewed the constitution of the Committee, its membership and terms of reference.
- Set and reviewed policy guidelines.
- Proposed salaries for executives for the RBS Group Remuneration Committee to consider.
- Considered the terms of the Executive Directors', executives' and senior management's contracts.
- Finalised the rules for the executive and all-employee share plans and Share Ownership Guidelines and approved their adoption and establishment.
- Granted awards to eligible employees under the Long-Term Incentive Plan ("**LTIP**").
- Approved the issue of free shares to employees on IPO.
- Considered post-IPO pay arrangements for the Executive Directors and members of the Executive Committee.
- Established an Employee Share Ownership Trust, and considered the proposed approach to funding it and its relationship with the trustees.

What have we achieved?

- Revised the constitution and membership of the Committee to meet the requirements of a listed company.
- Approved a remuneration policy for the Group.
- Developed the remuneration and incentive arrangements for Executive Directors and senior executives of the Group and considered the treatment of legacy entitlements under RBS Group share schemes.
- Revised Executive Directors' and senior executives' contractual terms.
- Introduced all-employee share schemes.
- Agreed the high level principles and key terms of the 2013 incentive plan arrangements.
- Recommended outcomes of the 2012 bonus award and LTIP.
- Prepared the Group's first Directors' remuneration report and recommended its inclusion in the 2012 Annual Report & Accounts.

What will we be focusing on?

- The 2013 remuneration and incentive plan arrangements in tandem with reviews of the pay review budget for 2013 and the outcomes from the annual performance review.
- The grants of awards under the Group's share schemes.
- The roll-out of the all-employee Buy-As-You-Earn scheme.
- The share ownership guidelines for members of the Executive Committee.
- The possible outcomes of the 2013 Annual Incentive Plan ("**AIP**") and the structure of the 2014 plan in light of the experience in 2013.

This report was reviewed and approved by the Board on 27 February 2013.

Priscilla Vacassin, Chair of the Remuneration Committee

Relations with shareholders

What does 'relations with shareholders' mean?

Actively engaging with our shareholders is fundamental to our business. We believe that ensuring an active dialogue and ongoing engagement is vital to keeping in touch with opinions, providing us with the opportunity to address any questions and concerns in a proactive way.

How do we communicate with shareholders?

The Executive Directors frequently meet with investors and the Chairman, Senior Independent Director and Non-Executive Directors are available to attend meetings with major shareholders at the shareholders' request. In such meetings, the Chairman has the opportunity to discuss governance and strategy with shareholders and ensure that any particular shareholder views are communicated to the Board.

The Board is also given the opportunity to understand the views of major shareholders through analysts' reports, broker briefings and meetings with major shareholders.

At the Company's first AGM the Chief Executive Officer will make a presentation on the Group's progress and shareholders will be encouraged to ask questions.

The Company also engages with holders of the Group's subordinated debt.

What did we do in 2012?

During the year, Directors spent a considerable amount of time understanding the views of potential investors and other market participants, to ensure they were aware of market sentiment in the run-up to, and following, the IPO. In October, the Chief Executive Officer, the Chief Financial Officer and members of the executive between them met and presented to 292 institutions, seeing over 700 individuals across eight cities (with calls to six more).

What are we focusing on in 2013?

We are planning to hold a number of events to foster engagement, in recognition of the importance of maintaining an active dialogue with our shareholders, target investors and other important insurance sector investors. These include:

- Presentations of our financial results.
- Investor road shows in the UK, Europe, the US and Canada.
- Attending key conferences to enable communication with a large number of existing and target investors in a time-efficient manner.
- Briefings with investors and banks to convey key messages on performance and strategy.
- Dinners with UK fund managers at the end of 2013.

What arrangements are we making for the Annual General Meeting?

The Notice of the AGM will be sent to shareholders well in advance of the meeting. We will propose all items requiring shareholder approval under separate resolutions.

We will provide proxy appointment forms for each resolution, with the option for shareholders to vote for, or against, or to withhold their vote. We have instructed our registrars, Computershare Investor Services plc, to ensure that all valid proxy appointments are properly recorded and counted.

We will announce the result of the poll as soon as practical after the meeting and also post the result on our website after that date. The proxy form and announcement of the results explicitly state that a vote withheld is not a vote in law and will therefore not be counted in the calculation when deciding whether the resolution has been passed.

We anticipate that all Directors will attend the AGM and that the Chairs of the Audit, Board Risk, Corporate Social Responsibility, Investment and Remuneration Committees will be available to answer questions.

What is the procedure at the AGM?

Following presentations by members of the Board, voting on the resolutions at the AGM will be conducted on a poll. Shareholders' proxy votes can be submitted electronically through the Company Registrar's website. Further details can be found in the Notice of AGM.

Directors' remuneration report

Priscilla Vacassin, Chair of the Remuneration Committee

Dear shareholder

I welcome you to this, the first remuneration report of Direct Line Insurance Group plc. In such a competitive market, we believe that our employees are critical to the success of our business, both now and into the future. As a result, the Group's remuneration policy seeks to provide, in the context of the Group's business strategy, a reward proposition at the right cost to attract, retain, motivate and reward high-calibre employees, so that they are engaged to deliver superior long-term business performance within acceptable risk parameters.

In determining Executive Directors' remuneration levels in the Group, we have endeavoured to provide fair pay for the job whilst also taking into account the context of pay in the wider market and their individual performances.

Linking remuneration to overall business objectives

The Group's strategy, building on its transformation plan, is to unlock the value in the UK's leading retail general insurance business, together with the Commercial and International businesses and to deliver superior shareholder returns, targeting a 15% RoTE and COR of 98%.

Our remuneration policy supports this strategy. Executive Directors will only receive their full remuneration opportunity if material value is created for our shareholders.

Similarly, we remain committed to the position disclosed at IPO of providing Executive Directors' remuneration at a market-competitive level compared with relevant peer companies.

- The 2013 salary pool available for pay increases is 2% of base pay. The pool will be distributed based on the individuals' positions in the market and their personal performance. There will be no general increase for all employees. For the Strategic Leadership Team (the "**SLT**") the average increase will be slightly less than 2%. It is not the intention of the Remuneration Committee (the "**Committee**") to award a pay increase to either of the Executive Directors in 2013 due to their packages having been reviewed just prior to the IPO.
- The 2012 bonus overall outcome is that the Group bonus payout is marginally below 'On-target' in aggregate. We have made good progress on our transformation plan, and the Board is encouraged by the progress towards the targets disclosed in September 2012. However, the level of bonus set in aggregate by the Committee takes into account a wider set of criteria than just these, including general affordability and market practice. We believe that the planned payout is appropriate taking into account these wider criteria. We intend to continue to set stretching but achievable targets for future bonus awards across a range of criteria.
- The 2013 bonus opportunity remains unchanged from the levels disclosed at IPO and for 2013 the metrics will be applied on a rigorous 'balanced scorecard' approach that accords with insurance industry practice. This will include financial, risk-based and customer-centric targets.
- We intend to continue the practice of making LTIP grants at regular six-month intervals at the levels indicated at the IPO and applying stretching performance conditions over each award's performance period.

Structure of report

Over the following pages we set out:

- The governance surrounding pay decisions in 2012, members of the Committee and advisers to the Committee in 2012.
- The Group's forward-looking pay policy which is effective for the financial year beginning 1 January 2013.
- The implementation of the Group's Reward Policy in 2012 and what was paid, vested or awarded (conditional upon the application of performance tests) to Executive Directors in respect of the financial year ended 31 December 2012.

As an insurance business, the Group is not subject to the provisions of the FSA's Remuneration Code. However, the Group seeks to comply with the core requirement of this code that it should establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management. Accordingly, for all senior employees, significant elements of incentive-related pay are subject to deferral and potential clawback as explained on pages 80 to 81.

Priscilla Vacassin, Chair of the Remuneration Committee

The Remuneration Committee independent review

Governance

The remuneration report has been prepared in accordance with the requirements of the Companies Act 2006 and Schedule 8 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

This report also provides a number of the requirements of the prospective new regulations recommended by the Department for Business, Innovation & Skills ("**BIS**") (albeit these are still in draft format) which will take effect in respect of financial years ending on or after October 2013.

The Group also complies with the Code in relation to remuneration. The Group is an active member of the Association of British Insurers (the "**ABI**"). The Committee, consistent with its approach of operating within the highest standards of corporate governance, takes significant account of guidelines issued by the ABI and shareholder bodies (such as the National Association of Pension Funds) when setting the remuneration strategy for the Group. The Committee will also seek to build an active and productive dialogue with investors generally and on changes to the Group's executive pay arrangements in particular.

Under its terms of reference the remit of the Committee, which is a committee of the Board, is to set and oversee the remuneration policy and contract terms of the Executive Directors, the Chairman of the Board and members of the Executive Committee. It also reviews the overall pay and bonus decisions in aggregate for the wider Group and therefore takes account of pay and conditions in the wider Group. The remuneration of the Non-Executive Directors is determined by the Board as a whole, without the individuals concerned being present.

This report has been prepared by the Committee and approved by the Board, for submission to shareholders at the 2013 AGM.

In 2012, the Committee met nine times.

Deloitte LLP has audited the following items, as stipulated by law:

- the table of Directors' emoluments and associated footnotes on page 86 and the disclosure of the items comprising benefits in kind;
- the tables of pensions benefits on page 90; and
- the table of disclosure of Executive Directors' share options and share awards on pages 88 to 90 and associated footnotes.

The Committee is made aware of input from employee groups (such as the ERB) within the Company. The Committee consults with the Chief Executive Officer and the Human Resources Director on matters relating to the appropriateness of all elements of remuneration for Executive Directors and other leadership team members. The Chief Executive Officer and the Human Resources Director are not present when their own remuneration is discussed. The Director of Performance and Reward provides advice on compensation and benefits to the Committee, and the Company Secretary advises the Committee on corporate governance guidelines and provides secretarial assistance to the Committee.

In addition, the Committee has appointed FIT Remuneration Consultants LLP ("**FIT**"), signatories to the Remuneration Consultants Group's Code of Conduct, as their independent adviser. FIT provided advice during the year on market practice, governance and incentive plan design. FIT does not provide any other services to the Group. Their total fees for the provision of remuneration services in 2012 were £274,883. Allen & Overy LLP has also provided legal advice in relation to the Group's executive remuneration arrangements, and has provided the Group with other legal services.

Future remuneration policy

Policy table

Remuneration for Executive Directors for the financial year commencing 1 January 2013 consists of the following elements:

Element	Purpose and link to strategy	Operation
Base salary	• This is the core element of pay that reflects the individual's role and position within the Group and is payable for doing the expected day-to-day job. • Ensuring we are competitive in the market allows us to attract, retain and motivate high-calibre employees with the skill sets to deliver our key aims whilst managing costs.	• Salaries are reviewed against: – level of skill, experience and scope of responsibilities, individual and business performance, economic climate and market conditions;
Annual Incentive Plan	• To motivate employees and incentivise delivery of performance over the one-year operating cycle, focusing on the short to medium-term elements of our strategic aims. • Company and individual performance can be reflected through variable pay. • Outstanding individual and Company performance is recognised and rewarded.	• Maximum and target bonus levels for Executive Directors are set by reference to practice at insurance and general market comparators. • The maximum bonus level potential under the AIP for the CEO is 175% of base salary, and for the CFO is 150% of base salary. • Target bonus – which is paid for on-target performance against the performance measures being operated for the AIP in the relevant financial year – is currently set at 60% of the maximum opportunity. • Performance over the financial year is measured against stretching financial and non-financial and individual performance targets set at the start of the financial year.
2012 Long-Term Incentive Plan	• To motivate and incentivise delivery of sustained performance over the long term, aligning interests with those of the shareholders. • Measures are those key to the business and driving long-term value to shareholders, to ensure that all major decisions are considered with long-term value in mind.	• Awards under the LTIP will be made twice in each financial year of the Company (at approximately six-month intervals following the announcement of the Company's annual and half-yearly results). For the Executive Directors, bi-annual awards will be made over shares with a face value equal to 100% of their then salary on each occasion. • The plan generally allows for awards with an absolute maximum value of 200% of base salary per financial year (although 300% is permitted in exceptional circumstances). • Awards are made in the form of nil-cost options which vest to the extent performance conditions are satisfied, three years from the date of grant. An additional share payment in lieu of dividends is also paid at vesting.
Pension	• To aid retention and remain competitive within the market place. • To encourage retirement planning by our employees and retain flexibility for individuals.	• Pension contributions are paid only in respect of base salary.
Benefits	• A comprehensive flexible benefits package is offered, with the emphasis on employees being able to choose the combination of cash and benefits that suits them. • This element supports many of our values, but particularly that in return for our employees 'bringing all of themselves to work', we will consider them as whole individuals with needs in and outside of the workplace.	• Executive Directors receive a benefits package in line with market practice. This includes a company car allowance, private medical insurance, life assurance and income protection insurance.
All employee share plans	• To encourage share ownership by employees, thereby allowing them to share in the long-term success of the Group and align their interests with those of the shareholders.	• Executive Directors are able to participate in the all-employee share plans on the same terms as other Group employees.
Shareholding guidelines	• To encourage share ownership by the Executive Directors and ensure interests are aligned.	• The Executive Directors and Executive Committee members are subject to Share Ownership Guidelines and, until they comply with these, are required to retain all of the Ordinary Shares that they obtain from any of
New hires and promotions	• To secure the appointment and promotion of high-calibre executives to strengthen the management team and secure the skill sets to deliver our strategic aims.	• For external appointments the Committee may offer additional cash and share-based elements when they consider it in the best interests of the Company and therefore of shareholders.

		Changes for 2013
– the median market pay in the context of insurance peers (Aviva, Hiscox, L&G, Old Mutual, Prudential, RSA, Resolution and Standard Life) and FTSE 31 to 100 listed companies; and – general base salary movement across the Group.	• Similar principles for base salary are applied to all employees in the Group. • Base salary is paid monthly in cash.	Base salaries are reviewed annually and set in April of each year. No changes will be made to the Executive Directors' salaries in 2013.
• Bonus levels and the appropriateness of measures and weightings are reviewed annually to ensure they continue to support our strategy. • Awards will be subject to a payment gateway such that the Committee must be satisfied that there are no material risk failings, reputational concerns or regulatory issues.	• For Executive Directors and senior employees, 40% of the award is deferred into shares vesting three years after grant. The percentage deferred will be kept under review by the Committee to ensure that levels are in line with regulatory requirements and best practice. The vesting of Deferred Share Awards is subject to potential clawback at the discretion of the Committee. An additional share payment in lieu of dividends is also paid at vesting of Deferred Share Awards. • All variable pay awards are subject to clawback up to three years post vesting at the discretion of the Committee.	2013 AIP targets are set as per detail on pages 84 and 85.
• The Committee will determine the performance condition for each award made under the LTIP, with performance measured over a single period of three years with no provision to retest. • Performance is measured against stretching targets set at the beginning of the performance period. For awards granted in 2012 vesting is determined based on two measures: – 60% will be based on RoTE performance; and – 40% will be based on relative total shareholder return ("**TSR**") performance against the FTSE 350 (excluding Investment Trusts). • Awards will be subject to a payment gateway such that the Committee must be satisfied that there are no material risk failings, reputational concerns or regulatory issues.	• In addition, there will be an underpin relating to the Committee's view of the underlying financial performance of the Company. • The use of RoTE and TSR in combination provides a balanced approach to the measurement of the Group's performance over the longer term by using both a stated financial KPI and a measure based on shareholder return. • The vesting of all awards is subject to clawback at the discretion of the Committee.	Full details of the performance conditions and targets for 2012 and 2013 awards are set out on page 85.
• Executive Directors are eligible to participate in the Group's defined contribution pension arrangement or alternatively they may choose to receive a cash allowance in lieu of pension.	• This is in line with the approach taken for all Group employees.	
• Employer products are offered to all employees at a discount. This discount is the same that is offered to all employees.		
the Company's employee share plans after any disposals necessary for the payment of personal taxes on the acquisition of such Ordinary Shares.	• The CEO and CFO are required to acquire and retain Ordinary Shares in the Company equivalent in value to no less than 200% and 150% of their salaries respectively.	
• For an internal appointment, any variable pay element awarded in respect of the prior role may either continue on its original terms or be adjusted to reflect the new appointment as appropriate.	• For external and internal appointments, the Committee may agree that the Group will meet certain relocation expenses as appropriate.	

There have been no changes (nor are there any planned in 2013) to remuneration for Executive or Non-Executive Directors since the Group listed on the London Stock Exchange.

Service agreements

The Executive Directors' service agreements summary is as follows:

Director	Effective date of contract	Notice period	Exit payment policy
Paul Geddes	1 September 2012	12 months	Base salary only for unexpired portion of notice period and to be paid in a lump sum or monthly instalments, in which case instalments are subject to mitigation if an alternative role is found.
John Reizenstein	1 September 2012	12 months	Base salary only for unexpired portion of notice period and to be paid in a lump sum or monthly instalments, in which case instalments are subject to mitigation if an alternative role is found.

Termination policy summary

It is appropriate for the Committee to retain discretion to consider the termination terms of any Executive Director, having regard to all the relevant facts and circumstances available to them at the time. The table below sets out the general position although it should be noted that the Committee, consistent with most other companies, has reserved a broad discretion to determine whether an Executive Director should be categorised as a 'good leaver' and that discretion forms part of the approved policy. Similarly, while the policy is generally to reduce awards on a pro-rata basis, the Committee has reserved discretion to disapply such reduction if, in the circumstances, it considers that to be appropriate.

Incentives	If a leaver is deemed to be a 'bad leaver', for example leaving through resignation or dismissal	If a leaver is deemed to be a 'good leaver', for example leaving through redundancy, ill health or death or otherwise at the discretion of the Committee	Other events, for example change in control
Annual Incentive Plan	No awards made	Pro-rata bonus	Pro-rata bonus
Deferred Annual Incentive Plan (the "**DAIP**")	All awards will lapse	Will receive all deferred shares at the end of the vesting period	Will usually receive all deferred shares
Long-Term Incentive Plan	All awards will lapse	Will receive a pro-rata award subject to the application of the performance conditions at the end of the vesting period	Will receive a pro-rata award subject to the application of the performance conditions

For as long as RBS Group owns more than 50% of the Ordinary Shares in the Company, Paul Geddes's and John Reizenstein's service agreements will continue to have the RBS Group policy provision regarding termination without notice or payment in lieu when personal underperformance is not remedied following a warning from the Board and after reasonable opportunity to remedy it has been given. The Direct Line Group Directors' service agreement provides that Paul Geddes and John Reizenstein are not eligible to receive any enhanced redundancy terms which may be offered by Direct Line Group from time to time. Their rights to a statutory redundancy payment are not affected.

Non-Executive Directors

Non-Executive Directors are appointed for a three-year term which may be renewed by mutual agreement. In common with the Executive Directors, all Non-Executives are subject to annual re-election by shareholders. The term of either Bruce Van Saun or Mark Catton as Directors will cease when RBS Group divests its controlling interest in Direct Line Group. Both will step down as Directors when RBS Group owns less than 20% of Direct Line Group; one will step down once the shareholding drops below 50% and the other when the shareholding drops below 20%.

The Directors may appoint additional members to join the Board during the year. Directors appointed in this way will be subject to election by shareholders at the first AGM after their appointment. In subsequent years the Directors are expected to submit themselves for re-election at the AGM.

Details of the terms of appointment of the serving Non-Executive Directors are set out in the table below:

Non-executive director	Position	Effective date of contract
Andrew Palmer	Non-Executive Director	23 March 2011
Jane Hanson	Non-Executive Director	20 December 2011
Mike Biggs	Chairman	27 April 2012
Bruce Van Saun	Non-Executive Director	27 April 2012
Clare Thompson	Non-Executive Director	3 September 2012
Priscilla Vacassin	Non-Executive Director	13 September 2012
Glyn Jones	Senior Independent Director	24 September 2012
Mark Catton	Non-Executive Director	24 September 2012

Terms and conditions of appointment of all of the Directors are available for inspection by any person at the Company's registered office and at the AGM.

The Chairman and Non-Executive Directors have notice periods of three months from either party.

The Chairman and Non-Executive Directors are not entitled to any compensation on exit.

External directorships

The Group encourages Executive Directors to accept, subject to the approval of the Chairman, an invitation to join the board of another company outside the Group in a non-executive capacity, recognising the value of such wider experience. In these circumstances, they are permitted to retain any remuneration from the non-executive appointment. Executive Directors are limited to accepting one external appointment.

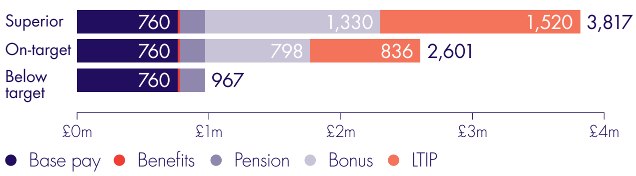
Currently the Executive Directors do not hold any external appointments.

Indicative total remuneration levels

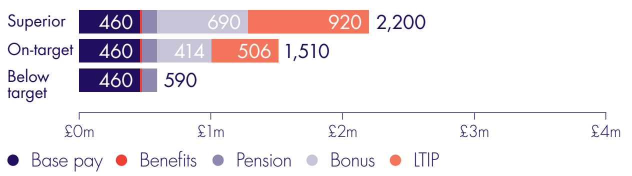
The charts below aim to show how the remuneration policy set out above for Executive Directors is applied by way of hypothetical performance scenarios.

- Superior – maximum bonus and maximum vesting under the LTIP.
- On-target – on-target bonus of 60% of maximum and LTIP vesting of 55% of maximum (10% of maximum bonus and 20% of maximum LTIP vest at threshold levels of performance).
- Below target – no bonus and no vesting under the LTIP.

Paul Geddes (£'000)



John Reizenstein (£'000)



Note: Share price growth and the value of dividend roll-up are ignored in this analysis.

2012 implementation

Base pay

The current base salaries paid to the Executive Directors, effective 1 October 2012, are:

Director	Position	Date of appointment to Direct Line Group role	Base salary £'000
Paul Geddes	Chief Executive Officer	1 September 2012	760
John Reizenstein	Chief Financial Officer	1 September 2012	460

There will be no increase to Executive Directors' salaries in 2013.

Annual Incentive Plan

For the 2012 AIP, the Committee determined the level of award for Paul Geddes, taking into account the views of RBS Group on his performance. The award for John Reizenstein was agreed by the Committee, making an assessment against the targets set by RBS Group at the beginning of 2012. Overall, the Committee felt the bonus outcome was marginally below 'On-target'. The Committee acknowledged that the commitments set out at IPO have been met, and that the share price has increased significantly since listing. However, taking into account wider factors and internal stretch targets, overall performance was slightly below 'On-target'.

For all other employees, their performance was assessed against the targets set at the beginning of 2012, and senior employees were specifically considered by the Committee.

Resulting from the performance described above, the annual incentive awards payable to the Executive Directors in respect of the financial year ended 31 December 2012 are:

Director	Position	Maximum annual incentive award (% of base salary)	Actual annual incentive award for 2012[1] (% of base salary)	Actual annual incentive award for 2012 £'000
Paul Geddes	Chief Executive Officer	175%	100%	760
John Reizenstein	Chief Financial Officer	150%	75%	345

Note:

1. Paul Geddes's bonus outcome for 2012 will be deferred on terms comparable to those applying to all members of the RBS Group Executive Committee, due to his having been a member of the RBS Group Executive Committee for nine months of the year, with the exception that any deferral is into the Company's shares. John Reizenstein's bonus will be paid 60% in cash and 40% in deferred shares under the DAIP as per the plan for all other senior employees.

Deferred Annual Incentive Plan

The table below shows details of the deferred awards granted to Paul Geddes and John Reizenstein for the 2012 financial year.

	Total award £'000	Percentage deferred	Vesting date(s)
Paul Geddes	760	60%	March 2013 – 2016
John Reizenstein	345	40%	March 2016

Annual Incentive Plan measures in 2013

For the Executive Directors, 75% of bonus opportunity is linked to clearly measureable corporate targets. These comprise a balanced scorecard of measures, which reflects both financial and strategically important non-financial measures (including a customer-based assessment), with the majority being financial measures. The final 25% is linked to clear personal objectives. Personal objectives are set in line with the Group's values and will be measured based on achievement of objectives and demonstration of these values.

Type of measure	Measure	Weighting
Financial	Profit	35%
Financial	Combined operating ratio	10%
Financial	£100 million gross annual cost savings in 2014	10%
Financial & risk adjusted	Risk management within risk appetite	10%
Strategic KPI	Customer satisfaction measure	10%
Personal objectives	No more than five defined objectives	25%

Long-Term Incentive Plan
The Company's policy is to make awards twice a year following the announcement of the Company's full and half-year results. The first awards were made on 7 November 2012, following IPO. These awards were treated by the Committee as an ordinary award, consistent with awards that will usually be made in the second half of the Company's financial year. The value of these awards was, therefore, equal to 50% of the normal annual policy level, that is, the awards granted to Paul Geddes and John Reizenstein were over Ordinary Shares with a face value of 100% of their salary. Awards were also granted to SLT members for lower amounts than those applicable to the Executive Directors.

Details of RBS Group long-term incentive awards previously made to the Executive Directors under RBS Group plans (prior to the IPO) are disclosed on page 89.

Performance conditions for awards made in 2012
The initial awards granted on 7 November are subject to the achievement of the following performance conditions:

- 60% is based on RoTE over a two-year performance period (2013 and 2014); and
- 40% is based on relative TSR performance against the constituents of the FTSE 350 (excluding investment trusts) over a three-year performance period starting on 16 October 2012. The starting TSR is measured over the period of one month following 16 October 2012 and closing TSR will be measured over the last three months of the three-year period.

For these purposes, the Company's standard definition for RoTE is used, subject to such other adjustments as the Committee considers appropriate.

The performance targets are as follows:

Performance measure	Threshold vesting	Maximum vesting
RoTE	20% of portion of award vests for average annual RoTE performance of 14%	Full vesting for average annual RoTE performance of 17%
Relative TSR	20% of portion of award vests for median performance	Full vesting for upper quintile performance

Vesting on the RoTE scale is weighted, with 40% vesting for RoTE of 15%. Otherwise, there is straight line interpolation by ranking between these points.

In addition, the LTIP awards will only vest to the extent that the Committee is satisfied that the outcome of the TSR and RoTE performance conditions reflects the underlying financial performance of the Group over the period from the awards date until vesting. In making these considerations, the Committee will take into account whether there have been any material risk failings.

Free share awards
Following the IPO in October, an offer of 143 shares (worth approximately £250 at the time of offer) was made to all employees in the Group under the all-employee, HMRC-approved, Share Incentive Plan ("**SIP**"). The SIP is not subject to performance conditions and the shares vest after three years. Both Executive Directors accepted this offer.

Pension provision

Paul Geddes elected to become a member of the Group's defined contribution pension plan with effect from 1 September 2012. Prior to this, he was a participant in an RBS Group defined benefit plan. Going forward, he receives a combination of Company contributions and a taxable cash allowance together worth 25% of annual gross salary. Information on the transfer value of his RBS Group legacy defined benefit pension can be found on page 90.

John Reizenstein elected not to join the Group's defined contribution pension plan and receives a taxable cash allowance in lieu of Company contributions. The cash payment is equal to 25% of annual gross salary.

Chairman and Non-Executive Directors' fees

The fees paid to the Chairman are inclusive of all Board and Committee membership fees and are determined by the Committee. The Chairman's fees have been set at £400,000 per annum.

The fees of the other Non-Executive Directors are determined by the Board, with affected persons absenting themselves from the deliberations, and aim to be competitive with other fully listed companies of equivalent size and complexity.

Additional fees are paid to Non-Executive Directors who chair a Board Committee or sit on a Board Committee and to the Senior Independent Director.

The Non-Executive Directors are not entitled to receive any compensation for loss of office and are not entitled to participate in the Company's bonus, employee share plan or pension arrangements. Fee levels for Non-Executive Directors are reviewed annually and set in April of each year.

The fees for the Chairman and Non-Executive Directors set in 2012 are as follows:

Position	Fees £'000
Basic Non-Executive Director fee	70
Additional fees	
Senior Independent Director fee	30
Chair of Board Committee (Audit, Risk and Remuneration)	30
Chair of Board Committee (CSR)	10
Member of Board Committee (Audit, Risk and Remuneration)	10
Member of Board Committee (CSR and Nomination)[1]	5

Note:

1. As there were no Nomination Committee meetings in 2012, the fees for membership of this Committee were waived.

Total remuneration for the 2012 financial year

Remuneration for the Executive Directors for the year ended 31 December 2012 was as follows:

	2012 Base salary[1] £'000	2012 Allowances and benefits[2] £'000	2012 Pension contributions and cash allowance in lieu of pension[3] £'000	2012 Bonuses awarded for performance during the year[4] £'000	2012 Total emoluments £'000	2011 Total emoluments[7] £'000	2012 Participation in RBS Group defined benefit plan[5] £'000	2012 LTI awards vesting[6] £'000	2012 Single figure of remuneration £'000
Paul Geddes	671	44	189	760	1,664	1,721	35	162	1,861
John Reizenstein	407	27	115	345	894	937	n/a	n/a	894

Notes:

1. Base salary earned during the financial year ending 31 December 2012. This includes eight months as an employee of RBS Group and four months as an employee of Direct Line Group.
2. Benefits in kind and allowances made during the financial year ending 31 December 2012. This includes eight months as an employee of RBS Group and four months as an employee of Direct Line Group.
3. This figure represents the cash equivalent received in lieu of pension whilst an employee of RBS Group and Direct Line Group.
4. Annual bonus includes both the cash element received and the deferred element awarded in relation to the financial year ending 31 December 2012.
5. This is the change in accrued benefits in RBS Group defined benefit plans for Paul Geddes.
6. This figure represents the vesting of the Medium Term Performance Plan award during the financial year ending 31 December 2012, with performance conditions and appropriate vesting amounts assessed by the RBS Group Remuneration Committee.
7. The 2011 statutory figure for John Reizenstein includes a buyout award granted on his appointment in 2011 that had a total value of £219,567 and which vests over a three-year period.
8. Sheree Howard was an Executive Director for the period to 23 March 2012. Pro-rata remuneration during 2012 amounted to base pay of £58,750, benefits of £5,946, pension of £10,572 and bonus of £31,500. The amounts for the year to 31 December 2011 amounted to base pay of £215,000, benefits of £22,409, pension of £17,620 and bonus of £130,000.

Remuneration for the Non-Executive Directors for the year ended 31 December 2012 was as follows:

	Total 2012[1] £'000	Total 2011[1] £'000
Mike Biggs	269.8	–
Andrew Palmer	81.6	45.0
Jane Hanson	79.8	–
Clare Thompson	30.7	–
Priscilla Vacassin	29.1	–
Glyn Jones	26.9	–
Mark Catton	–	–
Bruce Van Saun	–	–
Chris Sullivan[2]	–	–
Ian Falconer[2]	8.3	47.3

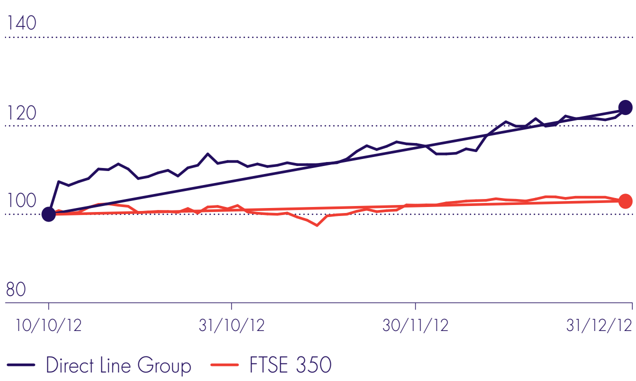
Notes:

1. The only remuneration paid to the Directors in 2011 and 2012 was in the form of fees.
2. Chris Sullivan and Ian Falconer resigned as Directors in 2012.

Bruce Van Saun and Mark Catton are RBS Group employees and fees are paid to RBS Group. Under the RBS Group policy on internal Non-Executive Directors, Chris Sullivan was not eligible to receive fees for the period he was a Director.

Historical total shareholder return performance

This graph is a requirement of Schedule 8 to The Large and Medium-sized Companies and Group (Accounts and Reports) Regulations 2008. However, as the Group has only existed as an independent entity since October 2012 we have provided the entire three-month historical performance versus the TSR of the FTSE 350 index over the same period.



Shareholdings

The Executive Directors are subject to the Group's Share Ownership Guidelines and until they reach the required amount they must retain the Ordinary Shares obtained from any of the Group's employee share plans after any disposals necessary for the payment of personal taxes on the acquisition of such Ordinary Shares. For these purposes, the holding of Ordinary Shares will be treated as including all vested but unexercised awards, valued on a basis that is net of applicable personal taxes.

Directors	Shares held at 31 December 2012[1, 2]
Mike Biggs	–
Paul Geddes	57,142
John Reizenstein	57,142
Andrew Palmer	11,428
Jane Hanson	28,571
Clare Thompson	28,571
Priscilla Vacassin	28,571
Glyn Jones	57,142
Mark Catton	–
Bruce Van Saun	–

Notes:

1. There are no changes between the year-end and a date not more than one month prior to the date of the notice for the AGM.
2. Includes holdings of connected persons, as defined in sections 252 – 255 of the Companies Act.

Direct Line Group share awards

The table below details the unvested awards held by Paul Geddes and John Reizenstein made under the Group's LTIP.

Director and scheme	Options held at 1 January 2012	Options granted during the year	Options vested during the year	Options cancelled during the year	Options held as at 31 December 2012	Grant date	Market price at date of grant £	Vesting date
Paul Geddes LTIP[2]	–	388,250	–	–	388,250[3]	7 November 2012	1.96	7 November 2015
John Reizenstein LTIP[2]	–	234,993	–	–	234,993[3]	7 November 2012	1.96	7 November 2015

Notes:

1. The Group's share price on 31 December 2012 was £2.164 and the range of prices in the portion of the year where the Group was listed (16 October 2012 to 31 December 2012) was £1.865 to £2.164.
2. These awards take the form of nil-cost options over the Group's shares and are subject to performance conditions to be assessed by the Committee and as described on page 85.
3. This figure does not include those RBS Group LTIP awards transferred into the Direct Line Group's share options during 2012 as per the table on page 89.

Direct Line Group free share awards

The table below details the unvested awards held by Paul Geddes and John Reizenstein made under the all-employee free share awards over 143 shares per employee referred to earlier in this report.

Director and scheme	Awards held as at 1 January 2012	Awards granted during the year	Awards vested during the year	Awards lapsed during the year	Awards held as at 31 December 2012	Grant date	Market price at date of grant £	Vesting date
Paul Geddes Free Share Award	–	143	–	–	143	27 November 2012	2.02	27 November 2015
John Reizenstein Free Share Award	–	143	–	–	143	27 November 2012	2.02	27 November 2015

Note:

1. The Group's share price on 31 December 2012 was £2.164 and the range of prices in year (11 October 2012 to 31 December 2012) was £1.865 to £2.164.

Dilution

Direct Line Group is not permitted to make awards over unissued shares while remaining a major subsidiary undertaking of RBS Group. In due course, unissued shares may be used and the Direct Line Group will ensure that it complies with both of the dilution levels recommended by the ABI guidelines (of 10% in 10 years for all share plans and 5% in 10 years for discretionary plans) consistent with the rules of the Direct Line Group's share plans. To date, legacy RBS Group awards to be satisfied in Direct Line Group shares will be satisfied by RBS Group rather than the Direct Line Group and RBS Group have placed shares in trust to facilitate this.

Legacy RBS Group awards vesting in the year

The Executive Directors continue to hold unvested awards previously granted to them under the RBS Group Employee Share Plans as employees of the RBS Group. We include details of these awards within our report as they were awarded to the Executive Directors in respect of their work as Executive Directors of Direct Line Group (previously RBS Insurance).

For the Medium Term Performance Plan award vesting to Paul Geddes in 2012, RBS Group determined the level which would vest based on the original performance targets as set at grant.

RBS Group Medium Term Performance Plan

Director and scheme	Awards held at 1 January 2012	Awards granted during the year	Awards vested during the year[2]	Awards lapsed during the year	Awards held as at 31 December 2012	Grant date	Market price at grant date £	Vesting date
Paul Geddes	125,294	–	75,176[1]	50,118	–	22 May 2009	4.09	22 May 2012

Note:

1. The market price of RBS Group shares at vesting was £2.16.

RBS Group Long-Term Incentive Plan ("RBS Group LTIP") awards

Awards originally granted under the RBS Group LTIP in 2011 and 2012 will now be delivered in the Direct Line Insurance Group plc shares transferred by RBS Group to the extent that the originally set performance conditions for these awards are considered achieved by the RBS Group Remuneration Committee.

The table below details the awards made to Paul Geddes and John Reizenstein under RBS Group plans which will vest in Direct Line Insurance Group plc shares.

Director and scheme	Awards held at 1 January 2012 (RBS Group shares)	Awards granted during the year	Awards vested during the year	Conversion of RBS Group shares to DLG shares in November 2012[2,3]	Awards held as at 31 December 2012 (DLG shares)	Grant date	Market price at grant date (RBS Group shares) £	Vesting date
Paul Geddes								
RBS Group LTIP 2011	337,139	–	–	501,394	501,394	7 March 2011	4.45	7 March 2014[2]
RBS Group LTIP 2012	–	535,906	–	797,000	797,000	9 March 2012	2.80	9 March 2015[2]
John Reizenstein								
RBS Group LTIP 2011	69,226	–	–	102,953	102,953	7 March 2011	4.45	7 March 2014[2]
RBS Group LTIP 2012	–	120,578	–	179,324	179,324	7 March 2012	2.80	7 March 2015[2]

Notes:

1. The Direct Line Insurance Group plc share price at 31 December 2012 was £2.164 and the range of prices in year (11 October 2012 to 31 December 2012) was £1.865 to £2.164.
2. It was agreed with RBS Group that participants now employed by Direct Line Group holding awards granted in 2011 and 2012 under the RBS Group LTIP would be given the opportunity to have those awards satisfied by the transfer of Direct Line Insurance Group plc shares from RBS Group on vesting. The conversion rate applied to these awards was the average price of RBS Group shares over the five business day period prior to 11 October 2012 divided by the Direct Line Insurance Group plc share offer price (£1.75). This conversion equated to 1.487 Direct Line Insurance Group plc shares for every RBS Group share under grant. Both Executive Directors took up this offer.
3. These are subject to performance conditions to be assessed by the RBS Group Remuneration Committee. The conditions relate to financial and operational performance against the strategic plan for Direct Line Group and effective risk management with, in the case of Paul Geddes only, 25% of vesting also dependent upon RBS Group performance. The 2012 awards also applied measures based on employee and customer satisfaction.

Awards that were originally awarded under the RBS Group LTIP in 2010 will continue to be delivered in RBS Group shares. The table below details the awards held by Paul Geddes made under RBS Group plans.

Director and scheme	Awards held at 1 January 2012[2]	Awards granted during the year	Awards vested during the year	Awards lapsed during the year	Awards held as at 31 December 2012[2]	Grant date	Market price at grant date £	Vesting date
Paul Geddes								
RBS Group LTIP 2010	229,779	–	–	–	229,779	14 May 2010	4.90	14 May 2013[2]

Notes:

1. The RBS Group share price on 31 December 2012 was £3.245 and the range of prices in year (1 January 2012 to 31 December 2012) was £1.966 to £3.250.
2. These are subject to performance conditions to be assessed by the RBS Group Remuneration Committee, as described above.

RBS Group deferred awards

Awards which were originally awarded under the RBS Group Deferral Plan will continue to be delivered in RBS Group shares. The awards detailed below under the RBS Group Deferral Plan give a conditional right to acquire Ordinary Shares under the RBS Group 2010 Deferral Plan.

Director and scheme	Awards held at 1 January 2012	Awards granted during the year	Awards vested during the year	Awards lapsed during the year	Awards held as at 31 December 2012	Grant date	Market price at grant date £	Vesting date
Paul Geddes								
March 2010	39,602	–	39,602	–	–	5 March 2010	3.79	18 June 2012
March 2011	53,941	–	17,980[1]	–	35,961	7 March 2011	4.45	7 March 2012 – 7 March 2014
March 2012	–	160,772	64,308[1]	–	96,464	9 March 2012	2.80	9 March 2012 – 9 March 2015
John Reizenstein								
March 2011	7,191	–	2,397[2]	–	4,794	7 March 2011	4.45	7 March 2012
March 2012	–	33,047	19,828[2]	–	13,219	7 March 2012	2.80	7 March 2012 – 7 March 2015

Notes:

1. Vested on 9 March 2012 when the RBS Group share price was £2.80.
2. Vested on 7 March 2012 when the RBS Group share price was £2.62.

Legacy RBS Group pension benefits

For the first part of the year, Paul Geddes participated in the RBS Group defined benefit pension plan. Mr. Geddes left this plan to join the Direct Line Group defined contribution plan on 1 September 2012 but kept his accrued pension in the RBS Group defined benefits pension plan. His deferred benefits and accrual in 2012 under the legacy RBS Group plan are shown below:

	Change in accrued pension in year £	Total accrued pension at 31 December 2012 £	Transfer value of total accrued pension at 31 December 2012 £	Transfer value of total accrued pension at 31 December 2011 £	Difference in transfer values less member contributions £
Paul Geddes	1,774	18,237	299,632	309,484	(9,852)

This report was reviewed and approved by the Board on 27 February 2013.

Priscilla Vacassin, Chair of the Remuneration Committee

Other disclosures

Activities, directors' report and business review

Direct Line Group is the largest retail general insurer in the UK. The number one direct motor insurer in Italy and the number three direct motor insurer in Germany. We operate a multi-brand, multi-product and multi-channel business that covers the majority of customer segments in the UK for personal lines general insurance and SME commercial lines.

The information that fulfils the requirements of the Directors' report for the purposes of section 415 of the Companies Act 2006 is included within this corporate governance report (pages 52 to 95).

Section 417 of the Companies Act 2006 requires the Directors to present a business review in the Directors' report. The information that fulfils this requirement can be found on pages 10 to 51, and is incorporated by reference into this corporate governance report.

Information about the use of financial instruments by the Company and its subsidiaries and its risk management policies is disclosed in the business review on pages 26 to 29.

Disclosure and Transparency Rule 4.1.5(2) also requires this Annual Report & Accounts to include a management report. The information that fulfils this requirement can be found in the business review on pages 10 to 51 and this report on pages 52 to 94.

The subsidiary and associated undertakings which principally affect the profits or net assets of the Group in the year are listed in note 19 to the financial statements.

The cautionary statement about forward-looking statements is set out on page 175.

Significant changes and events

Significant changes and events affecting the Group during 2012 and until the date of this report are set out on page 52 to 53 under 'A year of transformation'.

Post-balance sheet events

Details of events after the statement of financial position dates are contained in note 41 to the financial statements.

Dividends

The final dividend for 2012 of 8 pence per ordinary share will, subject to shareholder approval, be paid on 11 June 2013 to all holders of Ordinary Shares on the Register of Members at close of business on 8 March 2013. Full details of dividends paid and of the dividend policy may be found on pages 135 and 171 respectively.

Details of the Company's rules on the appointment and term of appointment of Directors are given on pages 65 to 66 of this report.

Remuneration of Directors

The Remuneration report starting on page 78 forms part of the Directors' report and includes details of the nature and amount of each element of the remuneration (including share options) of each of the Directors.

Secretary

Details of the Company Secretary of Direct Line Insurance Group plc, including his qualifications and experience, are set out on page 59.

Directors' indemnities

The Articles of the Company permit it to indemnify the officers of the Company (and the officers of any associated company) against liabilities arising from the conduct of Company business to the extent permitted by law. Accordingly, the Company executed deeds of indemnity for the benefit of each Director in respect of liabilities that may attach to them in their capacity as Directors of the Company or of associated companies. These indemnities are qualifying third-party indemnities as defined by section 234 of the Companies Act 2006. No amount was paid under any of these indemnities during the year.

The Company also purchased directors' and officers' liability insurance during the year, which provides appropriate cover for legal actions brought against its Directors.

Authorisation of conflicts of interest

The Company's Articles of Association permit the authorisation of a Director's potential conflict of interest or duty. Such authorisations may be given by the remaining Directors who are independent of the potential conflict.

The Board has approved a number of authorisations in this manner. Notwithstanding such authorisation, the Board continues to ensure that any actual conflict of interest or duty, should it arise, is dealt with appropriately, which will usually be by arranging that the Director takes no part in the relevant Board or Committee discussion or decision.

At no time during the year did any Director hold a material interest in any contract of significance with the Company or the Group other than the Relationship Agreement with RBS Group, the indemnity provision described above and service contracts between each Executive Director and the Company.

Share capital and control

The issued and fully paid share capital of the Company immediately following Admission to the Official List of the London Stock Exchange (the Official List) was 1,500,000,000 Ordinary Shares of 10 pence each.

Prior to listing, the Directors were authorised on 31 August 2012, conditional on admission to the Official List, to subdivide each of the 1,500,000,000 Ordinary Shares of £1 each in the Company into:

(a) 1,500,000,000 Ordinary Shares of 10 pence; and

(b) 1,500,000,000 deferred shares of 90 pence each.

Immediately following the subdivision of the Company's issued share capital described above, the deferred shares were acquired and cancelled by the Company in accordance with sections 659(1) and 662(1)(c) respectively of the Companies Act 2006.

Accordingly, the Directors were authorised on 21 September 2012, conditional on admission to the Official List of the London Stock Exchange, to:

- allot shares in the Company up to an aggregate nominal amount of £50,000,000, or grant rights to subscribe for or to convert any security into shares;
- allot shares up to an aggregate nominal amount of £100,000,000, for the purpose of a rights issue; and
- make market purchases of up to 150,000,000 shares of the Company (representing approximately 10% of the Company's issued share capital at the time).

These authorities have not been used to date and shareholders will be asked to renew them at the 2013 AGM. Details are contained in the Notice of AGM.

Following the IPO on 16 October 2012, the Ordinary Shares have a premium listing on the London Stock Exchange. As at the date of this report, 65.27% of the Company's issued shares are held by The Royal Bank of Scotland Group plc.

Details of the Company's share capital and shares under option at 31 December 2012 are given in notes 27 and 34 of the consolidated financial statements.

The Company held no treasury shares during the year or at the date of this report.

Details of Directors' remuneration, service contracts, employment contracts and interests in the shares of the Company are set out in the Directors' remuneration report.

The rights and obligations attaching to the Company's Ordinary Shares, together with the powers of the Company's Directors, are set out in the Company's Articles of Association, which can be obtained from the Company's website, www.directlinegroup.com. Unless expressly specified to the contrary in the Articles of Association, they may only be amended by a special resolution of the Company's shareholders at a general meeting.

Relationship Agreement with RBS Group

Under the terms of a Relationship Agreement between the Company and RBS Group, which is described on page 61, RBS Group has nominated Bruce Van Saun and Mark Catton as Directors of the Company.

Under the terms of the agreement, RBS Group may nominate up to two Directors to serve on the Company's Board of Directors. With the exception of the Relationship Agreement, there is no arrangement or understanding with any shareholder, customer, supplier, or any other external party, providing the right to appoint a Director or a member of the Executive Committee.

Restrictions on the transfer of shares

The Relationship Agreement in place between the Company and RBS Group contains certain restrictions on the transfer of the Ordinary Shares registered in the name of RBS Group.

In addition, there are restrictions on the transfer of the Ordinary Shares under the Company's employee share incentive plans while the shares are subject to the plan rules. Where, under an employee share incentive plan operated by the Company, participants are the beneficial owners of shares but not the registered owners, the voting rights are normally exercised at the discretion of the participants.

Other than those specified above, there are no restrictions on the voting rights attached to the Company's Ordinary Shares or the transfer of securities in the Company. There are no special rights with regard to control of the Company attached to the Company's Ordinary Shares. The Company is not aware of any agreements between holders of shares that may result in restrictions on the transfer of shares or voting rights.

Material contracts

A number of agreements may take effect, alter or terminate upon a change of control of the Company including following a takeover bid, for example commercial contracts and distribution agreements. None is considered to be significant in terms of its impact on the business of the Group as a whole.

- The Relationship Agreement between the Company and RBS Group remains in force until such time as the RBS Group's shareholding reduces below 20% of the issued share capital of the Company. There are also provisions which provide the RBS Group with the right automatically to terminate the Relationship Agreement if the Company ceases to be listed, or if it passes a resolution to wind up, or if an administration order is made or it makes an arrangement with creditors. There are no provisions in the Relationship Agreement which allows RBS Group to terminate the agreement in the event of a change of control of Direct Line Group.
- All of the Company's employee share incentive plans contain provisions relating to a change of control. Outstanding awards would typically vest and become exercisable on a change of control, subject usually to the satisfaction of performance conditions and pro-rata reduction.

Substantial shareholdings

In accordance with the provisions of chapter 5 of the Disclosure and Transparency Rules of the Financial Services Authority, the following shareholder has provided the Company with notice of interests in the Company's voting rights.

Shareholder	31 December 2012	27 February 2013
The Royal Bank of Scotland Group plc	65.27%	65.27%

Note: The interests indicated above are held directly.

Employee consultation

The Group's statement on our employees is set out in the Corporate Social Responsibility report. In summary, we encourage open, honest and transparent communication and dialogue with employees. ERBs are in place to advise the Executive Committee regarding employee matters, including concerns and reports on morale, and to support communications. Throughout 2012, ERBs have championed the BEST programme, helping all employees contribute to improving the Group's business. The BEST programme focuses on how we can achieve our ambition to become Britain's best retail general insurer. A key achievement of the programme was the distillation of the ideas received from employees to arrive at a set of values to govern the way the Group operates. In addition, we held workshops as part of the transformation plan focusing on what constitutes the BEST for People, BEST for Customers and BEST for Shareholders.

Group management uses an intranet-based social media site, run as part of the BEST programme, to share ideas and achieve a common awareness throughout the Group, including those financial and economic factors that affect our performance. The site also contains employee-feedback questionnaires. In addition, the Group encourages the involvement of employees in its performance by allowing eligible employees to participate in our all-employee share ownership plans.

The Group values the diversity of its employees and is committed to creating a working environment that is inclusive of all. The Group embraces people's differences in order to attract and retain talent and seeks to enable employees to reach their potential; these differences include but are not limited to age, belief, disability, ethnic or national origin, gender, gender identity, marital or civil partnership status, political opinion, race, religion or sexual orientation. These commitments extend to recruitment and selection, training, career development, flexible working arrangements, promotion and performance appraisal.

Disabled employees

Applications for employment by disabled persons are always fully considered, bearing in mind the aptitudes of the applicant concerned. In the event of members of staff becoming disabled every effort is made to ensure that they continue their employment with the Group and that they receive appropriate training. It is Group policy that the training, career development and promotion of disabled persons should, as far as possible, be identical to that of other employees.

Supplier payment policy

The Group's policy is to pay suppliers in accordance with agreed terms of business. Whenever possible, purchase orders are placed on the basis of the Group's standard terms and conditions. These include provision for the payment of suppliers within 30 days of the end of the month in which the Group receives the goods or in which services are provided.

The average trade creditors of the Group during 2012, which exclude insurance creditors, were equivalent to 26 days' purchases (2011: 18 days' purchases), based on the ratio of Group trade creditors at the end of the year to the amounts invoiced during the year.

Charitable and political contributions

Through our Community Cashback scheme our employees were able to donate £48,000 to the charities they are involved in. Through our payroll giving scheme, the Group matched employee donations and contributed a total of £112,000. The Group was also able to support Children in Need and Comic Relief with over 900 employees taking pledge telephone calls in 2012.

The Corporate Social Responsibility Committee is responsible for the approval of the Group's community-based activities; more detail on the role of the Group's CSR and community development activities can be found in the Corporate Social Responsibility report on pages 47 to 51.

The Group made no political donations during the year (2011: nil).

Governmental regulation

To comply with European Union state aid requirements, RBS Group agreed to cede control of Direct Line Group by the end of 2013 and divest its entire interest by the end of 2014. The initial minority tranche of the divestment of Direct Line Group, by way of a public flotation, was effected on 16 October 2012.

Financial instruments

The Group's companies use financial instruments to manage certain types of risk, including those relating to credit, foreign-currency exchange, cash flow, liquidity, interest rates and equity and property prices. Details of the objectives and management of these instruments are contained in the Risk management and Capital management sections on pages 26 to 29 and 45. An indication of the exposure of Group companies to such risks is also contained in note 3 to the consolidated financial statements.

Going concern

The Group has sufficient financial resources to meet its financial needs and it manages a mature portfolio of insurance risk. The Directors believe that the Group is well positioned to manage its business risks successfully in the current economic environment.

The Financial Review on pages 36 to 46 describes the Group's capital management strategy, which covers how we measure our regulatory and economic capital needs and how capital is deployed. The financial position of the Group is also covered in that section, including a commentary on cash and investment levels, reserves, currency management, insurance liability management, liquidity and borrowings.

In addition, note 27 to the consolidated financial statements describes capital management needs and policies and note 3 covers underwriting, market, liquidity and credit risks which may affect the Group's financial position.

After making due enquiries, the Directors have a reasonable expectation that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. Accordingly, they have adopted the going concern basis in preparing this Annual Report & Accounts.

Statement of disclosure of information to auditors

Each Director at the date of the approval of this Annual Report & Accounts confirms that:

- So far as the Director is aware, there is no relevant audit information of which Deloitte LLP, the Company's external auditor, is unaware.
- The Director has taken all the steps that he or she ought to have taken as a Director to make himself or herself aware of any relevant audit information and to establish that Deloitte LLP is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

Auditors

Deloitte LLP has expressed its willingness to continue in office as external auditors. A resolution to reappoint them will be proposed at the forthcoming AGM.

This Directors' report was reviewed and approved by the Board on 27 February 2013.

By order of the Board

Humphrey Tomlinson, General Counsel and Company Secretary

Directors' responsibilities statement

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare such financial statements for each financial year. Under that law the Directors are required to prepare the Group financial statements in accordance with International Financial Reporting Standards ("**IFRSs**") as adopted by the European Union and Article 4 of the IAS Regulation and have also chosen to prepare the parent company financial statements under IFRSs as adopted by the European Union. Under company law the Directors must not approve the accounts unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, International Accounting Standard 1 requires that Directors:

- properly select and apply accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRSs are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- make an assessment of the Company's ability to continue as a going concern.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Directors' responsibility statement

We confirm that to the best of our knowledge:

1. the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the EU, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole; and

2. the management report, which is incorporated into the Directors' report, includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board

Paul Geddes,
Chief Executive Officer
27 February 2013

John Reizenstein,
Chief Financial Officer
27 February 2013

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Notes to the parent company financial statements

Independent auditor's report to the members of Direct Line Insurance Group plc

We have audited the financial statements of Direct Line Insurance Group plc (the "**Company**") and its subsidiaries (together the "**Group**") for the year ended 31 December 2012 which comprise the accounting policies, the consolidated and Company balance sheets as at 31 December 2012, the consolidated income statement, the consolidated and Company statements of changes in equity and the consolidated and Company cash flow statements for the year ended 31 December 2012 and the related notes 1 to 41 on the consolidated financial statements, and the related notes 1 to 16 on the Company financial statements. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards ("**IFRSs**") as adopted by the European Union.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditor

As explained more fully in the Directors' responsibilities statement, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's and the Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Company's affairs as at 31 December 2012 and of the Group's and the Company's profit for the year then ended;
- the financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

Separate opinion in relation to IFRSs as issued by the IASB

As explained in the accounting policies to the Group financial statements, the Group in addition to complying with its legal obligation to apply IFRSs as adopted by the European Union, has also applied IFRSs as issued by the International Accounting Standards Board ("**IASB**").

In our opinion the Group financial statements comply with IFRSs as issued by the IASB.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the Company financial statements and the part of the Directors' remuneration report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the Directors' statement, contained within the Directors' report, in relation to going concern;
- the part of the Corporate Governance Statement relating to the Company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review; and
- certain elements of the Remuneration report.

David Rush (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London, United Kingdom
27 February 2013

Consolidated income statement

For the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Gross earned premium		**4,048.5**	4,522.9
Reinsurance premium ceded		**(326.5)**	(269.9)
Net earned premium	5	**3,722.0**	4,253.0
Investment return	6	**281.8**	281.9
Instalment income	7	**125.4**	145.0
Other operating income	7	**73.3**	95.1
Total income		**4,202.5**	4,775.0
Insurance claims	8	**(2,875.3)**	(3,160.6)
Insurance claims recoverable from reinsurers	8	**451.0**	193.1
Net insurance claims		**(2,424.3)**	(2,967.5)
Commission expenses	9	**(452.9)**	(518.9)
Operating expenses	10	**(1,047.5)**	(944.6)
Total expenses		**(1,500.4)**	(1,463.5)
Operating profit		**277.8**	344.0
Finance costs	11	**(28.7)**	(2.7)
Gain on disposal of subsidiary		**–**	1.6
Profit before tax		**249.1**	342.9
Tax charge	12	**(64.8)**	(93.9)
Profit for the year		**184.3**	249.0
Profit attributable to:			
Owners of the Company		**184.3**	249.0
Non-controlling interests		**–**	–
		184.3	249.0

Earnings per share:			
Basic (pence)	15	**12.3**	16.6
Diluted (pence)	15	**12.3**	16.6

The attached notes on pages 103 to 163 form an integral part of these consolidated financial statements.

Consolidated statement of comprehensive income

For the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Profit for the year		**184.3**	249.0
Other comprehensive income			
Actuarial loss on defined benefit plan	33	**(3.4)**	(0.6)
Exchange differences on translation of foreign operations		**(2.4)**	(3.5)
Fair value gain on available-for-sale investments	28	**109.9**	183.8
Less: realised net gains on available-for-sale investments	28	**(89.5)**	(52.3)
		14.6	127.4
Tax credit / (charge) on other comprehensive income		**1.9**	(36.8)
Other comprehensive income for the year		**16.5**	90.6
Total comprehensive income for the year		**200.8**	339.6
Total comprehensive income attributable to:			
Owners of the Company		**200.8**	339.6
Non-controlling interests		**–**	–
		200.8	339.6

The attached notes on pages 103 to 163 form an integral part of these consolidated financial statements.

Financial statements

Consolidated balance sheet

As at 31 December 2012

	Notes	2012 £m	2011 £m
Assets			
Goodwill and other intangible assets	16	**421.5**	365.8
Property, plant and equipment	17	**92.4**	46.9
Investment property	18	**128.9**	69.5
Reinsurance assets	20	**1,102.0**	741.6
Deferred tax assets	13	**22.5**	26.9
Current tax assets	12	**5.5**	–
Deferred acquisition costs	21	**327.6**	310.5
Insurance and other receivables	22	**1,164.0**	1,252.9
Prepayments, accrued income and other assets		**82.6**	92.2
Derivative financial instruments	23	**37.5**	0.1
Retirement benefit asset	33	**2.5**	2.6
Financial investments	24	**7,801.5**	9,480.3
Cash and cash equivalents	25	**1,508.4**	1,379.8
Assets held for sale	26	**1.0**	1.0
Total assets		**12,697.9**	13,770.1
Equity			
Shareholders' equity		**2,831.6**	3,612.8
Non-controlling interest		**–**	258.5
Total equity		**2,831.6**	3,871.3
Liabilities			
Subordinated liabilities	29	**787.5**	–
Insurance liabilities	30	**6,398.5**	6,509.0
Unearned premium reserve	30	**1,872.9**	1,931.6
Borrowings	32	**90.9**	317.9
Derivative financial instruments	23	**6.5**	–
Trade and other payables including insurance payables	35	**654.6**	910.2
Deferred tax liabilities	13	**20.9**	12.1
Current tax liabilities	12	**34.5**	218.0
Total liabilities		**9,866.3**	9,898.8
Total equity and liabilities		**12,697.9**	13,770.1

The attached notes on pages 103 to 163 form an integral part of these consolidated financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 27 February 2013. They were signed on its behalf by:

John Reizenstein
Chief Financial Officer

Consolidated statement of changes in equity

For the year ended 31 December 2012

	Share capital £m	Employee trust shares £m	Capital redemption reserve £m	Revaluation reserve £m	Non-distributable reserve £m	Foreign exchange translation reserve £m	Retained earnings £m	Total shareholders equity £m
Balance at 1 January 2011	1,500.0	–	100.0	41.9	197.6	5.4	1,378.7	3,223.6
Profit for the year	–	–	–	–	–	–	249.0	249.0
Other comprehensive income	–	–	–	94.7	–	(3.5)	(0.6)	90.6
Transfer from non-distributable reserve	–	–	–	–	(167.3)	–	167.3	–
Capital contribution[1]	–	–	–	–	–	–	55.9	55.9
Movement in net assets of Direct Line Versicherung AG[2]	–	–	–	0.5	–	4.5	(11.3)	(6.3)
Balance at 31 December 2011	1,500.0	–	100.0	137.1	30.3	6.4	1,839.0	3,612.8
Profit for the year	**–**	**–**	**–**	**–**	**–**	**–**	**184.3**	**184.3**
Other comprehensive income	**–**	**–**	**–**	**21.7**	**–**	**(2.4)**	**(2.8)**	**16.5**
Dividends	**–**	**–**	**–**	**–**	**–**	**–**	**(1,000.0)**	**(1,000.0)**
Transfer to non-distributable reserve	**–**	**–**	**–**	**–**	**32.9**	**–**	**(32.9)**	**–**
Capital contribution[1]	**–**	**–**	**–**	**–**	**–**	**–**	**30.9**	**30.9**
Movement in net assets of Direct Line Versicherung AG[2]	**–**	**–**	**–**	**–**	**–**	**1.0**	**(9.2)**	**(8.2)**
Share-based payments	**–**	**(5.0)**	**–**	**–**	**–**	**–**	**0.3**	**(4.7)**
Issue of own shares	**150.0**	**–**	**–**	**–**	**–**	**–**	**–**	**150.0**
Own shares redeemed	**(1,500.0)**	**–**	**1,350.0**	**–**	**–**	**–**	**–**	**(150.0)**
Balance at 31 December 2012	**150.0**	**(5.0)**	**1,450.0**	**158.8**	**63.2**	**5.0**	**1,009.6**	**2,831.6**

Notes:

1. See basis of preparation in note 1.
2. The movements in net assets of Direct Line Versicherung AG ceased on 2 April 2012, see note 1.

	Non-controlling interest £m
Balance at 1 January 2011 and 31 December 2011	258.5
Transfer to subordinated liabilities	**(258.5)**
Balance at 31 December 2012	**–**

The attached notes on pages 103 to 163 form an integral part of these consolidated financial statements.

Financial statements

Consolidated cash flow statement

For the year ended 31 December 2012

	Notes	2012 £m	2011 £m
Net cash used by operating activities before investment of insurance assets	36	**(966.0)**	(359.8)
Cash generated from investment of insurance assets	36	**2,004.8**	38.8
Net cash generated from / (used by) operating activities		**1,038.8**	(321.0)
Cash flows from investing activities			
Proceeds on disposal of property, plant and equipment		**–**	1.2
Purchases of property, plant and equipment	17	**(63.7)**	(7.5)
Purchases of intangible assets	16	**(96.6)**	(119.8)
Net cash flows from disposal of subsidiary		**–**	(0.1)
Cash flows from net investment hedges		**6.1**	–
Net cash used by investing activities		**(154.2)**	(126.2)
Cash flows from financing activities			
Dividends paid		**(1,000.0)**	–
Repayments of borrowings		**(246.4)**	(205.5)
Proceeds on issue of subordinated debt		**493.0**	–
Finance costs		**(16.1)**	–
Purchase of employee trust shares		**(5.0)**	–
Proceeds from borrowings		**–**	205.0
Net cash used by financing activities		**(774.5)**	(0.5)
Net increase / (decrease) in cash and cash equivalents		**110.1**	(447.7)
Cash and cash equivalents at the beginning of the year	25	**1,309.6**	1,763.5
Effect of foreign exchange rate changes		**(2.2)**	(6.2)
Cash and cash equivalents at the end of the year	25	**1,417.5**	1,309.6

The attached notes on pages 103 to 163 form an integral part of these consolidated financial statements.

Corporate information

Direct Line Insurance Group plc is a public limited company incorporated in the United Kingdom. The address of the registered office is Churchill Court, Westmoreland Road, Bromley, BR1 1DP, England.

1. Accounting policies

Basis of preparation

As required by the Companies Act 2006 and Article 4 of the EU IAS Regulation, the consolidated financial statements are prepared in accordance with IFRSs issued by the IASB as adopted by the EU. The financial statements have been prepared in accordance with and full compliance with IFRSs as issued by the IASB.

The consolidated financial statements are prepared on the historical cost basis except for available-for-sale financial assets, investment property and derivative financial instruments, which are measured at fair value.

The Company's financial statements and the Group's consolidated financial statements are presented in Pounds Sterling, which is the functional currency of the Company.

The Group in its current structure was formed on 2 April 2012 when the Company acquired Direct Line Versicherung AG from a fellow subsidiary of The Royal Bank of Scotland Group plc. Therefore the basis of preparation represents a reorganisation of entities under common control, which is outside the scope of IFRS 3 'Business Combinations'. Accordingly, as permitted by IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', it has been accounted for as a group reconstruction as described in Financial Reporting Standard 6, 'Acquisitions and Mergers'. The consolidated financial statements have been prepared as if the transaction that gave rise to the formation of the Group had taken place at the beginning of the comparative period. Under these principles, the consolidated financial statements have been prepared as if the Company were the holding company of Direct Line Versicherung AG from 1 January 2011, the date of the beginning of the comparative period.

As part of the divestment from RBS Group, the way in which expenses incurred by RBS Group on behalf of the Group changed. Up until 30 June 2012, only some of these expenses were recharged to the Group by RBS Group. From 1 July 2012, some of the services previously provided by RBS Group have been brought in-house and so the expense is now incurred directly by the Group and reflected in expenses in the income statement; other services are still provided by RBS Group under a transitional services agreement ("TSA") and the expense of these is charged to the Group. In order to aid comparability, the Group's accounting policy has been changed so that all expenses are included within the income statement. For the avoidance of doubt, this includes external costs incurred by the Group and costs incurred by RBS Group, irrespective of whether RBS Group recharged them to the Group. In the case of expenses incurred by RBS Group and not recharged to the Group, a capital contribution has been credited to retained earnings in the statement of changes in equity to reflect this contribution from a shareholder. In addition there was a further contribution of £6.3 million in respect of overseas taxation. The comparatives for the year ended 31 December 2011 have been prepared on the same basis.

The effect of the above on the Group profit for the year ended 31 December 2012 was to decrease profit after tax by £30.9 million, (31 December 2011: £55.9 million) with an equal and opposite credit in the statement of changes in equity. There was no impact on net assets at 1 January 2011 or 31 December 2011, and accordingly no balance sheet at 1 January 2011 has been provided.

Adoption of new and revised standards

There have been no new or revised standards adopted in the year.

1.1 Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and the entities that are controlled by the Group at 31 December 2012 and 2011. Control exists when the Group has the power to govern the financial and operating policies of an entity. In assessing if the Group controls another entity, the existence and effect of the potential voting rights that are currently exercisable or convertible are considered.

Where necessary, adjustments have been made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the Group. The policies set out below have been applied consistently throughout the years ended 2012 and 2011 to items considered material to the consolidated financial information.

A subsidiary acquired is included in the consolidated financial statements from the date it is controlled by the Group until the date the Group ceases to control it. On acquisition of a subsidiary, its identifiable assets, liabilities and contingent liabilities are included in the consolidated financial statements at fair value.

All intercompany transactions, balances, income and expenses between Group entities are eliminated on consolidation. The consolidated financial statements are prepared using consistent accounting policies.

1. Accounting policies continued

1.2 Foreign currencies

The Group's consolidated financial statements are presented in Pounds Sterling which is the presentational currency of the Group. Group entities record transactions in the currency of the primary economic environment in which they operate (their functional currency), translated at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the relevant functional currency at the foreign exchange rates ruling at the balance sheet date. Foreign exchange differences arising on the settlement of foreign currency transactions and from the translation of monetary assets and liabilities are reported in the income statement except for differences arising on hedges of net investments in foreign operations. Non-monetary items denominated in foreign currencies that are stated at fair value are translated into the relevant functional currency at the foreign exchange rates ruling at the dates the values are determined. Translation differences arising on non-monetary items measured at fair value are recognised in the income statement except for differences arising on available-for-sale non-monetary financial assets, for example equity shares, which are recognised in other comprehensive income.

Assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into Pounds Sterling at the foreign exchange rates ruling at the balance sheet date. Income and expenses of foreign operations are translated into Pounds Sterling at average exchange rates unless these do not approximate the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on the translation of a foreign operation are recognised in the consolidated statement of other comprehensive income. The amount accumulated in equity is reclassified from equity to the consolidated income statement on disposal or partial disposal of a foreign operation.

1.3 Contract classification

Insurance contracts are those contracts where the Group (the insurer) has accepted significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

Once a contract has been classified as an insurance contract, it remains an insurance contract for the remainder of its lifetime, even if the insurance risk reduces significantly during this period, unless all rights and obligations are extinguished.

1.4 Revenue recognition

Premiums earned

Insurance and reinsurance premiums comprise the total premiums receivable for the whole period of cover provided by contracts incepted during the financial year, adjusted by an unearned premium provision, which represents the proportion of the premiums incepted in prior periods and that relate to periods of insurance after the balance sheet date. Unearned premiums are calculated over the period of exposure under the policy, on a daily basis, 24ths basis or allowing for the estimated incidence of exposure under policies. Insurance premiums are shown gross of any commission payable to intermediaries or other parties.

Premiums collected by intermediaries or other parties, but not yet received, are assessed based on estimates from underwriting or past experience, and are included in insurance premiums. Insurance premiums exclude insurance premium tax or equivalent local taxes and are shown gross of any commission payable to intermediaries or other parties.

The Group's long-term assurance contracts include whole-life and term assurance contracts that are expected to remain in force for an extended period of time. These contracts insure events associated with human life (for example, death or the occurrence of a critical illness). These are recognised as revenue when they become payable by the contract holder. Premiums are shown before the deduction of commission.

Investment return

Interest income on financial assets is determined using the effective interest rate method. The effective interest rate method is a way of calculating the amortised cost of a financial asset (or group of financial assets) and of allocating the interest income over the expected life of the asset. In the case of financial assets classified as available for sale, estimates are based on the straight-line method, which the directors have determined is a close approximation to the effective interest rate.

Rental income from investment property is recognised in the income statement on a straight-line basis over the period of the contract. Any gains or losses arising from a change in fair value are recognised in the income statement.

Instalment income

Instalment income comprises the interest income earned on policyholder receivables, where outstanding premiums are settled by a series of instalment payments. Interest is earned using an effective interest rate method over the term of the policy.

Other operating income

Solicitors' referral fee income

Revenue relating to this activity is recognised when the service is rendered. The provision of these services is contractual and the associated cost is recognised when incurred.

Vehicle replacement referral income

Vehicle replacement referral fee income comprises fees in respect of referral income received when a customer or a non-fault policy holder (claimant) of another insurer has been provided with a hire vehicle from a preferred supplier.

Income is recognised immediately when the customer or claimant is provided with the hire vehicle.

Revenue from vehicle recovery and repairs services

Fees in respect of services for vehicle recovery are recognised as the right to consideration, and accrue through the provision of the service to the customer. The arrangements are generally contractual and the cost of providing the service is incurred as the service is rendered. The price is usually fixed and always determinable.

The Group's income also comprises vehicle repair services provided to other third-party customers. Income in respect of repairs to vehicles is recognised upon completion of the service. The price is determined using market rates for the services and materials used after discounts have been deducted where applicable.

Management systems income represents the sale of tracking units, installation services and monitoring services. Revenue is recognised immediately, with the exception of the non-cancellable network subscriptions receivable in advance, which are classified as deferred income in the balance sheet and recognised on a straight-line basis over the stated term of the subscription.

Other income

Commission fee income in respect of services is recognised when a policy has been placed and incepted. Income is stated excluding applicable sales taxes.

1.5 Insurance claims

Insurance claims are recognised in the accounting period in which the loss occurs. Provision is made for the full cost of settling outstanding claims at the balance sheet date, including claims incurred but not yet reported at that date, net of salvage and subrogation recoveries. Outstanding claims provisions are not discounted for the time value of money except for claims to be settled by PPOs established under the Courts Act 2003. A UK court can award damages for future pecuniary loss in respect of personal injury or for other damages in respect of personal injury and may order that the damages are wholly or partly to take the form of PPOs. These are covered in more detail in note 2.1. Costs for both direct and indirect claims handling expenses are also included.

Provisions are determined by management based on experience of claims settled and on statistical models which require certain assumptions to be made regarding the incidence, timing and amount of claims and any specific factors such as adverse weather conditions. When calculating the total provision required, the historical development of claims is analysed using statistical methodology to extrapolate, within acceptable probability parameters, the value of outstanding claims (gross and net) at the balance sheet date. Also included in the estimation of outstanding claims are factors such as the potential for judicial or legislative inflation. In addition, an allowance is made for reinsurance assets deemed not recoverable.

Provisions for more recent claims make use of techniques that incorporate expected loss ratios and average claims cost (adjusted for inflation) and frequency methods. As claims mature, the provisions are increasingly driven by methods based on actual claim experience. The approach adopted takes into account the nature, type and significance of the business and the type of data available, with large claims generally being assessed separately. The data used for statistical modelling purposes is generated internally and reconciled to the accounting data.

The calculation is particularly sensitive to the estimation of the ultimate cost of claims for the particular classes of business at gross and net levels and the estimation of future claims handling costs.

Actual claims experience may differ from the historical pattern on which the actuarial best estimate is based and the cost of settling individual claims may exceed that assumed. As a result, the Group sets provisions at a margin above the actuarial best estimate. This amount is recorded as claims provisions.

A liability adequacy provision is made for unexpired risks arising where the expected value of net claims and expenses attributable to the unexpired periods of policies in force at the balance sheet date exceeds the unearned premium reserve in relation to such policies after the deduction of any acquisition costs deferred and other prepaid amounts (for example, reinsurance). The expected value is determined by reference to recent experience and allowing for changes to the premium rates. The provision for unexpired risks is calculated separately by reference to classes of business that are managed together after taking account of relevant investment returns.

1.6 Reinsurance

The Group has reinsurance treaties and other reinsurance contracts that transfer significant insurance risk.

The Group cedes insurance risk by reinsurance in the normal course of business, with the arrangement and retention limits varying by product line. Outward reinsurance premiums are generally accounted for in the same accounting period as the premiums for the related direct business being reinsured. Outward reinsurance recoveries are accounted for in the same accounting period as the direct claims to which they relate.

Reinsurance assets include balances due from reinsurance companies for ceded insurance liabilities. Amounts recoverable from reinsurers are estimated in a consistent manner with the outstanding claims provisions or settled claims associated with the reinsured policies and in accordance with the relevant reinsurance contract. Recoveries in respect of PPOs are discounted for the time value of money.

A reinsurance bad debt provision is assessed in respect of reinsurance debtors, to allow for the risk that the reinsurance asset may not be collected or where the reinsurer's credit rating has been downgraded significantly. This also includes an assessment in respect of the ceded part of claims provisions to reflect the credit risk exposure to long-term reinsurance assets particularly in relation to periodical payments. This is affected by the Group reducing the carrying value of the asset accordingly and the impairment loss is recognised in the income statement.

1. Accounting policies continued

1.7 Deferred acquisition costs
Acquisition costs relating to new and renewing insurance policies are matched with the earning of the premiums to which they relate. A proportion of acquisition costs incurred during the year is therefore deferred to the subsequent accounting period to match the extent to which premiums written during the year are unearned at the balance sheet date.

The principal acquisition costs deferred are direct advertising expenditure, administration costs, commission paid and costs associated with telesales and underwriting staff.

1.8 Goodwill and other intangible assets
Acquired goodwill, being the excess of the cost of an acquisition over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the subsidiary, associate or joint venture acquired, is initially recognised at cost and subsequently at cost less any accumulated impairment losses. Goodwill arising on the acquisition of subsidiaries, associates and joint ventures is included in the balance sheet category 'goodwill and other intangible assets'. The gain or loss on the disposal of a subsidiary, associate or joint venture includes the carrying value of any related goodwill.

Intangible assets that are acquired by the Group are stated at cost less accumulated amortisation and impairment losses. Amortisation is charged to the income statement over the assets' economic lives using methods that best reflect the pattern of economic benefits and is included in other operating expenses. The estimated useful economic lives are as follows:

Software development costs	5 years

Expenditure on internally generated goodwill and brands is written off as incurred. Direct costs relating to the development of internal-use computer software and associated business processes are capitalised once technical feasibility and economic viability have been established. These costs include payroll costs, the costs of materials and services, and directly attributable overheads. Capitalisation of costs ceases when the software is capable of operating as intended. During and after development, accumulated costs are reviewed for impairment against the projected benefits that the software is expected to generate. Costs incurred prior to the establishment of technical feasibility and economic viability are expensed as incurred as are all training costs and general overheads. The costs of licences to use computer software that is expected to generate economic benefits beyond one year are also capitalised.

1.9 Property, plant and equipment
Items of property, plant and equipment (except investment property – see accounting policy 1.11) are stated at cost less accumulated depreciation and impairment losses. Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for separately.

Depreciation is charged to the income statement on a straight-line basis so as to write off the depreciable amount of property, plant and equipment over their estimated useful lives. The depreciable amount is the cost of an asset less its residual value. Land is not depreciated. Estimated useful lives are as follows:

Freehold and long leasehold buildings	50 years or the period of the lease if shorter
Vehicles	5 years
Computer equipment	Up to 5 years
Other equipment, including property adaptation costs	4 to 15 years

The gain or loss arising from the derecognition of an item of property, plant and equipment is determined as the difference between the disposal proceeds, if any, and the carrying amount of the item.

1.10 Impairment of intangible assets, goodwill and property, plant and equipment
At each reporting date, the Group assesses whether there is any indication that its intangible assets, goodwill or property, plant and equipment are impaired. If any such indication exists, the Group estimates the recoverable amount of the asset and the impairment loss, if any. Goodwill is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired. If an asset does not generate cash flows that are independent of those of other assets or groups of assets, the recoverable amount is determined for the cash-generating unit to which the asset belongs. The recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use. Value in use is the present value of future cash flows from the asset or cash-generating unit, discounted at a rate that reflects market interest rates, adjusted for risks specific to the asset or cash-generating unit that have not been reflected in the estimation of future cash flows.

If the recoverable amount of an intangible or a tangible asset is less than its carrying value, an impairment loss is recognised immediately in the income statement and the carrying value of the asset is reduced by the amount of the impairment loss.

A reversal of an impairment loss on intangible assets or property, plant and equipment is recognised as it arises provided the increased carrying value does not exceed the carrying amount that would have been determined had no impairment loss been recognised. Impairment losses on goodwill are not reversed.

1.11 Investment property
Investment property comprises freehold and long-leasehold properties that are held to earn rentals or for capital appreciation or both. Investment property is not depreciated but is stated at fair value based on valuations by independent registered valuers. Fair value is based on current prices for similar properties in the same location and condition. Any gain or loss arising from a change in fair value is recognised in the income statement.

Investment property is derecognised either when it has been disposed of, or permanently withdrawn from use and no future economic benefit is expected from disposal. Any gains or losses on the retirement or disposal of investment property are recognised in the income statement in the year of retirement or disposal.

1.12 Financial assets

Financial assets are classified as held-to-maturity, available-for-sale and designated at fair value through profit or loss, or loans and receivables. The Group only has available-for-sale financial assets and loans and receivables.

Available-for-sale – Financial assets that are not classified as loans and receivables, are classified as available-for-sale. Financial assets can be designated as available-for-sale on initial recognition. Available-for-sale financial assets are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at fair value. Impairment losses and exchange differences resulting from retranslating the amortised cost of foreign currency monetary available-for-sale financial assets are recognised in the income statement, together with interest calculated using the effective interest rate method. Other changes in the fair value of available-for-sale financial assets are reported in a separate component of shareholders' equity until disposal, when the cumulative gain or loss is recognised in the income statement.

Regular way purchases of financial assets classified as loans and receivables are recognised on settlement date; all other regular way purchases are recognised on trade date.

A financial asset is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The appropriate quoted market price for an asset held is usually the current bid price. When current bid prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (for example, a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate.

The valuation methodology described above uses observable market data.

If the market for a financial asset is not active, the Group establishes the fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties (if available), reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the Group uses that technique.

The fair value of other investments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument are reliably measurable if:

(a) the variability in the range of reasonable fair value estimates is not significant for that instrument; or

(b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

Loans and receivables – Non-derivative financial assets with fixed or determinable repayments that are not quoted in an active market are classified as loans and receivables, except those that are classified as available-for-sale. Loans and receivables are initially recognised at fair value plus directly related transaction costs and are subsequently measured at amortised cost using the effective interest rate method less any impairment losses.

Insurance receivables comprise outstanding insurance premiums where the policyholders have elected to pay in instalments, or amounts due from third parties where they have collected or are due to collect the money from the policyholder.

Other loans and receivables principally comprise loans to related parties and other debtors.

Impairment of financial assets

At each balance sheet date the Group assesses whether there is any objective evidence that a financial asset or group of financial assets classified as available-for-sale or loans and receivables is impaired. A financial asset or portfolio of financial assets is impaired and an impairment loss incurred if there is objective evidence that an event or events since initial recognition of the asset has adversely affected the amount or timing of future cash flows from the asset.

Available-for-sale – When a decline in the fair value of a financial asset classified as available-for-sale has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative loss is removed from equity and recognised in the income statement. The loss is measured as the difference between the amortised cost of the financial asset and its current fair value. Impairment losses on available-for-sale equity instruments are not reversed through profit or loss, but those on available-for-sale debt instruments are reversed, if there is an increase in fair value that is objectively related to a subsequent event. Subsequent increases in the fair value of available-for-sale other investment funds are all recognised in equity.

1. Accounting policies continued

Loans and receivables – If there is objective evidence that an impairment loss on a financial asset or group of financial assets classified as loans and receivables has been incurred, the Group measures the amount of the loss as the difference between the carrying amount of the asset or group of assets and the present value of estimated future cash flows from the asset or group of assets, discounted at the effective interest rate of the instrument at initial recognition.

Impairment losses are assessed individually where significant or collectively for assets that are not individually significant.

Impairment losses are recognised in the income statement and the carrying amount of the financial asset or group of financial assets is reduced by establishing an allowance for the impairment losses. If in a subsequent period the amount of the impairment loss reduces and the reduction can be ascribed to an event after the impairment was recognised, the previously recognised loss is reversed by adjusting the allowance.

For amounts due from policyholders, the bad debt provision is calculated based upon prior loss experience. For all balances outstanding in excess of three months, a bad debt provision is made. Where a policy is subsequently cancelled, the outstanding debt that is overdue is written off to the income statement and the bad debt provision is written back to the income statement.

Derivatives and hedging
Derivative financial instruments are recognised initially, and subsequently measured, at fair value. Derivative fair values are determined from quoted prices in active markets where available. Where there is no active market for an instrument, fair value is derived from prices for the derivative's components using appropriate pricing or valuation models.

Gains and losses arising from changes in the fair value of a derivative are recognised as they arise in the income statement unless the derivative is the hedging instrument in a qualifying hedge. The Group currently enters into a number of hedge relationships, including net investment, cash flow and fair value hedges.

Hedge relationships are formally documented at inception. The documentation identifies the hedged item and the hedging instrument and details the risk that is being hedged and the way in which effectiveness will be assessed at inception and during the period of the hedge. If the hedge is not highly effective in offsetting changes in cash flows and fair values attributable to the hedged risk, consistent with the documented risk management strategy, or if the hedging instrument expires or is sold, terminated or exercised, hedge accounting is discontinued.

In the hedge of a net investment in a foreign operation, the portion of foreign exchange differences arising on the hedging instrument determined to be an effective hedge is recognised directly in equity. Any ineffective portion is recognised in the income statement. Non-derivative financial liabilities as well as derivatives may be the hedging instrument in a net investment hedge.

In a cash flow hedge, the effective portion of the gain or loss on the hedging instrument is recognised directly in equity. Any ineffective portion is recognised in the income statement.

In a fair value hedge, the gain or loss on the hedging instrument is recognised in the income statement. The gain or loss on the hedged item attributable to the hedged risk is recognised in the income statement and, where the hedged item is measured at amortised cost, adjusts the carrying amount of the hedged item.

Derecognition of financial assets
A financial asset is derecognised when the rights to receive the cash flows from that asset have expired or when the Group has transferred its rights to receive cash flows from the asset and has transferred substantially all the risk and rewards of ownership of the asset.

1.13 Cash and cash equivalents
Cash and cash equivalents comprise cash in hand and demand deposits with banks together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

Borrowings, comprising bank overdrafts and group loans, are measured at amortised cost using the effective interest rate method.

1.14 Financial liabilities
Financial liabilities are initially recognised at fair value net of transaction costs incurred. Other than derivatives which are recognised and measured at fair value, all other financial liabilities are subsequently measured at amortised cost using the effective interest rate method.

A financial liability is derecognised when the obligation under the liability is discharged, cancelled or expires.

1.15 Subordinated liabilities
Subordinated liabilities comprise subordinated dated loan notes and undated loans, which are initially measured at the consideration received less related transaction costs. Subsequently, subordinated liabilities are measured at amortised cost using the effective interest rate method.

1.16 Provisions
The Group recognises a provision for a present legal or constructive obligation from a past event when it is more likely than not that it will be required to transfer economic benefits to settle the obligation and the amount can be reliably estimated.

Restructuring provisions are made, including redundancy costs, when the Group has a constructive obligation to restructure. An obligation exists when the Group has a detailed formal plan and has communicated the plan to those affected by the plan.

When the Group has an onerous contract, it recognises the present obligation under the contract as a provision. A contract is onerous when the unavoidable costs of meeting the contractual obligations exceed the expected economic benefit. A provision is recognised when the Group vacates a leasehold property for the costs under the lease which exceed expected economic benefits.

The Group accrues for all insurance industry levies, such as the Financial Services Compensation Scheme and Motor Insurance Bureau in the UK, as a provision in the balance sheet and not within insurance liabilities. The levy accruals are based on past underwriting levels at the best estimate rate given the available information at the balance sheet date.

1.17 Leases

Payments made under operating leases are charged to the income statement on a straight-line basis over the term of the lease.

1.18 Pensions and other post-retirement benefits

The Group provides post-retirement benefits in the form of pensions and healthcare plans to eligible employees.

Contributions to the Group's defined contribution pension scheme are recognised in the income statement when payable. As described in note 33, the Group's defined benefit pension scheme was closed in 2003. Scheme liabilities are measured on an actuarial basis, using the projected unit credit method and discounted at a rate that reflects the current rate of return on a high quality corporate bond of equivalent term and currency to the scheme liabilities.

Scheme assets are measured at their fair value. Any surplus or deficit of scheme assets over liabilities is recognised in the balance sheet as an asset (surplus) or liability (deficit). The current service cost and any past service costs together with the expected return on scheme assets, less the unwinding of the discount on the scheme liabilities, is charged to operating expenses. Actuarial gains and losses are recognised in full in the period in which they occur outside the income statement and presented in other comprehensive income.

1.19 Taxation

The tax expense represents the sum of the tax currently payable and deferred tax.

The current tax expense is based on the taxable profits for the year as determined in accordance with the relevant tax legislation, after any adjustments in respect of prior years. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible.

Provision for taxation is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date, and is allocated over profits before taxation and amounts charged or credited to components of other comprehensive income and equity, as appropriate.

Deferred taxation is accounted for in full using the balance sheet liability method on all temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes.

Deferred tax liabilities are generally recognised for all taxable temporary timing differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax assets are reviewed at each balance sheet date and reduced to the extent that it is probable that they will not be recovered.

Deferred tax liabilities are calculated at the tax rates expected to apply when the liability is settled and deferred tax assets based on laws and rates that have been enacted or substantively enacted at the balance sheet date. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited in other comprehensive income, in which case the deferred tax is also dealt with in other comprehensive income.

1.20 Share-based payments

The Group operates a number of share-based compensation schemes under which it awards Company shares and share options to its employees. Such awards are generally subject to vesting conditions: conditions that vary the amount of cash or shares to which an employee is entitled.

Vesting conditions include service conditions (requiring the employee to complete a specified period of service) and performance conditions (requiring the employee to meet specified performance targets).

The fair value of options granted is estimated using valuation techniques which incorporate exercise price, term, risk-free interest rates, the current share price and its expected volatility.

The cost of employee services received in exchange for an award of shares or share options granted is measured by reference to the fair value of the shares or share options on the date the award is granted and takes into account non-vesting conditions and market performance conditions (conditions related to the market price of the Company's shares).

The cost is expensed on a straight-line basis over the vesting period (the period during which all the specified vesting conditions must be satisfied) with a corresponding increase in equity in an equity-settled award, or a corresponding liability in a cash-settled award. The cost is adjusted for vesting conditions (other than market performance conditions) so as to reflect the number of shares or share options that actually vest.

1. Accounting policies continued

1.21 Capital instruments
The Group classifies a financial instrument that it issues as a financial liability or an equity instrument in accordance with the substance of the contractual arrangement. An instrument is classified as a liability if it is a contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities on potentially unfavourable terms, or as equity if it evidences a residual interest in the assets of the group after the deduction of liabilities.

The consideration for any ordinary share of the Company purchased by the Group (employee trust shares) is deducted from equity. On the cancellation of employee trust shares their nominal value is removed from equity and any excess of consideration over nominal value is treated in accordance with the capital maintenance provision of the Companies Act 2006. On the sale or reissue of employee trust shares the consideration received is credited to equity, net of any directly attributable incremental costs and related tax.

1.22 Dividends
Interim dividends on ordinary shares are recognised in equity in the period in which they are paid. Final dividends on ordinary shares are recognised when they have been approved at the AGM.

1.23 Accounting developments
The IASB issued an amendment to IAS 12 'Income Taxes' in December 2010 to clarify that recognition of deferred tax should have regard to the expected manner of recovery or settlement of the asset or liability. The amendment and consequential withdrawal of SIC 21 'Deferred Tax: Recovery of Underlying Assets', effective for annual periods beginning on or after 1 January 2012, will not have a material effect on the Group.

IFRS 10 'Consolidated Financial Statements', which replaces SIC 12 'Consolidation – Special Purpose Entities' and the consolidation elements of the existing IAS 27 'Consolidated and Separate Financial Statements', was issued by the IASB in May 2011. The new standard adopts a single definition of control: a reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity. Effective for annual periods beginning on or after 1 January 2013, the new standard is not expected to have any effect on the Group.

In May 2011 the IASB issued amendments to IAS 27 'Separate Financial Statements' which comprises those parts of the existing IAS 27 that dealt with separate financial statements, effective for annual periods beginning on or after 1 January 2013. The amendment to this standard is not expected to have any effect on the Group.

IFRS 11 'Joint Arrangements', which supersedes IAS 31 'Interests in Joint Ventures', was issued by the IASB in May 2011. Joint operations are accounted for by the investor recognising its assets and liabilities including its share of any assets held and liabilities incurred jointly and its share of revenues and costs. Joint ventures are accounted for in the investor's consolidated accounts using the equity method. This standard is effective for annual periods beginning on or after 1 January 2013 but as the Group does not have any joint arrangements at this time, it is not expected to have any effect on the Group.

In May 2011 the IASB issued amendments to IAS 28 'Investments in Associates and Joint Ventures' to cover joint ventures as well as associates; both must be accounted for using the equity method. The mechanics of the equity method are unchanged. Effective for annual periods beginning on or after 1 January 2013, the amendments to this standard are not expected to have any effect on the Group.

IFRS 12 'Disclosure of Interests in Other Entities' covers disclosures for entities reporting under IFRS 10 and IFRS 11, replacing requirements in IAS 28 and IAS 27, and was issued by the IASB in May 2011. Entities are required to disclose information that helps financial statement readers evaluate the nature, risks and financial effects associated with an entity's interests in subsidiaries, in associates and joint arrangements and in unconsolidated structured entities. The new standard is effective for annual periods beginning on or after 1 January 2013, and is not expected to have any effect on the Group.

In May 2011 the IASB issued IFRS 13 'Fair Value Measurement' which sets out a single IFRS framework for defining and measuring fair value and requiring disclosures about fair value measurements, effective for annual periods beginning on or after 1 January 2013. The new standard will have an impact on the quantitative and qualitative disclosure requirements of financial assets and liabilities of the Group that are not covered by IFRS 7 'Financial Instruments: Disclosures'.

In June 2011 the IASB issued amendments to IAS 1 'Presentation of Items of Other Comprehensive Income' which require items that will never be recognised in the income statement to be presented in other comprehensive income separately from those that are subject to subsequent reclassification. The amendments are effective for annual periods beginning on or after 1 July 2012, and will have an impact on the disclosure requirements of the Group's financial statements commencing on 1 January 2013.

Amendments to IAS 19 'Employee Benefits' require the immediate recognition of all actuarial gains and losses eliminating the 'corridor approach'; interest costs to be calculated on the net pension liability or asset at the appropriate corporate bond rate; and all past service costs to be recognised immediately when a scheme is curtailed or amended. The amendments are effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted. The Group is reviewing the amendments to determine their effect on the Group's financial reporting. The new standard is not expected to have any material effect on the Group.

In December 2011 the IASB issued amendments to IFRS 7 'Financial Instruments: Disclosure – Offsetting Financial Assets and Financial Liabilities'. The amended disclosure requirements are intended to enable the evaluation of the effect or potential effect of netting arrangements as permitted by IAS 32 (paragraph 42), on the financial statements. The amendments are effective for annual periods beginning on or after 1 January 2013 and are not expected to have any effect on the Group.

In December 2011 the IASB amended IAS 32 'Financial Instruments: Presentation' for the section dealing with offsetting a financial asset and a financial liability. Effective for annual periods beginning on or after 1 January 2014, to be applied retrospectively, this amendment is not expected to have any effect on the Group.

The IASB has published IFRS 9 'Financial Instruments: Recognition and Measurement' that will apply to financial years beginning on 1 January 2015. The new standard has not been adopted by the EU. The standard is a complete revision and will replace the current standard IAS 39 'Financial Instruments: Recognition and Measurement'. The standard reduces the number of valuation categories for financial assets and means that they are recognised at amortised cost or fair value through profit or loss. The rules for financial liabilities correspond to the existing rules in IAS 39 plus a supplement on how credit risk is presented when financial liabilities are measured at fair value. The change in the credit risk for financial liabilities designated at fair value according to the so-called "fair value option" is normally presented in other comprehensive income and not in the income statement, provided that further inconsistencies do not arise in presentation of any eliminated changes in value.

The standard will be complemented by new rules for impairment of financial assets that are categorised as financial assets at amortised cost and new rules for hedge accounting. The adoption of IFRS 9 will impact both the measurement and disclosures of financial instruments (the Group does not plan to adopt this before the year beginning on 1 January 2015).

2. Critical accounting estimates and judgements

The reported results of the Group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial information. The Group's principal accounting policies are set out on pages 103 to 111. UK company law and IFRSs require the Directors, in preparing the Group's financial statements, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent. In the absence of an applicable standard or interpretation, IAS 8 requires management to develop and apply an accounting policy that results in relevant and reliable information in the light of the requirements and guidance in IFRS dealing with similar and related issues and the IASB's Framework for the Preparation and Presentation of Financial Statements. The judgements and assumptions involved in the Group's accounting policies that are considered by the Board to be the most important to the portrayal of its financial condition are discussed below. The use of estimates, assumptions or models that differ from those adopted by the Group would affect its reported results.

2.1 General insurance: outstanding claims provisions and related reinsurance recoveries

The Group makes provision for the full cost of outstanding claims from its general insurance business at the balance sheet date, including claims estimated to have been incurred but not yet reported at that date and loss adjustment expenses. Outstanding claims provisions net of related reinsurance recoveries and liability adequacy provision at 31 December 2012 amounted to £5,377.6 million (2011: £5,807.7 million).

The most common method of settling bodily injury claims is by a lump sum paid to the claimant and in the cases where this includes an element of indemnity for recurring costs such as loss of earnings or ongoing medical care, settlement normally occurs using a standardised Ogden annuity factor at a discount rate of 2.5%. This is normally referred to as the Ogden discount rate which is a prescribed rate set by the Ministry of Justice. Other estimates are also required for case management expenses, loss of pension, court protection fees, alterations to accommodation and transportation fees.

In August 2012, the Ministry of Justice announced a review of the approach to setting the Ogden discount rate within the existing legal framework in light of the current economic climate. The consultation has now taken place and the results are pending. In addition, in February 2013, a further consultation has been initiated on the legal framework within which the rate is set as well as consideration of the usage of PPOs as a form of settlement.

2. Critical accounting estimates and judgements continued

The Group holds provisions for a reduction in the Ogden discount rate at 31 December 2012 to 1.5% (2011: 1.5%), excluding PPOs, which are reserved for separately. A reduction in the Ogden discount rate would reduce the amount by which the cost of settling a claim as a PPO exceeds a lump sum settlement and this offset is allowed for in the provision. Outstanding claims provisions based on expected future settled amounts, are not discounted from settlement date to valuation date except for those in respect of PPOs under the Courts Act 2003. PPOs give rise to additional claims costs which are in excess of those calculated based on the Ogden tables and discounting is applied to the total cost of the PPO and not just the additional cost. The following table provides information regarding the outstanding claims provisions in respect of PPOs on a discounted and undiscounted basis. These represent the total cost of PPOs rather than any costs in excess of purely Ogden-based settlement.

At 31 December	Discounted 2012 £m	Undiscounted 2012 £m	Discounted 2011 £m	Undiscounted 2011 £m
Gross claims				
Approved PPO claims provisions	**300.5**	**918.3**	203.9	730.4
Anticipated PPOs	**962.9**	**2,778.6**	962.6	3,126.5
Total gross	**1,263.4**	**3,696.9**	1,166.5	3,856.9
Reinsurance				
Approved PPO claims provisions	**175.5**	**573.3**	123.6	485.3
Anticipated PPOs	**270.0**	**1,074.4**	207.6	966.7
Total reinsurance	**445.5**	**1,647.7**	331.2	1,452.0
Net of reinsurance				
Approved PPO claims provisions	**125.0**	**345.0**	80.3	245.1
Anticipated PPOs	**692.9**	**1,704.2**	755.0	2,159.8
Total net	**817.9**	**2,049.2**	835.3	2,404.9

The table above shows the discounted and undiscounted provision estimates for PPO claims split between those which have already settled as PPOs (approved PPO claims reserves) and those expected to settle as PPOs in the future (anticipated PPOs). Anticipated PPOs consists of both existing large loss case reserves including estimated incurred but not reported ("IBNR") on these claims as well as claims yet to be reported to the Group. The results are produced from cash flow projections of individual PPO claims. For settled PPOs, these projections allow for the terms of settlement including assumed future life expectancy and indexation. Both the Group's and the claimant's medical expert advice of life expectancy are considered. Reinsurance is applied at claim level and the net cash flows are discounted for the time value of money. The discount rate is consistent with the long duration of the claims payments and the assumed future indexation of the claims payments. Future PPO settlements are estimated using a similar projection of cash flows based on a sample of the claim characteristics from settled PPOs adjusted for timing differences.

In the majority of cases the inflation index agreed in the settlement is the Annual Survey of Hours and Earnings inflation, for which the long-term rate is assumed to be 4.0% (2011: 4.5%). The rate of interest used for the calculation of present values is 4.0% (2011: 4.5%), which results in a real discount rate of 0.0% (2011: 0.0%). All future payments in respect of approved PPOs are discounted to the current valuation date. All future payments in respect of anticipated PPO claims are discounted to the assumed settlement date of each claim, rather than the current valuation date.

Details of sensitivity analysis to the discount rate applied to PPO claims are shown in note 3.3.1.

2.2 Impairment provisions – financial assets

Available-for-sale – the Group determines that available-for-sale financial assets are impaired when there is objective evidence that an event or events since initial recognition of the assets have adversely affected the amount or timing of future cash flows from the asset. The determination of which events could have adversely affected the amount or timing of future cash flows from the asset requires judgement. In making this judgement, the Group evaluates, among other factors, the normal price volatility of the financial asset, the financial health of the investee, industry and sector performance, changes in technology and operational and financing cash flow or where there has been a significant or prolonged decline in the fair value of the asset below its cost. Impairment may be appropriate when there is evidence of deterioration in these factors.

On a quarterly basis, the Group reviews whether there is any objective evidence that the direct investments in debt securities are impaired based on the following criteria:

- price performance of a particular debt security, or group of debt securities, demonstrating an adverse trend compared to the market as a whole;
- adverse movements in the credit rating for corporate debt;
- actual, or imminent, default on coupon interest or nominal; or
- offer on buyback of perpetual bonds below par value.

Impairment provision charges on available-for-sale financial assets at 31 December 2012 amounted to £nil (2011: £2.0 million).

Had all the declines in available-for-sale asset values met the criteria above at 31 December 2012, the Group would suffer a further £21.5 million loss (2011: £37.3 million loss), being the transfer of the total available-for-sale reserve for unrealised losses to the income statement. These movements represent mark to market movements and where there is no objective evidence of any loss events that could affect future cash flows, no impairments are recorded for these movements.

2.3 Fair value

Financial assets classified as available for sale are recognised in the financial statements at fair value. In the balance sheet, financial assets carried at fair value are included within available-for-sale debt securities and other investment funds. Unrealised gains and losses on available-for-sale financial assets are recognised directly in other comprehensive income unless an impairment loss is recognised.

The fair value of all available-for-sale financial assets was determined using observable market input and at 31 December 2012 amounted to £7,156.5 million (2011: £7,990.7 million). The judgements and assumptions adopted by the directors in the valuation of available-for-sale financial assets when a market is not active require the use of valuation techniques. These valuation techniques involve a degree of estimation and are shown in note 1.12. Details of sensitivity analysis are shown in note 3.4.1.

2.4 Deferred acquisition costs

The Group defers a proportion of acquisition costs incurred during the year to subsequent accounting periods. Management use estimation techniques to determine the level of costs to be deferred, by category of business. Judgement is used to determine the types of cost that can be deferred and these are referred to in note 1.7. The total deferred acquisition costs at 31 December 2012 amounted to £327.6 million (2011: £310.5 million). During 2012, the Group reviewed the costs included in the calculation of deferred acquisition costs and considers them to be appropriate, and has determined that they are recoverable.

2.5 Goodwill

The Group capitalises goodwill arising on the acquisition of businesses as discussed in note 1.8. The carrying value of goodwill at 31 December 2012 was £211.0 million (2011: £211.0 million).

Goodwill is the excess of the cost of an acquired business over the fair value of its net assets. The determination of the fair value of assets and liabilities of businesses acquired requires the exercise of management judgement; for example those financial assets and liabilities for which there are no quoted prices and those non-financial assets where valuations reflect estimates of market conditions, such as property. Different fair values would result in changes to the goodwill arising and to the post-acquisition performance of the acquisition. Goodwill is not amortised but is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired.

For the purpose of impairment testing, goodwill acquired in a business combination is allocated to each of the Group's cash-generating units or groups of cash-generating units expected to benefit from the combination. Goodwill impairment testing involves the comparison of the carrying value of a cash-generating unit or group of cash-generating units with its recoverable amount. The recoverable amount is the higher of the unit's fair value and its value in use. Value in use is the present value of expected future cash flows from the cash-generating unit or group of cash-generating units. Fair value is the amount obtainable from the sale of the cash-generating unit in an arm's length transaction between knowledgeable, willing parties.

Impairment testing inherently involves a number of judgemental areas: the preparation of cash flow forecasts for periods that are beyond the normal requirements of management reporting; the assessment of the discount rate appropriate to the business; estimation of the fair value of cash-generating units; and the valuation of the separable assets of each business whose goodwill is being reviewed. Details of sensitivity analysis are shown in note 16.

3. Risk management

3.1 Enterprise-Wide Risk Management framework
The ERM framework within the Group is designed to ensure that risk management is a forward-looking discipline, focused on facilitating appropriate and fair outcomes on a consistent and reliable basis for all stakeholders. The ERM process provides the Group with a consistent and holistic view of risk management. Further information can be found in the Risk management section on page 26.

3.2 Risk and capital management modelling
The Board has ultimate responsibility for ensuring that the Group has sufficient capital to meet its liabilities as they fall due. The Group carries out detailed capital modelling of its assets, liabilities and the key risks to which these are exposed. This modelling includes the Group's own assessment of its capital requirements for solvency purposes, in its submission of its ICA to the FSA in respect of its UK regulated entities. The ICA quantifies the insurance, market, credit, liquidity, operational and group risk that the UK regulated entities are undertaking.

The Board is closely involved in the ICA process and signs off on its assumptions and results.

3.3 Insurance risk
Insurance risk can arise from:

- fluctuations in the timing, frequency and severity of insured events and their ultimate settlement, relative to the expectations of the Group at the time of underwriting, including those driven by inaccurate pricing, inappropriate underwriting guidelines and terms and conditions, and holding inadequate reserves;
- inadequate reinsurance protection; and
- concentration of business leading to unexpected claim levels (frequency and severity) from a single source.

The Group predominantly underwrites personal lines insurance including residential property, motor, assistance, creditor, travel and pet business. The Group also underwrites commercial risks primarily for low-to-medium risk trades within the SME market. Contracts are typically issued on an annual basis, which means that the Group's liability usually extends for a 12-month period, after which the Group is entitled to decline to renew or can impose renewal terms by amending the premium or other policy terms and conditions such as the excess as appropriate.

The Group underwrites long-term insurance falling within the business classes of life and annuity and permanent health. However, from 6 July 2011 the Group ceased accepting new business. The products provided include mortgage life cover, fixed term life cover with critical illness, over 50s life cover and the life cover associated with the creditor business underwritten by the Group's general insurance business. Contracts were issued typically on a long-term basis, which means that the Group's liability can extend for a period ranging from five years up to 52 years.

For creditor insurance, contracts were issued either on a monthly renewable basis (regular premium), which can be amended or cancelled by the customer at any point during the contract, or cover period of a loan (single premium). In the former case, the Group can cancel or amend the policy following a 90-day written notice period. In the latter case (these policies were withdrawn from sale in April 2009), the customer has the option to cancel the contract at any point but generally the Group is obligated for the full term up to a maximum of 10 years, but typically three to five years.

3.3.1 Reserving risk
Reserving risk relates to both premiums and claims. It is the risk that reserves are assessed incorrectly such that either insufficient funds have been retained to pay or handle claims as the amounts fall due both in relation to those claims which have already been incurred (in relation to claims reserves) or will be incurred in future periods of insurance (in relation to premium reserves), or a surplus of funds has been retained resulting in opportunity costs.

Reserving risk is controlled through a range of processes:

- regular periodic reviews of the claims and premium / liability adequacy reserves for the main classes of business by the internal actuarial team;
- the use of external actuaries to review periodically the actuarial best estimate reserves produced internally, either through peer review or through provision of independent reserve estimates;
- accompanying all reserve reviews with actuarial assessment of the uncertainties through a variety of techniques including bootstrapping and scenario analysis;
- oversight of the reserving process by relevant senior management and the Board;

- regular reconciliation of the data used in the actuarial reviews against general ledger data and reconciliation of the claims data history against the equivalent data from prior reviews; and
- assessing the volatility in the reserves to help the Board set management best estimate reserves which it feels comfortable with.

As referred to on page 28, uncertainty in claims reserve estimation is larger for claims such as PPOs for which annually indexed payments are made periodically over several years or even the lifetime of the injured party. Claims reserves for PPOs are held on a discounted basis and the table below indicates the sensitivity of discounted reserves to changes in the discount rate.

The table below provides a sensitivity analysis of the potential impact of a change in a single factor with all other assumptions left unchanged. Other potential risks beyond the ones described in the table could have an additional financial impact on the Group.

	Increase / (decrease) in income statement		Increase / (decrease) in total equity at 31 December	
	2012 £m	2011 £m	**2012 £m**	2011 £m
PPOs[1]				
Impact of an increase in the discount rate used in the calculation of present values of 100bps	**104.7**	106.5	**104.7**	106.5
Impact of a decrease in the discount rate used in the calculation of present values of 100bps	**(150.4)**	(152.1)	**(150.4)**	(152.1)

Notes:

1. The sensitivities relating to an increase or decrease in the discount rate used for PPOs illustrate a movement in the time value of money from the assumed level of 4%. An increase in the discount rate reflects a decrease in the time value of money and therefore the present value of future liabilities which increases the total equity which would be reflected in the income statement.
2. The selection of these sensitivities should not be interpreted as a prediction.
3. The sensitivities set out above reflect one-off impacts at 31 December.
4. The sensitivities set out above exclude the impact of taxation.

3.3.2 Claims management risk

Claims management risk is the risk that claims are paid or handled inappropriately.

Claims are managed utilising a range of IT system driven controls coupled with manual processes outlined in detailed policies and procedures to ensure claims are handled in an appropriate, timely and accurate manner.

Each member of staff has a specified handling authority, with controls preventing them handling or paying claims outside their authority, as well as controls to mitigate the risk of paying invalid claims. In addition, there are various outsourced claims handling arrangements, all of which are monitored closely by management, with similar principles applying in terms of the controls and procedures.

Loss adjustors are used in certain circumstances to handle claims to conclusion. This involves liaison with the policyholder, third parties, suppliers and the claims function.

Specialist bodily injury claims teams in the UK are responsible for handling these types of losses with the nature of handling dependent on the level and type of claim. Where applicable they are referred to the technical and large loss teams who also deal with all other claim types above defined limits or within specific criteria.

A process is in place in the UK business to deal with severe weather and other catastrophic events, known as the 'Surge Demand Plan'. A surge is the collective name given to an incident which significantly impacts the volume of claims reported to the Group's claims functions. The plan covers surge demand triggers, stages of incident, operational impact, communication and management information monitoring of the impact.

3. Risk management continued

3.3.3 Reinsurance risk
The Group uses reinsurance to:

- protect the insurance results against low-frequency, high-severity losses through the transfer of catastrophe claims volatility to reinsurers;
- protect the insurance results against unforeseen volumes of, or adverse trends in, large individual claims, in order to reduce volatility and to improve stability of earnings;
- reduce the Group's capital requirements; and/or
- transfer risk that is not within the Group's current risk retention strategy.

Using reinsurance the Group cedes away insurance risk to reinsurers but in return assumes back credit risk against which a reinsurance bad debt provision is assessed. The financial security of the Group's panel of reinsurers is therefore extremely important and both the quality and quantum of the assumed credit risk are subject to a credit risk approval process. The Group's leading counterparty exposures are analysed on a monthly basis where utilisation is monitored against agreed individual reinsurer limits. These limits represent the accumulated credit risk for all Group underwriting entities. The Group aims to contract with a diverse range of reinsurers on its contracts to mitigate the credit and/or non-payment risks associated with its reinsurance exposures.

Certain reinsurance contracts have long durations as a result of PPOs, and insurance reserves therefore include provisions beyond the levels created for shorter term reinsurance bad debt.

Reinsurance risk arises from:

- a failure of reinsurance to control exposure to losses, to reduce volatility or to protect capital;
- an inability to place reinsurance cost effectively or on acceptable terms; and/or
- reinsurer defaults.

3.3.4 Insurance concentration risk
The Group is subject to concentration risk in a variety of forms, including:

- geographic concentration risk – the Group purchases a UK catastrophe reinsurance programme to protect against a modelled 1 in 200 year combined windstorm and coastal inundation loss. The retained deductible is £125.0 million at 31 December 2012. There are also relevant covers to protect the Group's international businesses;
- product concentration risk – the Group's business is heavily concentrated in the UK general insurance market. However, the Group offers a diversified portfolio of products and a variety of brands sold through a range of distribution channels to its customers;
- sector concentration risk – the concentration of the Group to any given industry sector is monitored and analysed in respect of commercial customers; and
- reinsurance concentration risk – reinsurance is purchased from a number of providers to ensure that a diverse range of counterparties is contracted with, within the desired credit rating range.

3.4 Financial risk
The Group is exposed to financial risk through its financial assets and financial liabilities. The Group's financial risk is concentrated within its investment portfolio and reinsurance.

The strategic asset allocation within the investment portfolio is agreed for each legal entity by the Investment Committee. The Investment Committee determines high level policy and controls, covering such areas as safety, liquidity and performance. They meet at least three times a year to evaluate risk exposure, the current strategy, associated policies and investment guidelines and to consider investment recommendations submitted to it. Oversight of the implementation of decisions taken by the Investment Committee is via various risk fora.

The objectives set out in the investment management minimum standard are:

- to maintain the safety of the portfolio's principal both in economic terms and from an accounting and reporting perspective;
- to maintain sufficient liquidity to provide cash requirements for operations; and
- to maximise the portfolio's total return within the constraints of the other objectives and the limits defined by the investment guidelines.

3.4.1 Market risk

Market risk is the risk associated with the adverse impact of the market risk factors movement on the Group's balance sheet due to changes in the fair value or cash flows of its assets or liabilities.

The Group is mainly exposed to the following market risk factors:

- interest rate risk;
- credit spread risk;
- foreign currency risk; and
- property risk.

The Group has policies and limits approved by the Board for managing the market risk exposure. These set out the principles that the business should adhere to for managing market risk and establishing the maximum limits the Group is willing to accept considering strategy, risk appetite and capital resources.

The Group has the ability to monitor market risk exposure on a daily basis and has established limits per interest rate and credit spread exposures. The limits per asset class have been approved at the investment strategy level.

The Group uses its internal capital model to determine its capital requirements and market risk limits, and monitors its market risk exposure based on a 98% one-year value at risk measure. The Group also applies market risk stressed scenarios testing for analysing the economic impact of specific severe market conditions. The results of this analysis are used to enhance the understanding of market risk spots not captured by the value-at-risk metric and for implementing mitigating actions as appropriate.

The Group uses derivatives for hedging its exposure to foreign currency and interest rate risks. The market risk policy explicitly prohibits the use of derivatives for speculative or gearing purposes.

Interest rate risk

The Group's interest rate risk arises mainly from its debt, floating interest rate investments and assets and liabilities exposed to fixed interest rates.

In 2012, the Group issued £500 million of subordinated debt with a thirty-year maturity and fixed rate coupon for the first 10 years. The cost of the fixed rate coupon has been hedged down to the three-month LIBOR floating rate, using the treasury investment benchmark as a reference.

The Group also invests in floating rate notes. A downward movement of the short-term interest rate will affect the expected return on the investments.

The market value of the Group's investments in fixed coupon securities is affected by the movement of the interest rates. For the investments in US Dollar corporate bonds of £984.8 million, the Group hedges the exposure of this portfolio to the US Dollar interest rate risk using swaps. The derivatives reduce the duration of the portfolio to close to zero, eliminating its sensitivity to the US Dollar interest rate fluctuation.

Credit spread risk

The credit spread risk represents the risk of the adverse fluctuation of the values of assets and liabilities due to changes in the level of credit spreads. This represents the main market risk exposure of the Group's investments in investment grade bonds.

Foreign currency risk

The exposure to currency risk is generated by the Group's investments in US Dollar corporate bonds and its investment in subsidiaries.

At 31 December 2012, the Group maintained two investment portfolios in US Dollar corporate bonds. The foreign currency exposure of these investments is hedged by foreign currency forward contracts. The currency risk exposure is monitored on a daily basis and minimal exposure has been identified since its inception in May 2012.

The Group is also exposed to currency risk through its subsidiaries in Italy and Germany. The Group's currency risk arises from its investments in the subsidiaries' capital; this risk is hedged by foreign currency forward contracts from the date of acquisition.

Property risk

Property risk results from adverse price fluctuations on real estate investments. In 2012, the Board authorised the allocation of 5% of the UK subsidiary investment portfolio into real estate assets. At 31 December 2012, the value of these investments in property was £128.9 million (2011: £69.5 million). The property investments are located in the UK and are subject to the asset admissibility rules as defined by the FSA.

3. Risk management continued

The table below provides the sensitivity analysis of the potential impact of a change in a single factor with all other assumptions left unchanged. Other potential risks beyond the ones described in the table could have an additional financial impact on the Group.

	Increase / (decrease) in income statement		Increase / (decrease) in total equity at 31 December	
	2012 £m	2011 £m	**2012 £m**	2011 £m
Credit spread				
Impact of an increase in AFS debt securities of 100bps movement in credit spreads[1]	**–**	–	**(155.3)**	(137.3)
Interest rate				
Impact on AFS debt securities of an increase in interest rate of 100bps[1,2]	**12.9**	9.2	**(168.6)**	(233.2)
Other investment funds and investment property				
Impact of a decrease in property markets of 15%	**(19.3)**	(10.4)	**(19.3)**	(10.4)
Impact of a decrease in investment funds markets of 15%[3]	**–**	–	**–**	(57.4)

Notes:

1. The income statement impacts on AFS debt securities is limited to floating rate bonds and interest rate derivatives used to hedge a portion of the portfolio. The income statement is not impacted in relation to fixed rate bonds, where the coupon return is not changed through an alteration in prevailing market rates, as the accounting treatment for AFS debt securities means that only the coupon received is processed through this statement with fair value movements being recognised through total equity.
2. The sensitivities set out above reflect one-off impacts at 31 December with the exception of the income statement interest rate sensitivity on AFS debt securities, which projects a movement in a full year's interest charge as a result of the increase in the interest rate applied to the AFS debt securities and interest rate hedges on those positions held at 31 December.
3. The impact in 2011 results is a reduction in total equity only as a result of the accounting policy.
4. The subordinated debt is excluded from the sensitivity analysis.
5. The selection of these sensitivities should not be interpreted as a prediction.
6. The sensitivities set out above have not considered the impact of the general market changes on the value of the Group's insurance contract liabilities or retirement benefit obligations.
7. The sensitivities set out above exclude the impact of taxation.

The tables below analyse the maturity of the Group's derivative assets and liabilities at 31 December 2012. In the prior period, the Group conducted a small amount of derivative activity, primarily in relation to hedging its investment in its foreign subsidiary in Italy. All these contracts had a maturity of three months or less.

At 31 December 2012	Notional amounts £m	Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total fair value £m
Derivative assets					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	**1,339.7**	11.9	–	–	**11.9**
Interest rate swaps	**505.5**	1.7	–	23.7	**25.4**
Interest rate futures	**121.5**	–	0.1	0.1	**0.2**
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	**1.2**	–	–	–	**–**
Total	**1,967.9**	**13.6**	**0.1**	**23.8**	**37.5**

At 31 December 2012	Notional amounts £m	Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total fair value £m
Derivative liabilities					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	**666.5**	0.2	–	–	**0.2**
Interest rate swaps	**468.7**	–	3.1	0.7	**3.8**
Interest rate futures	**375.7**	–	0.1	–	**0.1**
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	**228.2**	2.4	–	–	**2.4**
Total	**1,739.1**	**2.6**	**3.2**	**0.7**	**6.5**

At 31 December 2012, £4.6 million in cash has been pledged by the Group and £0.8 million in cash and £1.1 million in a US Treasury bond pledged to the Group as collateral with regards to facilitating derivative trading (both interest rate and foreign exchange). The terms and conditions of collateral pledged for both assets and liabilities are market standard. The US Treasury bond is readily convertible to cash and as such there has been no policy established for the disposal of assets not readily convertible into cash.

3.4.2 Credit risk

Credit risk arises from the potential that losses are incurred from the failure of counterparties to meet their credit obligations, due either to their failure and/or their inability to pay, or their unwillingness to pay amounts due.

The objective of the credit risk policy and supporting minimum standards is to document the control processes by which the Group is able to identify, monitor, measure, manage, control and mitigate the level of credit risk to which it is exposed effectively. The credit risk control environment is primarily managed through the Credit Risk and Investment Forum. The main responsibility of this forum is to ensure that all material aspects of credit risk within the Group are identified, monitored and measured.

The main sources of credit risk for the Group are:

- investment counterparty – this arises from the investment of monies in the range of investment vehicles permitted by the investment policy; and
- reinsurance recoveries – credit exposure to reinsurance counterparties arises in respect of reinsurance claims against which a reinsurance bad debt provision is assessed. The Courts Act 2003, implemented in April 2005, gave the courts the power to award PPOs in place of lump sum awards to cover the future costs element of claims (that is, loss of future earnings and/or cost of future care). PPOs have the potential to increase the ultimate value of a claim and, by their very nature, to significantly increase the length of time to reach final payment. This has increased reinsurance credit risk in terms of both quantum and longevity.

The tables below provide information regarding the carrying value of financial and insurance assets that bear credit risk, and that have been impaired, and the ageing of financial assets that are past due but not impaired.

At 31 December 2012	Neither past due nor impaired £m	Past due 1 – 90 days £m	Past due more than 91 days £m	Financial assets that have been impaired £m	Carrying value in the balance sheet £m
Debt securities	**7,147.9**	–	–	8.6	**7,156.5**
Deposits with credit institutions	**1,951.7**	–	–	–	**1,951.7**
Reinsurance assets	**1,102.0**	–	–	–	**1,102.0**
Derivative assets	**37.5**	–	–	–	**37.5**
Cash at bank and in hand	**201.7**	–	–	–	**201.7**
Insurance and other loans and receivables	**1,109.8**	50.3	3.9	–	**1,164.0**
Total	**11,550.6**	**50.3**	**3.9**	**8.6**	**11,613.4**

3. Risk management continued

At 31 December 2011	Neither past due nor impaired £m	Past due 1 – 90 days £m	Past due more than 91 days £m	Financial assets that have been impaired £m	Carrying value in the balance sheet £m
Debt securities	7,598.3	–	0.7	8.9	7,607.9
Deposits with credit institutions	3,050.3	–	–	–	3,050.3
Reinsurance assets	741.6	–	–	–	741.6
Derivative assets	0.1	–	–	–	0.1
Cash at bank and in hand	201.9	–	–	–	201.9
Insurance and other loans and receivables	1,223.1	28.0	1.8	–	1,252.9
Total	12,815.3	28.0	2.5	8.9	12,854.7

There were no material financial assets that would have been past due or impaired had the terms not been renegotiated.

The tables below analyse, by type of asset, the credit quality of available-for-sale debt securities (note 24) that are neither past due nor impaired.

At 31 December 2012	Sovereign, supranational and local government debt securities £m	Corporate debt securities £m	Bank debt securities £m	Other financial institutions debt securities £m	Total available-for-sale debt securities £m	of which: Mortgage backed securities £m	Total non-mortgage backed securities £m
AAA rated	2,406.1	133.0	372.3	17.0	**2,928.4**	24.8	**2,903.6**
AA and above	196.9	377.4	371.0	–	**945.3**	–	**945.3**
A and above	15.6	1,810.6	691.8	48.6	**2,566.6**	16.7	**2,549.9**
BBB– and above	17.1	615.2	57.5	8.2	**698.0**	–	**698.0**
BB+ and below	–	–	18.2	–	**18.2**	3.7	**14.5**
Total	**2,635.7**	**2,936.2**	**1,510.8**	**73.8**	**7,156.5**	**45.2**	**7,111.3**

At 31 December 2011	Sovereign, supranational and local government debt securities £m	Corporate debt securities £m	Bank debt securities £m	Other financial institutions debt securities £m	Total available-for-sale debt securities £m	of which: Mortgage backed securities £m	Total non-mortgage backed securities £m
AAA rated	3,415.0	96.4	637.0	27.3	4,175.7	206.8	3,968.9
AA and above	57.0	279.9	434.0	–	770.9	67.2	703.7
A and above	9.2	1,377.3	858.1	11.3	2,255.9	9.5	2,246.4
BBB– and above	–	287.7	82.4	4.7	374.8	–	374.8
BB+ and below	–	–	23.3	–	23.3	–	23.3
Unrated	–	–	7.3	–	7.3	–	7.3
Total	3,481.2	2,041.3	2,042.1	43.3	7,607.9	283.5	7,324.4

Bank debt securities, at 31 December 2012, can be further analysed as: secured £211.1 million (2011: £418.8 million); unsecured £1,153.4 million (2011: £1,357.1 million); subordinated £146.3 million (2011: £193.9 million) and certificates of deposit £nil (2011: £72.3 million).

The tables below analyse, by type of asset, the credit quality of financial and insurance assets that are neither past due nor impaired excluding debt securities. The table includes reinsurance exposure, after provision. Note 3.3.3 details the Group's approach to reinsurance credit risk management.

At 31 December 2012	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB £m	BB+ £m	Not rated £m	Total £m
Deposits with credit institutions	1,256.7	145.0	550.0	–	–	–	**1,951.7**
Reinsurance assets	–	747.9	339.0	4.6	–	10.5	**1,102.0**
Derivative assets	–	2.5	35.0	–	–	–	**37.5**
Cash at bank and in hand	–	–	193.2	4.2	4.3	–	**201.7**
Insurance and other loans and receivables	–	10.7	88.7	1.0	1.8	1,061.8	**1,164.0**
Total	**1,256.7**	**906.1**	**1,205.9**	**9.8**	**6.1**	**1,072.3**	**4,456.9**

At 31 December 2011	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB £m	BB+ £m	Not rated £m	Total £m
Deposits with credit institutions	637.1	398.0	1,622.4	10.0	–	–	2,667.5
Reinsurance assets	32.4	484.9	177.4	5.9	–	41.0	741.6
Derivative assets	–	–	0.1	–	–	–	0.1
Cash at bank and in hand	–	–	201.9	–	–	–	201.9
Insurance and other loans and receivables	1.2	23.7	143.9	–	–	1,084.1	1,252.9
Total	670.7	906.6	2,145.7	15.9	–	1,125.1	4,864.0

Other investment funds at 31 December 2012 were £nil (2011: £382.8 million). These were not included in deposits with credit institutions above, as the disclosure of the funds held by credit quality is considered to be impractical.

Other loans and receivables due from policyholders, agents, brokers and intermediaries generally do not have a credit rating.

3.4.3 Liquidity risk

Liquidity risk is the potential that obligations cannot be met as they fall due as a consequence of having a timing mismatch and/or an inability to raise sufficient liquid assets or cash without suffering a substantial loss on realisation.

The measurement and management of liquidity risk within the Group is undertaken within the limits and other policy parameters of the Group's liquidity risk appetite. Compliance is monitored in respect of both the internal policy and the regulatory requirements of local regulators.

In the event that one or more liquidity stresses or scenarios crystallises, or should any other event that may impact liquidity occur, the Group ensures a rapid and controlled response to the event. In such an event, a liquidity crisis management team will be formed to assess the nature and extent of the threat and to develop an appropriate response.

The table below provides information regarding the maturity of available-for-sale debt securities.

	At 31 December	
	2012 £m	2011 £m
Within 1 year	**760.1**	818.8
1 – 3 years	**3,088.5**	2,808.3
3 – 5 years	**2,026.5**	2,140.0
5 – 10 years	**1,152.3**	1,576.4
Over 10 years	**129.1**	264.4
Total	**7,156.5**	7,607.9

In addition to the above, the Group held cash and cash equivalents at 31 December 2012 of £1,508.4 million (2011: £1,379.8 million) to cover short-term liabilities arising from insurance contracts.

3. Risk management continued

The tables below show the gross liability analysed by remaining duration for each category of insurance and financial liabilities. The total liability is split by remaining duration in proportion to the cash flows expected to arise during that period.

At 31 December 2012	Total £m	Within 1 year £m	1 – 3 years £m	3 – 5 years £m	5 – 10 years £m	Over 10 years £m
Subordinated liabilities	**787.5**	266.7	–	–	520.8	–
Insurance liabilities	**6,398.5**	1,872.6	1,749.9	857.9	785.5	1,132.6
Borrowings	**90.9**	90.9	–	–	–	–
Trade and other payables including insurance payables	**654.6**	648.7	2.1	0.6	3.2	–
Total	**7,931.5**	**2,878.9**	**1,752.0**	**858.5**	**1,309.5**	**1,132.6**

At 31 December 2011	Total £m	Within 1 year £m	1 – 3 years £m	3 – 5 years £m	5 – 10 years £m	Over 10 years £m
Insurance liabilities	6,509.0	2,054.8	1,844.4	864.6	850.3	894.9
Borrowings	317.9	71.5	205.0	–	11.3	30.1
Trade and other payables including insurance payables	910.2	910.2	–	–	–	–
Total	7,737.1	3,036.5	2,049.4	864.6	861.6	925.0

The above tables exclude unearned premium reserves as there are no liquidity risks inherent in them.

3.4.4 Investment concentration risk

Investment concentration risk arises through excessive exposure to particular industry sectors, groups of business undertakings or similar activities. The Group may suffer significant losses in its investment portfolio as a result of over-exposure to particular sectors engaged in similar activities or similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions.

The table below analyses the distribution of available-for-sale debt securities held by geographical area at 31 December 2012 as follows:

	Sovereign, supranational and local government debt securities £m	Corporate debt securities £m	Bank debt securities £m	Other financial institutions debt securities £m	Total available-for-sale debt securities £m	of which: Mortgage backed securities £m	Total non-mortgage backed securities £m
Australia	–	89.6	122.9	26.5	**239.0**	–	**239.0**
Austria	2.9	–	–	–	**2.9**	–	**2.9**
Belgium	7.1	14.3	1.7	–	**23.1**	–	**23.1**
Brazil	–	0.4	–	–	**0.4**	–	**0.4**
Canada	134.6	34.6	34.8	–	**204.0**	–	**204.0**
Cayman Islands	–	7.5	–	–	**7.5**	–	**7.5**
Czech Republic	–	6.4	–	–	**6.4**	–	**6.4**
Denmark	–	14.5	18.0	–	**32.5**	–	**32.5**
Finland	–	7.1	6.2	–	**13.3**	–	**13.3**
France	4.5	216.4	83.7	–	**304.6**	8.4	**296.2**
Germany	–	207.4	185.3	–	**392.7**	33.1	**359.6**
Hong Kong	–	3.3	–	–	**3.3**	–	**3.3**
Ireland	–	5.4	12.2	–	**17.6**	3.7	**13.9**
Israel	–	4.4	–	–	**4.4**	–	**4.4**
Italy	–	33.7	2.7	–	**36.4**	–	**36.4**
Japan	–	61.3	4.4	–	**65.7**	–	**65.7**
Mexico	17.2	5.8	–	–	**23.0**	–	**23.0**
Netherlands	4.3	47.2	71.8	–	**123.3**	–	**123.3**
New Zealand	–	26.5	13.8	–	**40.3**	–	**40.3**
Norway	82.2	6.7	15.7	–	**104.6**	–	**104.6**
Singapore	–	25.5	–	–	**25.5**	–	**25.5**
South Korea	–	–	7.4	–	**7.4**	–	**7.4**
Spain	–	4.2	12.1	–	**16.3**	–	**16.3**
Sweden	31.0	36.9	163.8	–	**231.7**	–	**231.7**
Switzerland	–	68.7	39.8	–	**108.5**	–	**108.5**
UK	1,824.0	1,285.5	481.6	5.5	**3,596.6**	–	**3,596.6**
UAE	–	12.2	–	–	**12.2**	–	**12.2**
USA	6.1	710.7	232.9	41.8	**991.5**	–	**991.5**
Multilateral / supranational	521.8	–	–	–	**521.8**	–	**521.8**
Total	**2,635.7**	**2,936.2**	**1,510.8**	**73.8**	**7,156.5**	**45.2**	**7,111.3**

3. Risk management continued

The table below analyses the distribution of available-for-sale debt securities held by geographical area at 31 December 2011 as follows:

	Sovereign, supranational and local government debt securities £m	Corporate debt securities £m	Banks debt securities £m	Other financial institutions debt securities £m	Total available-for-sale debt securities £m	of which: Mortgage backed securities £m	Total non-mortgage backed securities £m
Australia	–	74.6	164.9	38.3	277.8	–	277.8
Austria	2.8	–	10.0	–	12.8	–	12.8
Belgium	6.9	2.7	4.4	–	14.0	–	14.0
Canada	68.1	16.6	1.8	–	86.5	–	86.5
Cayman Islands	–	2.8	–	–	2.8	–	2.8
Denmark	–	8.4	23.0	–	31.4	–	31.4
Finland	–	3.6	4.3	–	7.9	–	7.9
France	77.4	249.3	108.5	–	435.2	9.7	425.5
Germany	–	108.7	275.7	–	384.4	29.0	355.4
Ireland	–	13.4	28.9	–	42.3	3.7	38.6
Italy	–	13.8	–	–	13.8	–	13.8
Japan	–	16.3	–	–	16.3	–	16.3
Luxembourg	–	5.2	–	–	5.2	–	5.2
Mexico	–	7.5	–	–	7.5	–	7.5
Netherlands	4.4	183.9	111.1	–	299.4	–	299.4
New Zealand	–	18.0	8.5	–	26.5	–	26.5
Norway	43.0	–	18.1	–	61.1	–	61.1
Spain	–	8.7	16.0	–	24.7	–	24.7
Sweden	9.2	25.6	123.7	–	158.5	–	158.5
Switzerland	–	7.1	36.8	–	43.9	–	43.9
UK	2,780.8	1,144.2	921.0	5.0	4,851.0	241.1	4,609.9
UAE	–	2.6	0.4	–	3.0	–	3.0
USA	–	128.3	185.0	–	313.3	–	313.3
Multilateral / supranational	488.6	–	–	–	488.6	–	488.6
Total	3,481.2	2,041.3	2,042.1	43.3	7,607.9	283.5	7,324.4

The table below analyses the distribution of debt securities held across industry sectors using Bloomberg classifications as follows:

	At 31 December			
	2012		2011	
	£m	**%**	£m	%
Basic materials	**199.7**	**3%**	117.9	2%
Communications	**333.7**	**5%**	196.7	3%
Consumer, cyclical	**137.2**	**2%**	56.1	1%
Consumer, non-cyclical	**475.7**	**6%**	291.4	4%
Diversified	**120.9**	**2%**	148.5	2%
Energy	**273.8**	**4%**	210.2	3%
Financial	**1,798.3**	**25%**	1,917.4	25%
Sovereign, supranational and local government	**2,635.7**	**37%**	3,481.2	44%
Industrial	**265.1**	**4%**	100.9	1%
Mortgage backed securities	**45.2**	**0%**	283.5	4%
Technology	**59.9**	**1%**	–	–
Transport	**18.1**	**0%**	–	–
Utilities	**793.2**	**11%**	804.1	11%
Total	**7,156.5**	**100%**	7,607.9	100%

Other investment funds at 31 December 2012 were £nil (2011: £382.8 million). These were not analysed in the above for prior periods, as the disclosure of the funds held by industry sector is considered to be impractical.

3.5 Operational risk

Effective operational risk management requires the Group to identify, assess, manage, monitor, report and mitigate all areas of exposure. Operational risk is inherent in all of the Group's processes, systems and products, and from external events, with the Group's ERM framework detailing the minimum standards, tools, techniques and other processes used to ensure that operational risks are identified, managed and mitigated to an acceptable level and that contingency plans are in place.

There are a number of key factors that cause operational risk:

- the Group's operations support complex transactions and are highly dependent on the proper functioning of its IT and communication systems;
- a dependency on the use of third-party information technology, software, data and service providers;
- a need to adequately maintain and protect customer and employee information; and
- the ability of the Group to attract and retain key qualified personnel.

Effective operational risk management helps the Group to achieve its objectives, including:

- focus on doing things the right way, leading to fewer surprises;
- reducing operational errors and losses, leading to increased customer satisfaction and higher-quality earnings;
- informed analytical risk taking;
- increased management attention to the risks and issues that really matter; and
- lower risk-based capital due to lower expected losses.

3.6 Regulatory risk

The risk is managed by a dedicated team responsible for providing expert advice and guidance to all parts of the business on regulatory, political and legislative change, including Solvency II. Through proactive and early engagement the team raises awareness of regulatory changes, enabling management to plan for potential threats and opportunities. The team also supports the business in identifying, analysing and coordinating responses to relevant UK and European regulatory developments through to facilitating the initiation of implementation programmes.

3. Risk management continued

3.7 Capital adequacy
The Group defines its capital requirement in accordance with regulations prescribed by the FSA, other regulatory bodies and the credit rating agencies. Capital is managed in accordance with the Group's capital management minimum standard, the objective of which is to manage capital efficiently and maintain an appropriate level of capitalisation and solvency.

The Group determines the appropriate level of capital on the basis of a number of criteria including its risk-based requirement, the maintenance of a prudent excess versus regulatory capital requirements, and its capital risk appetite statement of ensuring consistency with a credit rating in the 'A' range. The Group seeks to hold capital coverage in the range of 125% to 150% of the risk-based capital requirement. The Group also manages its subsidiaries on an ongoing basis to ensure that capital resources exceed regulatory minima in accordance with its risk appetite.

The Group uses a risk-based capital model to determine how much capital it needs to maintain in order to operate in accordance with its risk strategy for the UK general insurance underwriters established within its ERM framework. The risk-based capital model also supports decision making in the business. In addition, the Group monitors financial resources with reference to the requirements of the IGD.

The UK regulated insurance entities of the Group carry out an assessment of the adequacy of their overall financial resources in accordance with the FSA's ICA methodology. For the UK, this is based on an internal capital model which is calibrated, as required by the FSA, to a 99.5% confidence interval over a one-year time horizon. As stated above, the Group's capital risk appetite is to hold capital consistent with the Group maintaining a credit rating in the 'A' range and as such its capital resources are in excess of the ICA requirement. The capital for European entities is maintained in accordance with the local regulatory solvency requirements.

The Group has an IGD surplus at 31 December 2012 of approximately £1.8 billion (2011: £2.4 billion).

Management information to monitor the Group's capital requirements and solvency position is produced and presented to the asset and liability committee on a regular basis.

4. Segmental analysis

The Group is a general insurer with leading direct market positions in the UK, Italy and Germany. The Group utilises a multi-brand, multi-product, multi-channel business model that covers most major customer segments in the UK for personal lines general insurance and a more limited presence in the commercial market.

The Directors manage the Group primarily by product type and present the segmental analysis on that basis. The segments reflect the management structure whereby a member of the Executive Committee is accountable to the Chief Executive Officer for each of the following operating segments:

Motor
This segment consists of personal car insurance cover together with the associated legal expenses business. The Group sells motor insurance through its own brands – Direct Line, Churchill and Privilege – and through partnership brands directly to customers or through PCWs. As a result, the Group has a brand and product offering that covers most major retail customer segments for motor insurance in the UK.

Home
This segment consists of the underwriting of home insurance cover. The Group sells home insurance through its own brands – Direct Line, Churchill and Privilege – and through partnerships or PCWs. The Group's brand and product offering covers most of the major retail customer segments for home insurance in the UK.

Rescue and other personal lines
This segment consists of the underwriting of rescue and recovery insurance products and other personal lines business including travel, pet, life (closed for new business) and creditor.

The Group sells rescue and recovery insurance as a stand-alone product through the Green Flag brand or as an insurance add-on to all Group own brand and certain partner motor policies, or as part of packaged bank accounts. Rescue insurance policies range from basic roadside rescue to a full Europe-wide breakdown recovery service.

The Group sells its other personal lines insurance through its own brands – Direct Line, Churchill and Privilege – and through partnerships.

Commercial
This segment consists of the underwriting of commercial insurance for micro businesses and SMEs in the UK. The Group sells commercial products through its own brands – NIG and DL4B – and through its partnership with RBS and NatWest.

International
This segment consists primarily of motor insurance, sold to private customers in Germany and Italy using a multi-channel strategy through the Direct Line brand and through partnerships and PCWs.

Certain charges are not allocated to the specific operating segments above as they are considered by management to be outside underlying business activities by virtue of their one-off incidence, size or nature. Such charges are categorised as either run-off or restructuring and other one-off items, as described below:

Run-off
The businesses included in the run-off segment consist of two principal lines, being policies written through partnership arrangements with TPF and NIG personal lines business sold via brokers. The partnership arrangements have been exited and the residual businesses are now in run-off. TPF was entered into as a 50:50 joint venture with Tesco in 1999, whereby the Group underwrote a range of general and life insurance products under the Tesco brand to Tesco customers.

Restructuring and other one-off costs
Costs included within restructuring and other one-off costs include items that are exceptional in nature, including additional expenses as a result of separation and divestment from RBS Group and impairment of goodwill.

No inter-segment transactions occurred in the periods ending 2012 and 2011. If any transaction were to occur, transfer prices between operating segments are set on an arm's length basis in a manner similar to transactions with third parties. Segment income, expenses and results will include those transfers between business segments which will then be eliminated on consolidation.

For each operating segment, there is no individual policyholder or customer that represents 10% or more of the Group's total revenue.

4. Segmental analysis continued

The table below is an analysis of the Group's revenue and results by reportable segment for the year ended 31 December 2012:

	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	International £m	Total ongoing £m	Run-off £m	Restructuring and other one-off costs £m	Total Group £m
Gross written premium	1,623.5	989.0	389.8	435.6	552.7	**3,990.6**	10.8	–	**4,001.4**
Gross earned premium	1,677.8	1,005.2	402.5	433.2	510.3	**4,029.0**	19.5	–	**4,048.5**
Reinsurance premium ceded	(48.6)	(54.4)	(19.7)	(30.4)	(167.2)	**(320.3)**	(6.2)	–	**(326.5)**
Net earned premium	1,629.2	950.8	382.8	402.8	343.1	**3,708.7**	13.3	–	**3,722.0**
Investment return	140.0	34.1	7.5	29.4	23.7	**234.7**	47.1	–	**281.8**
Instalment and other operating income	148.1	26.5	10.7	5.9	7.1	**198.3**	0.4	–	**198.7**
Total income	1,917.3	1,011.4	401.0	438.1	373.9	**4,141.7**	60.8	–	**4,202.5**
Insurance claims	(1,364.8)	(560.7)	(218.1)	(278.2)	(401.9)	**(2,823.7)**	(51.6)	–	**(2,875.3)**
Insurance claims recoverable from reinsurers	148.3	6.0	23.2	24.1	133.9	**335.5**	115.5	–	**451.0**
Net insurance claims	(1,216.5)	(554.7)	(194.9)	(254.1)	(268.0)	**(2,488.2)**	63.9	–	**(2,424.3)**
Commission expenses	(31.9)	(154.2)	(22.9)	(87.0)	(41.5)	**(337.5)**	(115.4)	–	**(452.9)**
Operating expenses	(407.1)	(209.2)	(98.8)	(94.8)	(44.9)	**(854.8)**	(3.2)	(189.5)	**(1,047.5)**
Total expenses	(439.0)	(363.4)	(121.7)	(181.8)	(86.4)	**(1,192.3)**	(118.6)	(189.5)	**(1,500.4)**
Operating profit / (loss)	**261.8**	**93.3**	**84.4**	**2.2**	**19.5**	**461.2**	**6.1**	**(189.5)**	**277.8**
Finance costs									**(28.7)**
Profit before tax									**249.1**
Loss ratio	74.6%	58.4%	50.9%	63.1%	78.1%	**67.1%**			
Commission ratio	2.0%	16.2%	6.0%	21.6%	12.1%	**9.1%**			
Expense ratio	25.0%	22.0%	25.8%	23.5%	13.1%	**23.0%**			
Combined operating ratio	**101.6%**	**96.6%**	**82.7%**	**108.2%**	**103.3%**	**99.2%**			

The table below is an analysis of the Group's revenue and results by reportable segment for the year ended 31 December 2011:

	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	International £m	Total ongoing £m	Run-off £m	Restructuring and other one-off costs £m	Total Group £m
Gross written premium	1,734.8	1,031.3	350.2	438.6	570.0	4,124.9	43.4	–	4,168.3
Gross earned premium	1,797.4	1,031.1	410.3	420.5	482.8	4,142.1	380.8	–	4,522.9
Reinsurance premium ceded	(25.8)	(57.0)	(19.5)	(27.8)	(121.1)	(251.2)	(18.7)	–	(269.9)
Net earned premium	1,771.6	974.1	390.8	392.7	361.7	3,890.9	362.1	–	4,253.0
Investment return	145.2	28.5	9.5	30.5	25.0	238.7	43.2	–	281.9
Instalment and other operating income	208.2	35.1	–	5.0	7.2	255.5	(15.4)	–	240.1
Total income	2,125.0	1,037.7	400.3	428.2	393.9	4,385.1	389.9	–	4,775.0
Insurance claims	(1,501.6)	(579.2)	(195.7)	(268.6)	(391.4)	(2,936.5)	(224.1)	–	(3,160.6)
Insurance claims recoverable from reinsurers	54.8	19.9	22.1	11.9	96.8	205.5	(12.4)	–	193.1
Net insurance claims	(1,446.8)	(559.3)	(173.6)	(256.7)	(294.6)	(2,731.0)	(236.5)	–	(2,967.5)
Commission expenses	(25.9)	(170.0)	(87.8)	(82.3)	(28.6)	(394.6)	(124.3)	–	(518.9)
Operating expenses	(397.5)	(196.5)	(75.6)	(101.6)	(66.4)	(837.6)	(53.0)	(54.0)	(944.6)
Total expenses	(423.4)	(366.5)	(163.4)	(183.9)	(95.0)	(1,232.2)	(177.3)	(54.0)	(1,463.5)
Operating profit / (loss)	254.8	111.9	63.3	(12.4)	4.3	421.9	(23.9)	(54.0)	344.0
Finance costs									(2.7)
Gain on disposal of subsidiary									1.6
Profit before tax									342.9
Loss ratio	81.7%	57.4%	44.4%	65.4%	81.4%	70.2%			
Commission ratio	1.5%	17.5%	22.5%	21.0%	7.9%	10.1%			
Expense ratio	22.4%	20.2%	19.4%	25.9%	18.3%	21.5%			
Combined operating ratio	105.6%	95.1%	86.3%	112.3%	107.6%	101.8%			

The table below is an analysis of the Group's segment assets and liabilities at 31 December 2012:

	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	International £m	Run-off £m	Total Group £m
Goodwill	126.4	45.8	28.7	10.1	–	–	**211.0**
Other segment assets	7,146.8	873.1	358.2	1,318.0	1,199.6	1,591.2	**12,486.9**
Segment liabilities	(5,519.5)	(674.3)	(276.6)	(1,017.9)	(977.5)	(1,400.5)	**(9,866.3)**
Reportable segment net assets	**1,753.7**	**244.6**	**110.3**	**310.2**	**222.1**	**190.7**	**2,831.6**

4. Segmental analysis continued

The table below is an analysis of the Group's segment assets and liabilities at 31 December 2011:

	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	International £m	Run-off £m	Total Group £m
Goodwill	126.4	45.8	28.7	10.1	–	–	211.0
Other segment assets	7,241.2	1,565.9	316.7	1,486.4	1,070.8	1,878.1	13,559.1
Segment liabilities	(5,204.5)	(1,138.5)	(244.0)	(1,057.1)	(871.3)	(1,383.4)	(9,898.8)
Reportable segment net assets	2,163.1	473.2	101.4	439.4	199.5	494.7	3,871.3

All operations are in the UK except for International which operates in Germany and Italy. The reportable segment net assets do not represent the Group's view of the capital requirements for its operating segments.

5. Net earned premium

	2012 £m	2011 £m
Premium income from insurance contracts issued:		
Premium receivable	**4,001.4**	4,168.3
Change in unearned premium reserve	**47.1**	354.6
	4,048.5	4,522.9
Premium revenue ceded to reinsurers on insurance contracts issued:		
Premium payables	**(365.4)**	(257.1)
Change in reinsurance unearned premium reserve	**38.9**	(12.8)
	(326.5)	(269.9)
Total	**3,722.0**	4,253.0

6. Investment return

	2012 £m	2011 £m
Investment income:		
Interest income on debt securities	**172.5**	208.1
Other investment funds income	**3.1**	8.5
Cash and cash equivalent interest income	**19.3**	20.4
Rental income from investment property	**4.4**	6.6
Total	**199.3**	243.6
Net realised gains:		
Debt securities	**66.3**	54.3
Other investment funds	**23.2**	–
Derivatives[1]	**17.8**	–
Impairments of available-for-sale debt securities	**–**	(2.0)
Net unrealised losses:		
Derivatives[2]	**(20.0)**	–
Investment property (note 18)	**(4.8)**	(14.0)
Total	**281.8**	281.9

Notes:

1. Derivative net realised gains includes a £3.8 million loss on interest rate derivatives, with a £0.2 million gain on associated hedged risk and a £24.3 million gain on foreign exchange derivatives with a £2.9 million loss on the associated hedged risk.
2. Derivative net unrealised losses includes a £2.1 million loss on interest rate derivatives with a £3.0 million gain on the associated hedged risk and a £11.7 million gain on foreign exchange derivatives with a £32.6 million loss on the associated hedged risk.

7. Instalment and other operating income

	2012 £m	2011 £m
Instalment income	**125.4**	145.0
Solicitors' referral fee income	**21.2**	27.9
Vehicle replacement referral income	**17.5**	21.9
Revenue from vehicle recovery and repair services	**25.9**	39.3
Fee income from insurance intermediary services	**1.9**	3.4
Other income	**6.8**	2.6
Other operating income	**73.3**	95.1
Total	**198.7**	240.1

8. Insurance claims

	2012		
	Gross £m	**Reinsurance £m**	**Net £m**
Current accident year claims paid	**1,360.0**	**(71.3)**	**1,288.7**
Prior accident years claims paid	**1,612.1**	**(55.6)**	**1,556.5**
Movement in claims provision	**(96.8)**	**(324.1)**	**(420.9)**
Total	**2,875.3**	**(451.0)**	**2,424.3**

	2011		
	Gross £m	Reinsurance £m	Net £m
Current accident year claims paid	1,646.5	(113.2)	1,533.3
Prior accident years claims paid	1,976.4	(37.4)	1,939.0
Movement in claims provision	(462.3)	(42.5)	(504.8)
Total	3,160.6	(193.1)	2,967.5

Loss adjustment expenses for the year ended 31 December 2012 of £290.3 million (2011: £296.4 million) have been included in the claims figures above.

An increase in the liability adequacy provision for the year ended 31 December 2012 of £0.7 million (2011: £21.8 million reduction) has been included in the movement in claims provision.

9. Commission expenses

	2012 £m	2011 £m
Commission expenses	**316.5**	324.5
Expenses incurred under profit participations	**136.4**	194.4
Total	**452.9**	518.9

10. Operating expenses

	2012 £m	2011 £m
Staff costs	**416.7**	321.6
Marketing	**203.1**	203.5
Management fees	**145.5**	282.0
Depreciation	**13.1**	10.4
Amortisation and impairment of other intangible assets	**40.7**	29.8
Impairment of goodwill	**–**	10.2
Other operating expenses	**228.4**	87.1
Total	**1,047.5**	944.6

Staff costs attributable to claims handling activities are allocated to claims and loss adjustment expenses.

Management fees are in respect of expenses recharged from RBS Group up until 30 June 2012; management fees are charged on an arm's length basis. These costs since 30 June 2012 have been incurred directly and included in staff costs and other operating expenses.

Included in operating expenses are run-off, restructuring and other one-off costs as follows:

	2012 £m	2011 £m
Staff costs	**103.9**	33.0
Management fees	**16.3**	42.0
Impairment of goodwill	**–**	10.2
Other operating expenses	**72.5**	21.8
Total	**192.7**	107.0

Average number of persons employed	2012	2011
Operations	**13,662**	14,765
Support	**1,880**	1,552
Total	**15,542**	16,317

Their aggregate remuneration comprised:

	2012 £m	2011 £m
Wages and salaries	**444.5**	425.3
Social security costs	**50.0**	47.6
Pension costs	**62.3**	41.6
Share-based payments	**0.3**	–
Total	**557.1**	514.5

Auditor's remuneration

	2012 £m	2011 £m
Fees payable for the audit of:		
The Company's annual accounts – Deloitte LLP	**0.2**	0.1
The Company's subsidiaries – Deloitte LLP	**1.3**	1.4
The Company's subsidiaries – Mazars	**0.1**	0.1
Total audit fees	**1.6**	1.6
Fees payable to Deloitte LLP for non-audit services:		
Audit-related assurance services	**0.3**	0.3
Taxation advisory services	**0.1**	–
Corporate finance services	**4.1**	0.7
Other services	**–**	1.0
Total non-audit services	**4.5**	2.0
Total	**6.1**	3.6

Fees in relation to corporate finance services relate to the divestment of Direct Line Group from RBS Group. Fees in relation to other services in 2011 relate to the provision of advice and design support on the new claims operating model.

Aggregate Directors' emoluments

The remuneration and pension benefits of the Directors, including those of the highest paid Director, are included in the Directors' remuneration report in the corporate governance section of the Annual Report & Accounts.

At 31 December 2012, one Director (2011: three) had retirement benefits accruing under money purchase pension schemes in respect of qualifying service.

During the year ended 31 December 2012 one Director exercised share options (2011: none).

11. Finance costs

	2012 £m	2011 £m
Interest expense on subordinated dated notes[1]	**26.7**	–
Other interest expense	**2.0**	2.7
Total	**28.7**	2.7

Note:

1. As described in note 29, the Group entered into a 10-year hedge to exchange the fixed rate of interest on the subordinated loan notes for a floating rate of three-month LIBOR plus a spread of 706 basis points.

12. Tax charge

	2012 £m	2011 £m
Current taxation:		
Charge for the year	**61.7**	157.2
(Over) / under-provision in respect of prior year	**(1.0)**	10.8
	60.7	168.0
Deferred taxation (note 13):		
Charge / (credit) for the year	**13.9**	(56.1)
Over-provision in respect of prior year	**(9.8)**	(18.0)
	4.1	(74.1)
Current taxation	**60.7**	168.0
Deferred taxation (note 13)	**4.1**	(74.1)
Tax charge for the year	**64.8**	93.9

The actual income tax charge differs from the expected income tax charge computed by applying the standard rate of UK corporation tax of 24.5%[1] (2011: 26.5%) as follows:

	2012 £m	2011 £m
Profit before tax	**249.1**	342.9
Expected tax charge	**61.0**	90.9
Effects of:		
Higher tax rates on overseas earnings	**3.0**	–
Net movement in impairment of goodwill	**–**	2.9
Realised gains on disposal of subsidiary	**–**	0.4
Disallowable expenses	**9.6**	7.1
Non-taxable items	**(0.7)**	–
Effect of change in UK taxation rate	**2.7**	(0.2)
Over-provision in respect of prior year	**(10.8)**	(7.2)
Tax charge for the year	**64.8**	93.9
Effective income tax rate	**26.0%**	27.4%

Note:

1. The UK Government enacted a reduction in the UK corporation tax rate from 26% to 24% effective from 1 April 2012 in the Finance Act 2012, which also enacted a further reduction to 23% to be effective from 1 April 2013. As a consequence the closing deferred tax assets and liabilities have been recognised at an effective rate of 23%. The impact of these changes on the tax charge for the year is set out in the table above.

	2012 £m	2011 £m
Per balance sheet:		
Current tax assets	**5.5**	–
Current tax liabilities	**34.5**	218.0

13. Deferred tax

The following are the deferred tax assets and liabilities recognised by the Group, and the movements thereon, during the current and prior reporting years.

	Other temporary differences £m	Retirement benefit obligation £m	Depreciation in excess of capital allowances £m	Non-distributable reserve £m	**Total £m**
At 1 January 2011	(5.8)	–	1.4	(54.9)	(59.3)
Credit / (charge) to income statement	28.3	(0.6)	(0.5)	46.9	74.1
At 31 December 2011	22.5	(0.6)	0.9	(8.0)	14.8
Credit / (charge) to income statement	**4.4**	**(0.6)**	**(0.5)**	**(7.4)**	**(4.1)**
(Charge) / credit to other comprehensive income	**(6.1)**	**0.6**	**–**	**–**	**(5.5)**
Other movements	**(3.6)**	**–**	**–**	**–**	**(3.6)**
At 31 December 2012	**17.2**	**(0.6)**	**0.4**	**(15.4)**	**1.6**

A deferred tax asset of £1.2 million has not been recognised in respect of capital losses arising on the revaluation of investment property as there are currently no eligible gains against which these unrealised losses can be utilised.

	2012 £m	2011 £m
Per balance sheet:		
Deferred tax assets	**22.5**	26.9
Deferred tax liabilities	**(20.9)**	(12.1)
	1.6	14.8

14. Dividends

	2012 pence	2011 pence	**2012 £m**	2011 £m
Ordinary dividend:				
Interim dividend paid in respect of current year on 27 March 2012	**20.0**	–	**300.0**	–
Interim dividend paid in respect of current year on 6 June 2012	**33.3**	–	**500.0**	–
Interim dividend paid in respect of current year on 3 September 2012	**13.3**	–	**200.0**	–
Total			**1,000.0**	–

The Directors have recommended that, subject to approval at the AGM on 6 June 2013, a final dividend of 8 pence per Ordinary Share totalling £120.0 million is to be paid on 9 June 2013 to members on the register at the close of business on 6 March 2013.

15. Earnings and net assets per share, return on equity

Earnings per share is calculated by dividing earnings attributable to the owners of the Company by the weighted average of Ordinary Shares in issue during the period.

Basic

Basic earnings per share is calculated by dividing the earnings attributable to the owners of the Company and the weighted average of Ordinary Shares in issue during the period, excluding Ordinary Shares held as employee trust shares.

	2012 £m	2011 £m
Earnings attributable to owners of the Company	**184.3**	249.0
Weighted average number of Ordinary Shares in issue (millions)	**1,499.4**	1,500.0
Basic earnings per share (pence)	**12.3**	16.6

Diluted

Diluted earnings per share is calculated by dividing the earnings attributable to the owners of the Company and the weighted average of Ordinary Shares in issue during the period adjusted for the dilutive potential Ordinary Shares. The Company has share options and contingently issuable shares as categories of dilutive potential Ordinary Shares.

	2012 £m	2011 £m
Earnings attributable to owners of the Company	**184.3**	249.0
Weighted average number of Ordinary Shares in issue (millions)	**1,499.4**	1,500.0
Adjustments for share options and contingently issuable shares (millions)	**0.6**	–
Weighted average number of Ordinary Shares for diluted earnings per share (millions)	**1,500.0**	1,500.0
Diluted earnings per share (pence)	**12.3**	16.6

Net asset value and tangible net asset value per share

Net asset value per share is calculated as total shareholders' equity (excluding non-controlling interest) divided by the number of Ordinary Shares in issue at the end of the period. Ordinary Shares in issue exclude shares held by employee share trusts at 31 December 2012 of 2,848,991 (2011: nil).

Tangible net asset value per share is calculated as total shareholders' equity (excluding non-controlling interest) less goodwill and other intangible assets divided by the number of Ordinary Shares in issue at the end of the period.

Net asset and tangible net asset value per share are as follows:

At 31 December	2012 £m	2011 £m
Net assets	**2,831.6**	3,612.8
Goodwill and other intangible assets	**(421.5)**	(365.8)
Tangible net assets	**2,410.1**	3,247.0
Number of Ordinary Shares in issue (millions)	**1,500.0**	1,500.0
Shares held by employee share trusts (millions)	**(2.8)**	–
Closing number of Ordinary Shares in issue (millions)	**1,497.2**	1,500.0
Net asset value per share (pence)	**189.1**	240.9
Tangible net asset value per share (pence)	**161.0**	216.5

Return on equity
Return on equity is calculated as follows:

	2012 £m	2011 £m
Profit for the year	**184.3**	249.0
Opening shareholders' equity	**3,612.8**	3,223.6
Closing shareholders' equity	**2,831.6**	3,612.8
Average shareholders' equity	**3,222.2**	3,418.2
Return on equity	**5.7%**	7.3%

16. Goodwill and other intangible assets

	Goodwill £m	Other intangible assets £m	Total £m
Cost			
At 1 January 2011	346.2	426.8	773.0
Effect of foreign currency exchange adjustment	(1.0)	(0.8)	(1.8)
Additions	–	119.8	119.8
Impairment and write-off of intangible assets	–	(8.8)	(8.8)
At 31 December 2011	345.2	537.0	882.2
Effect of foreign currency exchange adjustment	**(0.6)**	**(0.9)**	**(1.5)**
Additions	**–**	**96.6**	**96.6**
Fully utilised	**–**	**(282.1)**	**(282.1)**
Impairment and write-off of intangible assets	**–**	**(21.2)**	**(21.2)**
At 31 December 2012	**344.6**	**329.4**	**674.0**

	Goodwill £m	Other intangible assets £m	Total £m
Amortisation / accumulated impairment losses			
At 1 January 2011	125.0	361.9	486.9
Charge for the year	–	21.1	21.1
Effect of foreign currency exchange adjustment	(1.0)	(0.7)	(1.7)
Impairment and write-off of intangible assets	10.2	(0.1)	10.1
At 31 December 2011	134.2	382.2	516.4
Charge for the year	**–**	**30.0**	**30.0**
Effect of foreign currency exchange adjustment	**(0.6)**	**(0.7)**	**(1.3)**
Fully utilised	**–**	**(282.1)**	**(282.1)**
Impairment and write-off of intangible assets	**–**	**(10.5)**	**(10.5)**
At 31 December 2012	**133.6**	**118.9**	**252.5**
Net book amount			
At 31 December 2012	**211.0**	**210.5**	**421.5**
At 31 December 2011	211.0	154.8	365.8

Goodwill arose on the acquisition of U K Insurance Limited (£141 million) and Churchill Insurance Company Limited (£70 million), which is allocated across Motor, Home, Rescue and other personal lines and Commercial.

16. Goodwill and other intangible assets continued

The Group's goodwill is reviewed annually at 30 September for impairment by comparing the recoverable amount of each cash-generating unit ("CGU") to which goodwill has been allocated with its carrying value and updated at each reporting date in the event of indicators of impairment.

The goodwill of the CGUs of the Group is as follows:

	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	Tracker Network (UK) Limited £m	Total £m
At 1 January 2011	126.4	45.8	28.7	10.1	10.2	221.2
Impairment of goodwill	–	–	–	–	(10.2)	(10.2)
At 31 December 2011 and 2012	**126.4**	**45.8**	**28.7**	**10.1**	**–**	**211.0**

The recoverable amount is the higher of the CGU's fair value less the costs to sell and its value in use. Value in use is the present value of expected future cash flows from the CGU. Fair value is the amount obtainable for the sale of the CGU in an arm's length transaction between knowledgeable and willing parties.

Impairment testing inherently involves a number of judgemental areas: the preparation of cash flow forecasts for periods that are beyond the normal requirements of management reporting; the assessment of the discount rate appropriate to the business; and estimation of the fair value of CGUs and the valuation of the separable assets of each business whose goodwill is being reviewed.

The recoverable amounts of all CGUs at 30 September were based on the value in use test, using the Group's latest five-year forecasts. The long-term growth rates have been based on GDP rates adjusted for inflation. The risk discount rates are based on observable market long-term government bond yields and average industry betas adjusted for an appropriate risk premium based on independent analysis.

The recoverable amounts in excess of carrying value for the CGUs where goodwill is held are analysed as follows:

CGU	Assumptions[1]			Sensitivity: Impact on recoverable amount of a:		
	Terminal growth rate	Pre-tax discount rate	Recoverable amount in excess of carrying value £m	1% change in pre-tax discount rate £m	1% change in terminal growth rate £m	1% change in forecast pre-tax profit[2] £m
Motor	3.0%	11.9%	1,284.1	323.7	292.3	31.0
Home	3.0%	11.9%	836.7	117.7	106.9	11.1
Rescue and other personal lines	3.0%	11.9%	645.8	81.3	74.6	7.3
Commercial	3.0%	11.9%	43.5	40.4	37.3	3.5

Notes:

1. Key assumptions used in impairment testing in 2011 were terminal growth rate of 3% and pre-tax discount rate of 12.1%.
2. Reflects a 1% change to each year of the five-year forecast and terminal profit forecast.

Tracker Network UK Limited provides stolen vehicle recovery systems and vehicle asset management systems. Goodwill was fully impaired by 31 December 2011 (impairment charge 2011: £10.2 million) as performance was not in line with that anticipated at the date of purchase. The recoverable amount was calculated in 2011 using a value in use methodology, with the key assumptions underlying the calculation being a terminal growth rate of 3% and a pre-tax discount rate of 12.1%.

17. Property, plant and equipment

	£m
Cost	
At 1 January 2011	91.6
Additions	7.5
Disposals	(7.9)
Reclassified as held-for-sale	(1.5)
Effect of foreign currency exchange adjustment	(0.6)
At 31 December 2011	89.1
Additions	**63.7**
Disposals	**(9.2)**
Effect of foreign currency exchange adjustment	**(1.2)**
At 31 December 2012	**142.4**

	£m
Depreciation	
At 1 January 2011	39.0
Depreciation charge for the year	10.4
Disposals	(6.4)
Reclassified as held-for-sale	(0.5)
Effect of foreign currency exchange adjustment	(0.3)
At 31 December 2011	42.2
Depreciation charge for the year	**13.1**
Disposals	**(4.4)**
Effect of foreign currency exchange adjustment	**(0.9)**
At 31 December 2012	**50.0**
Net book amount	
At 31 December 2012	**92.4**
At 31 December 2011	46.9

18. Investment property

	2012 £m	2011 £m
At 1 January	**69.5**	83.5
Additions	**133.7**	–
Disposals	**(69.5)**	–
Decrease in fair value	**(4.8)**	(14.0)
At 31 December	**128.9**	69.5

Investment properties were purchased during the year to provide an investment return over the long term in accordance with the Group's investment strategy. These properties are managed, on behalf of the Group, by a property services company.

The lease agreements are drawn up in line with local practice and the Group has no exposure to leases that include contingent rents.

Disposals in the year comprised freehold property occupied by RBS Group under operating leases.

19. Subsidiaries

The principal subsidiary undertakings of the Group are shown below. Their capital consists of ordinary shares which are unlisted.

Direct Line Versicherung AG, DL Insurance Services Limited ("**DLISL**" – the company changed its name from RBS Insurance Services Limited on 10 September 2012) and U K Insurance Limited are owned directly by Direct Line Insurance Group plc. Direct Line Insurance S.p.A is owned indirectly through intermediary holding companies. All subsidiaries are included in the Group's consolidated financial information and have an accounting reference date of 31 December.

Name of subsidiary	Place of incorporation and operation	Type of ownership interest (share type)	Proportion of voting power held	Principal activity
Direct Line Insurance S.p.A	Italy	Ordinary	100%	General insurance
Direct Line Versicherung AG	Germany	Ordinary	100%	General insurance
DL Insurance Services Limited	Great Britain	Ordinary	100%	Management services
U K Insurance Limited	Great Britain	Ordinary	100%	General insurance

The above information is provided in relation to principal related undertakings as permitted by Section 410(2) of the Companies Act 2006. Full information on all related undertakings is included in the Annual Return available from Companies House by visiting www.companieshouse.gov.uk.

The Group acquired 100% of the share capital of Direct Line Versicherung AG on 2 April 2012. The fair value of identifiable assets acquired was £368.7 million (including cash and cash equivalents of £39.7 million) and the fair value of identifiable liabilities assumed was £263.5 million. The total cash consideration paid was £105.2 million.

The Group did not dispose of any of its subsidiaries in the year ended 31 December 2012.

In 2011 Devitt Insurance Services Limited was sold to CKH Limited for a consideration of £2.3 million. Cash and cash equivalents included in the disposal were £2.4 million along with other assets of £7.3 million and other liabilities of £9.0 million.

20. Reinsurance assets

	2012 £m	2011 £m
Reinsurers' share of general insurance	**1,068.0**	712.8
Impairment provision	**(60.7)**	(53.9)
	1,007.3	658.9
Reinsurers' share of life insurance	**94.7**	82.7
Total	**1,102.0**	741.6

	2012 £m	2011 £m
Analysis of movement in impairment provision:		
At 1 January	**(53.9)**	(9.2)
Impairment loss recognised on reinsurance contracts	**(7.6)**	(44.8)
Impairment losses reversed	**0.8**	0.1
At 31 December	**(60.7)**	(53.9)

21. Deferred acquisition costs

	2012 £m	2011 £m
At 1 January	**310.5**	299.5
Net credit to the income statement	**17.1**	11.0
At 31 December	**327.6**	310.5

22. Insurance and other receivables

	2012 £m	2011 £m
Receivables arising from insurance and reinsurance contracts:		
Due from policyholders	**965.3**	988.9
Impairment of policyholder receivables	**(9.7)**	(8.8)
Due from agents, brokers and intermediaries	**106.6**	176.9
Impairment of agent, broker and intermediary receivables	**(0.3)**	(0.4)
Due from reinsurers	**34.8**	46.0
Other loans and receivables:		
Accrued interest	**2.0**	3.3
Receivables from related parties	**5.1**	7.7
Other debtors	**60.2**	39.3
Total	**1,164.0**	1,252.9

23. Derivative financial instruments

	2012 £m	2011 £m
Derivative assets		
At fair value through the income statement	**37.5**	–
Designated as hedging instruments	**–**	0.1
Total	**37.5**	0.1
Derivative liabilities		
At fair value through the income statement	**4.1**	–
Designated as hedging instruments	**2.4**	–
Total	**6.5**	–

Derivative financial instruments as shown above are all classified as level 2 under the fair value hierarchy as described in note 24. These are measured at fair value, which equates to carrying value.

Included in the above are related party transactions with RBS Group at 31 December 2012 £23.0 million (2011: £0.1 million).

24. Financial investments

	2012 £m	2011 £m
Available-for-sale debt securities		
Sovereign, supranational and local government debt securities	**2,635.7**	3,481.2
Corporate debt securities	**4,475.6**	3,843.2
Mortgage backed securities	**45.2**	283.5
Total	**7,156.5**	7,607.9

	2012 £m	2011 £m
Available-for-sale debt securities		
Listed – fixed interest rate	**6,854.2**	6,747.8
Listed – floating interest rate	**302.3**	860.1
	7,156.5	7,607.9
Other investment funds[1]	**–**	382.8
Total	**7,156.5**	7,990.7
Loans and receivables		
Deposits with credit institutions with maturities in excess of three months:		
Third parties	**595.0**	1,342.6
Related parties	**50.0**	147.0
Total	**645.0**	1,489.6
Total	**7,801.5**	9,480.3

Note:

1. Other investment funds comprised a single fund which included Euro and US Dollar-denominated bonds, hedged back to Pounds Sterling.

Included within the debt securities balance at 31 December 2012 is £75.0 million (2011: £304.6 million) relating to securities issued by members of RBS Group.

The following table shows an analysis of financial instruments recorded at fair value, which equates to their carrying value, by level of the fair value hierarchy:

	2012			2011		
At 31 December	**Available-for-sale debt securities £m**	**Other investment funds £m**	**Total £m**	Available-for-sale debt securities £m	Other investment funds £m	Total £m
Level 1[1]	**1,839.9**	–	**1,839.9**	2,862.6	–	2,862.6
Level 2[2]	**5,316.6**	–	**5,316.6**	4,745.3	382.8	5,128.1
Total	**7,156.5**	**–**	**7,156.5**	7,607.9	382.8	7,990.7

Notes:

1. Level 1 financial assets are measured in whole or in part by reference to published quotes in an active market. In an active market quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices represent actual and regularly occurring market transactions on an arm's length basis.
2. Included in the Level 2 category are financial assets measured using a valuation technique based on assumptions that are supported by prices from observable current market transactions. These are assets for which pricing is obtained via pricing services, but where prices have not been determined in an active market, or financial assets with fair values based on broker quotes, investments in private equity funds with fair values obtained via fund managers or assets that are valued using the Group's own models whereby the majority of assumptions are market-observable.
3. The Group held no Level 3 securities at 31 December 2012 and 31 December 2011.

25. Cash and cash equivalents

	2012 £m	2011 £m
Cash at bank and in hand:		
Third parties	**132.6**	153.5
Related parties	**69.1**	48.4
	201.7	201.9
Short-term deposits with credit institutions:		
Third parties[1]	**1,277.9**	1,029.5
Related parties	**28.8**	148.4
	1,306.7	1,177.9
Total	**1,508.4**	1,379.8

Note:

1. Included in the above are investments of £492.5 million (2011: £612.0 million) held by the Group in Global Treasury Funds PLC (an open ended umbrella investment company with variable capital incorporated with limited liability in Ireland). RBS Asset Management (Dublin) Limited is the appointed manager to the fund.

The effective interest rate on short-term deposits with credit institutions for the year ended 31 December 2012 was 0.35% (2011: 0.78%) and has an average maturity of 11 days (2011: 85 days).

For the purposes of the cash flow statement, cash and bank overdrafts are as follows:

	2012 £m	2011 £m
Cash and cash equivalents	**1,508.4**	1,379.8
Bank overdrafts	**(90.9)**	(70.2)
Total	**1,417.5**	1,309.6

26. Assets held for sale

	2012 £m	2011 £m
Freehold property held for sale	**1.0**	1.0

The Group intends to dispose of freehold property it no longer utilises at Lumbry Park, Alton. At 31 December 2012, the property is being actively marketed, with no impairment losses recognised in the year ended 31 December 2012.

27. Share capital

	2012 Number million	2011 Number million
Issued and fully paid: equity shares		
Ordinary Shares of £1 each	**–**	1,500.0
Ordinary Shares of 10 pence each	**1,500.0**	–

On 31 August 2012, board and shareholder resolutions were approved to subdivide the share capital of Direct Line Insurance Group plc from 1.5 billion Ordinary Shares of £1 each to 1.5 billion Ordinary Shares of 10 pence each and 1.5 billion deferred shares of 90 pence each.

The deferred shares were then transferred back to the Company by its parent, The Royal Bank of Scotland Group plc, for no value and immediately cancelled by the Company. This cancellation has created a non-distributable capital redemption reserve in the Company of £1,350.0 million.

The Company's issued share capital now comprises 1.5 billion Ordinary Shares of 10 pence each. For the year ended 31 December 2012, this has not altered the earnings per share calculation.

The Group satisfies share-based payments under the Group's share plans primarily through shares purchased in the market and held by employee share trusts. This note gives details of the shares held in these trusts.

At 31 December 2012, 2,848,991 Ordinary Shares (2011: nil) were owned by the employee share trusts with a cost of £5.0 million, with an undertaking to satisfy the awards of shares in the Company under the Company's share plans and schemes.

These shares were purchased by the employee share trusts and are carried at cost. At 31 December 2012, they had an aggregate nominal value of £0.3 million (2011: £nil) and a market value of £6.2 million (2011: £nil).

28. Other reserves

Movements in the revaluation reserve for available-for-sale investments were as follows:

	Other investment funds £m	Debt securities £m	Total £m
At 1 January 2011	4.0	37.9	41.9
Revaluation during the year – gross	11.8	172.0	183.8
Revaluation during the year – tax	(3.1)	(47.3)	(50.4)
Realised gains – gross	–	(52.3)	(52.3)
Tax on realised gains	–	14.1	14.1
At 31 December 2011	12.7	124.4	137.1
Revaluation during the year – gross	**6.3**	**103.6**	**109.9**
Revaluation during the year – tax	**(1.5)**	**(19.1)**	**(20.6)**
Realised gains – gross	**(23.2)**	**(66.3)**	**(89.5)**
Tax on realised gains	**5.7**	**16.2**	**21.9**
At 31 December 2012	**–**	**158.8**	**158.8**

Movements in the non-distributable reserve were as follows:

	2012 £m	2011 £m
At 1 January	**30.3**	197.6
Transfer from / (to) retained earnings	**32.9**	(167.3)
At 31 December	**63.2**	30.3

The non-distributable reserve relates to a UK statutory claims equalisation reserve that is calculated in accordance with the rules of the FSA. The transfer to retained earnings in 2011 was a consequence of the Group's consolidation of its four UK general insurance underwriting entities by way of a UK Financial Services and Markets Act 2000 Part VII transfer, which is a mechanism used to transfer all the insurance business, rights, benefits, obligations and interests into one insurance underwriter.

29. Subordinated liabilities

	2012 £m	2011 £m
Subordinated dated notes	**529.0**	–
Undated subordinated loans	**258.5**	–
Total	**787.5**	–

The subordinated dated notes were issued on 27 April 2012 at a fixed rate of 9.25%. On issuance the Group entered into a 10-year hedge to exchange the fixed rate of interest for a floating rate of three-month LIBOR plus a spread of 706 basis points. The nominal £500 million bonds have a redemption date of 27 April 2042. The Group has the option to repay the notes on specific dates from 27 April 2022. If the notes are not repaid on that date, the rate of interest would be reset at a rate of the six-month LIBOR plus 7.91%.

The notes are unsecured, subordinated obligations of the Group, and rank pari passu without any preference among themselves. In the event of a winding-up or of bankruptcy, they are to be repaid only after the claims of all other creditors have been met.

There have been no defaults on any of the notes during the year. The Group has the option to defer interest payments on the notes but to date has not exercised this right. The aggregate fair value of subordinated dated notes is £597.6 million (2011: £nil).

The undated subordinated loans of £258.5 million were provided by TPF in 2006 and were reclassified from non-controlling interest in total equity following FSA approval to repay the loans. There is no interest payable on this instrument. The loans were fully repaid on 8 January 2013 (see note 41).

30. Insurance liabilities, unearned premium reserve and reinsurance assets

	2012 £m	2011 £m
Insurance liabilities		
Life insurance (note 31)	**107.2**	97.8
General insurance	**6,291.3**	6,411.2
Total	**6,398.5**	6,509.0
Gross general insurance		
Claims reported	**3,969.3**	4,036.9
Claims incurred but not reported	**2,153.9**	2,217.5
Loss adjustment expenses	**163.8**	153.2
Liability adequacy provision	**4.3**	3.6
Total	**6,291.3**	6,411.2
Unearned premium reserve	**1,872.9**	1,931.6
Total	**8,164.2**	8,342.8
Reinsurers' share of general insurance		
Claims reported	**(397.8)**	(318.1)
Claims incurred but not reported	**(511.6)**	(281.8)
Total	**(909.4)**	(599.9)
Unearned premium reserve	**(97.9)**	(59.0)
Total	**(1,007.3)**	(658.9)
Net general insurance		
Claims reported	**3,571.5**	3,718.8
Claims incurred but not reported	**1,642.3**	1,935.7
Loss adjustment expenses	**163.8**	153.2
Liability adequacy provision	**4.3**	3.6
Total	**5,381.9**	5,811.3
Unearned premium reserve	**1,775.0**	1,872.6
Total	**7,156.9**	7,683.9

General insurance claims – gross

Accident year	2003 £m	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	**Total £m**
Estimate of ultimate claims costs:											
At end of accident year	3,648.5	3,679.1	4,007.5	4,091.6	4,390.5	3,878.1	4,148.0	4,261.9	3,080.5	2,797.3	37,983.0
One year later	(135.6)	(187.2)	(175.8)	(266.1)	(62.0)	23.2	120.0	(98.1)	(80.3)	–	(861.9)
Two years later	(105.5)	(89.8)	(141.7)	(42.0)	(1.1)	43.9	(42.5)	(115.3)	–	–	(494.0)
Three years later	(62.1)	(61.3)	(57.9)	(17.6)	49.4	(38.3)	(24.2)	–	–	–	(212.0)
Four years later	(42.9)	(41.9)	(59.5)	10.1	(7.0)	(22.0)	–	–	–	–	(163.2)
Five years later	(19.7)	(15.2)	15.3	(21.6)	(17.8)	–	–	–	–	–	(59.0)
Six years later	(25.3)	70.5	7.8	(9.1)	–	–	–	–	–	–	43.9
Seven years later	19.5	12.8	5.4	–	–	–	–	–	–	–	37.7
Eight years later	7.7	22.0	–	–	–	–	–	–	–	–	29.7
Nine years later	(12.1)	–	–	–	–	–	–	–	–	–	(12.1)
Current estimate of cumulative claims	3,272.5	3,389.0	3,601.1	3,745.3	4,352.0	3,884.9	4,201.3	4,048.5	3,000.2	2,797.3	36,292.1
Cumulative payments to date	(3,156.2)	(3,175.3)	(3,432.2)	(3,489.5)	(3,956.7)	(3,424.8)	(3,396.4)	(3,139.1)	(2,009.7)	(1,194.9)	(30,374.8)
Liability recognised in balance sheet	**116.3**	**213.7**	**168.9**	**255.8**	**395.3**	**460.1**	**804.9**	**909.4**	**990.5**	**1,602.4**	**5,917.3**
2002 and prior											**205.9**
Loss adjustment expenses											**163.8**
Total gross liability[1]											**6,287.0**

Note:

1. This balance excludes liability adequacy provision.

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30. Insurance liabilities, unearned premium reserve and reinsurance assets continued

General insurance claims – net

Accident year	2003 £m	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	**Total £m**
Estimate of ultimate claims costs:											
At end of accident year	3,207.4	3,486.1	3,869.6	4,030.8	4,341.3	3,816.0	4,113.0	4,219.3	2,946.1	2,570.1	36,599.7
One year later	(103.3)	(169.2)	(159.3)	(249.7)	(81.7)	24.1	70.0	(109.7)	(119.3)	–	(898.1)
Two years later	(101.8)	(94.1)	(159.4)	(52.7)	(23.3)	8.2	(23.0)	(136.4)	–	–	(582.5)
Three years later	(71.0)	(68.3)	(62.0)	(28.2)	17.7	(24.5)	(64.2)	–	–	–	(300.5)
Four years later	(42.4)	(53.3)	(61.6)	9.9	(10.4)	(51.2)	–	–	–	–	(209.0)
Five years later	(36.0)	(13.5)	7.2	(43.5)	(22.4)	–	–	–	–	–	(108.2)
Six years later	(20.5)	60.7	(0.4)	(21.0)	–	–	–	–	–	–	18.8
Seven years later	5.5	(4.1)	(12.2)	–	–	–	–	–	–	–	(10.8)
Eight years later	6.2	(5.4)	–	–	–	–	–	–	–	–	0.8
Nine years later	(3.4)	–	–	–	–	–	–	–	–	–	(3.4)
Current estimate of cumulative claims	2,840.7	3,138.9	3,421.9	3,645.6	4,221.2	3,772.6	4,095.8	3,973.2	2,826.8	2,570.1	34,506.8
Cumulative payments to date	(2,778.4)	(3,020.9)	(3,303.4)	(3,439.4)	(3,895.9)	(3,391.6)	(3,366.2)	(3,122.8)	(1,929.2)	(1,141.9)	(29,389.7)
Liability recognised in balance sheet	**62.3**	**118.0**	**118.5**	**206.2**	**325.3**	**381.0**	**729.6**	**850.4**	**897.6**	**1,428.2**	**5,117.1**
2002 and prior											**96.7**
Loss adjustment expenses											**163.8**
Total net liability[1]											**5,377.6**

Note:

1. This balance excludes liability adequacy provision.

Movements in general insurance liabilities and reinsurance assets

	Gross £m	Reinsurance £m	Net £m
Notified claims	4,327.6	(310.0)	4,017.6
Incurred but not reported	2,514.2	(220.8)	2,293.4
Liability adequacy provision	25.4	–	25.4
At 1 January 2011	6,867.2	(530.8)	6,336.4
Cash paid for claims settled in the year	(3,547.7)	81.7	(3,466.0)
Increase / (decrease) in liabilities:			
Arising from current-year claims	3,345.3	(134.4)	3,210.9
Arising from prior-year claims	(209.9)	(17.2)	(227.1)
Net exchange differences	(21.9)	0.8	(21.1)
Decrease in liability adequacy provision	(21.8)	–	(21.8)
At 31 December 2011	6,411.2	(599.9)	5,811.3
Notified claims	4,190.1	(318.1)	3,872.0
Incurred but not reported	2,217.5	(281.8)	1,935.7
Liability adequacy provision	3.6	–	3.6
At 31 December 2011	6,411.2	(599.9)	5,811.3
Cash paid for claims settled in the year	**(2,949.1)**	**108.6**	**(2,840.5)**
Increase / (decrease) in liabilities:			
Arising from current-year claims	**3,038.2**	**(227.2)**	**2,811.0**
Arising from prior-year claims	**(196.5)**	**(193.0)**	**(389.5)**
Net exchange differences	**(13.2)**	**2.1**	**(11.1)**
Increase in liability adequacy provision	**0.7**	**–**	**0.7**
At 31 December 2012	**6,291.3**	**(909.4)**	**5,381.9**
Notified claims	**4,133.1**	**(397.8)**	**3,735.3**
Incurred but not reported	**2,153.9**	**(511.6)**	**1,642.3**
Liability adequacy provision	**4.3**	**–**	**4.3**
At 31 December 2012	**6,291.3**	**(909.4)**	**5,381.9**

Movement in prior-year net claims liabilities by operating segment

	2012 £m	2011 £m
Motor	**(174.3)**	(138.2)
Home	**(37.4)**	48.5
Rescue and other personal lines	**(23.9)**	(52.8)
Commercial	**(56.2)**	(38.4)
International	**(30.2)**	(7.9)
Total ongoing	**(322.0)**	(188.8)
Run-off	**(67.5)**	(38.3)
Total	**(389.5)**	(227.1)

30. Insurance liabilities, unearned premium reserve and reinsurance assets continued

Movement in unearned premium reserve

	Gross £m	Reinsurance £m	Net £m
At 1 January 2011	2,288.6	(71.8)	2,216.8
Net (decrease) / increase in the year	(354.6)	12.8	(341.8)
Exchange movement	(2.4)	–	(2.4)
At 31 December 2011	1,931.6	(59.0)	1,872.6
Net decrease in the year	**(47.1)**	**(38.9)**	**(86.0)**
Exchange movement	**(11.6)**	**–**	**(11.6)**
At 31 December 2012	**1,872.9**	**(97.9)**	**1,775.0**

31. Life insurance liabilities and reinsurance assets

	2012 £m	2011 £m
Gross life insurance		
Long-term insurance contracts:		
With fixed and guaranteed terms	**102.9**	93.0
Benefits outstanding	**4.3**	4.8
Total	**107.2**	97.8
Reinsurers' share of life insurance		
Long-term insurance contracts:		
With fixed and guaranteed terms	**(91.1)**	(78.6)
Benefits outstanding	**(3.6)**	(4.1)
Total	**(94.7)**	(82.7)
Net life insurance		
Long-term insurance contracts:		
With fixed and guaranteed terms	**11.8**	14.4
Benefits outstanding	**0.7**	0.7
Total	**12.5**	15.1

Movements in life insurance liabilities and reinsurance assets

	Gross £m	Reinsurance £m	Net £m
At 1 January 2011	68.4	(53.3)	15.1
Provisions in respect of new and existing business	45.9	(25.4)	20.5
Expected change in existing business provisions	(21.7)	16.2	(5.5)
Variance between actual and expected experience	8.7	(16.1)	(7.4)
Other movements	(8.3)	–	(8.3)
At 31 December 2011	93.0	(78.6)	14.4
Provisions in respect of new and existing business	**42.8**	**(24.7)**	**18.1**
Expected change in existing business provisions	**(20.3)**	**18.3**	**(2.0)**
Variance between actual and expected experience	**(4.7)**	**(6.1)**	**(10.8)**
Other movements	**(7.9)**	**–**	**(7.9)**
At 31 December 2012	**102.9**	**(91.1)**	**11.8**

32. Borrowings

	2012 £m	2011 £m
Loans from related parties	**–**	247.7
Bank overdrafts with related parties	**90.9**	64.2
Bank overdrafts with third parties	**–**	6.0
Total	**90.9**	317.9

The carrying value of borrowings approximates to their fair value.

33. Retirement benefits obligations

Defined contribution scheme

DLISL operates the Group pension scheme which was established in 1988. The contributions paid by DLISL are charged to the income statement, as incurred.

The pension charge in respect of the defined contribution scheme at 31 December 2012 was £26.0 million (2011: £28.0 million).

In addition, certain employees of the Group who were previously members of the RBS Group defined benefit pension scheme transferred to the Group's defined contribution scheme in the year. As a result of standardising employment terms for all Group employees, which included changes to the employment terms of a small number of Group employees who were members of the RBS Group defined benefit pension scheme, the Group crystallised a debt under section 75 of the UK Pensions Act 1995. Consequently the Group was required to pay into the RBS Group's defined benefit pension scheme (in which those employees ceased to participate) as a result of a deficit in that scheme. The debt was calculated based on the amount needed to secure Direct Line Group's share of the pension liabilities in the pension scheme with an insurance company. An amount of £31.3 million was paid to the RBS Group pension scheme on 29 June 2012 in full and final settlement.

Defined benefit scheme

The Group's defined benefit pension scheme was closed in 2003 although DLISL remains the sponsoring employer for obligations to current and deferred pensioners.

The weighted average duration of the defined benefit obligation at 31 December 2012 is 20 years (2011: 19 years) using accounting assumptions.

The assumptions in respect of the defined benefit scheme and the amounts accounted for under IAS 19 are set out below.

	2012 %	2011 %
Rate of increase in pension payment	**2.1**	2.1
Rate of increase of deferred pensions	**2.1**	2.1
Discount rate	**4.5**	5.0
Inflation rate	**2.8**	3.0

No assumption has been made for salary growth as there are no liabilities in the scheme that are linked to future increases in salaries.

33. Retirement benefits obligations continued

The expected return on the scheme assets at 31 December is based upon the assumed returns in the table below together with the present value of the obligations and deficit in the scheme.

	Expected return 2012 %	Value at 2012 £m	Expected return 2011 %	Value at 2011 £m
Equities	**7.7**	**13.9**	7.7	34.5
Index-linked bonds	**3.2**	**10.2**	3.1	7.2
Government bonds	**3.2**	**6.5**	3.1	7.2
Corporate bonds	**4.2**	**32.5**	4.7	7.2
Other	**4.5**	**0.6**	5.0	0.6
Total market value of assets		**63.7**		56.7
Present value of fund obligations		**61.2**		54.1
Surplus in the scheme		**2.5**		2.6
Deferred tax asset at 23% (2011: 25%)		**0.6**		0.6

IAS 19 'Employee benefits revised' is effective for accounting periods beginning on or after 1 January 2013. Under the revised standard, an expected rate of return will no longer be applied to assets. The interest cost to be calculated on the net pension liability or asset will be at the long-term bond rate.

The deferred tax asset has been netted off against the net pension liability and has been accounted for as a liability (note 13).

Amounts credited to the income statement

	2012 £m	2011 £m
Interest on obligation	**(2.7)**	(3.0)
Expected return on plan assets	**3.5**	3.7
	0.8	0.7

The credit to the income statement has been included under other operating expenses.

Amounts charged to the statement of comprehensive income

	2012 £m	2011 £m
Actual return on scheme assets	**(5.7)**	(1.1)
Expected return on scheme assets	**3.5**	3.7
Experience (gain) / loss on scheme assets	**(2.2)**	2.6
Experience loss / (gain) on scheme liabilities	**0.1**	(0.4)
Changes in assumptions underlying the present value of scheme liabilities	**5.5**	(1.6)
Actuarial loss	**3.4**	0.6

Changes in the present value of the defined benefit obligation are as follows:

	2012 £m	2011 £m
Opening defined benefit obligation	**54.1**	54.5
Interest cost	**2.7**	3.0
Actuarial losses / (gains)	**5.6**	(2.1)
Benefits paid	**(1.2)**	(1.3)
Closing defined benefit obligation	**61.2**	54.1

Changes in the fair value of the plan assets are as follows:

	2012 £m	2011 £m
Opening fair value of plan assets	**56.7**	54.4
Expected return	**3.5**	3.7
Actuarial gains / (loss)	**2.2**	(2.6)
Contributions	**2.5**	2.5
Benefits paid	**(1.2)**	(1.3)
Closing fair value of plan assets	**63.7**	56.7
Net pension surplus / (deficit) before deferred tax:		
At 1 January	**2.6**	(0.1)
At 31 December	**2.5**	2.6

The history of the plan for the current and prior years is as follows:

	2012 £m	2011 £m	2010 £m	2009 £m	2008 £m
Present value of defined benefit obligation	**(61.2)**	(54.1)	(54.5)	(60.8)	(45.3)
Fair value of plan assets	**63.7**	56.7	54.4	47.2	37.5
Surplus / (deficit)	**2.5**	2.6	(0.1)	(13.6)	(7.8)
Experience adjustments on plan liabilities	**0.1**	(0.4)	(0.5)	(2.6)	(0.7)
Experience adjustments on plan assets	**(2.2)**	2.6	(3.1)	(5.4)	(10.7)

Sensitivity analysis
The table on page 154 provides the sensitivity analysis of the potential impact of a change in a single factor with all other assumptions left unchanged. Other potential risks beyond the ones described in the table could have an additional financial impact on the Group.

Sensitivity factor
Discount rate

The impact of a change in the principal actuarial assumptions on the discount rate for the present value of pension scheme obligations. This sensitivity analysis has been selected to reflect the changes to discounted cash flows as a result of changes to the discount rate. The methodology adopted involves actuarial techniques.

Inflation rate

The impact of a change in the principal actuarial assumptions on the inflation rate for the present value of pension scheme obligations. This sensitivity analysis has been selected to reflect the changes to the general level of prices of goods and services over time. The methodology adopted involves actuarial techniques.

33. Retirement benefits obligations continued

Sensitivity analysis

	Discount rate +0.25%	Discount rate –0.25%	Inflation rate +0.25%	Inflation rate –0.25%
At 31 December 2012				
Impact on profit before tax (£m)	**–**	**–**	**–**	**–**
Impact before tax on total equity (£m)	**(3.0)**	**3.2**	**3.1**	**(3.0)**
At 31 December 2011				
Impact on profit before tax (£m)	–	–	–	–
Impact before tax on total equity (£m)	(2.6)	2.6	2.5	(2.4)

The most recent funding valuation of the defined benefit scheme took place at 1 October 2011. The Group has agreed to make contributions of £2.8 million per annum from 2013 to 2016 for the future accrual of benefits, and does not anticipate any material change to the level of funding before the next valuation, which is due on 1 October 2014.

34. Share-based payments

The Group operates a number of equity-settled, share-based compensation plans, details of which and their financial effect are set out below:

Free share awards

During the year ended 31 December 2012, upon listing on the London Stock Exchange, the Group offered all employees a 'free share' award granting shares to the value of £250 to each eligible employee free of charge. These awards will be satisfied using market-purchased shares.

The details of the award are set out below:

Type of arrangement	Free share award
Date of grant	27 November and 3 December 2012
Number granted	1,951,950
Forfeited during the period	3,718
Vested during the period	8,151
Number outstanding at 31 December 2012	1,940,081
Contractual life	3 years
Vesting conditions	Continuing employment or leavers in certain circumstances

The awards outstanding at 31 December 2012 have no performance criteria attached, other than the requirement that the employee remains in employment with the Group for three years. Awards granted under the plan will be exercised upon the award vesting date.

The estimated fair value of the free shares granted under the award is £3,942,939, or £2.02 per share award. The fair value of each award is based upon the market value of the award at grant date of £2.02, applicable to both grants.

Long-Term Incentive Plan

In November 2012, conditional awards were made over 3,159,625 ordinary shares under the Group's LTIP. Senior management are eligible to participate in the LTIP and awards are granted in the form of a nil-priced option.

Under the scheme, the shares vest at the end of a three-year period dependent upon the following: continued employment by the Group and achieving predefined performance conditions associated with TSR and RoTE.

The awards are subject to both non-market and market-based performance conditions.

	Value at grant £	Options over shares Number
Granted during the year	**5,001,813**	**3,159,625**
Forfeited during the year	**–**	**–**
Exercised during the year	**–**	**–**
Expired during the year	**–**	**–**
At 31 December 2012	**5,001,813**	**3,159,625**

In respect of the outstanding options at 31 December 2012, the exercise price was £nil with a weighted average remaining contractual life of 2.85 years.

The estimated fair value of the LTIP share awards made during the year, at the date of grant, was £5,001,813. For awards with market-based performance conditions, this was calculated using the Monte-Carlo simulation model.

The inputs into the model were as follows:

	2012
Share price (pence)	**194**
Exercise price (pence)	**0**
Volatility of Company share price (%)	**27**
Average comparator volatility (%)	**32**
Expected life (years)	**3**
Risk-free rate (%)	**0.3**
Expected dividend yields (%)	**0**

As historic data is not available for the Group, expected volatility was determined by calculating the median historic volatility for a group of comparable companies using daily share price data over a period commensurate with the expected life assumption. The companies chosen as comparable companies for the LTIP award were from members of the TSR comparator group (all companies in the FTSE 350 excluding investment trusts) and are classified as being in the insurance sector.

Expected life was based on the contractual life of the awards and adjusted based on management's best estimate, for the effects of exercise restrictions and behavioural considerations.

Prior to October 2012 certain employees benefited from share-based awards originally granted by RBS Group. The expense incurred in respect of awards granted by RBS Group to Direct Line Group employees is not material and has been included within operating expenses.

RBS Group has indemnified Direct Line Group for all future costs in respect of RBS Group share-based awards made to Direct Line Group staff. All costs in respect of these share awards for Direct Line Group employees have since been borne by RBS Group.

The RBS Group Remuneration Committee has agreed that RBS Group will be responsible for the settlement of the following outstanding LTIP Awards, with no charge to be made to Direct Line Group:

- LTIP awards in 2010 – expected to vest in March 2013
- LTIP awards in 2011 – expected to vest in March 2014
- LTIP awards in 2012 – expected to vest in March 2015

It was agreed that the 2010 LTIP award scheme will continue to be settled in RBS Group shares; however, the 2011 and 2012 LTIP award schemes will be settled with Company shares currently held by RBS Group.

35. Trade and other payables including insurance payables

	2012 £m	2011 £m
Due to agents, brokers and intermediaries	**6.9**	4.8
Due to reinsurers	**81.9**	66.1
Due to insurance companies	**13.8**	5.4
Due to related parties	**34.7**	158.7
Trade creditors and accruals	**201.0**	184.6
Other creditors	**107.8**	287.6
Other taxes	**81.7**	86.5
Provisions	**114.2**	105.2
Deferred income	**12.6**	11.3
Total	**654.6**	910.2

On 2 April 2012, the Group acquired Direct Line Versicherung AG. In the preparation of the consolidated financial statements for the year ended 31 December 2011, a liability for the payment to RBS Group for the transfer of ownership and control was recognised. This liability was settled in April 2012. Included within other creditors is an amount of £nil (2011: £110.9 million) in respect of an inter-company creditor with RBS Group.

Movements during the year in provisions are as follows:

	Regulatory levies £m	Restructuring £m	Other[1] £m	Total £m
At 1 January 2012	42.6	7.7	54.9	105.2
Charged to the income statement:				
Additional provisions	**28.3**	**28.8**	**50.9**	**108.0**
Used during year	**(37.7)**	**(5.6)**	**(55.7)**	**(99.0)**
At 31 December 2012	**33.2**	**30.9**	**50.1**	**114.2**

Note:

1. Other provisions include £11.0 million (2011: £nil) held in respect of costs associated with vacated leasehold properties.

36. Notes to the consolidated cash flow statement

	2012 £m	2011 £m
Profit for the year	**184.3**	249.0
Adjustments for:		
Investment revenues	**(199.3)**	(249.0)
Instalment income	**(125.4)**	(145.0)
Other operating loss	**2.1**	12.4
Net fair value gains on assets at fair value through income statement	**4.8**	14.0
Finance costs	**28.7**	2.7
Equity-settled share-based payment transactions	**0.3**	–
Tax charge	**64.8**	93.9
Depreciation and amortisation expenses	**43.1**	31.5
Non-cash movement in demerger reserve	**24.6**	55.9
Impairment of property, plant and equipment, goodwill and intangible assets	**10.7**	18.9
Impairment losses on financial investments	**–**	2.0
Impairment losses on reinsurance contracts	**6.8**	44.7
Profit on sale of available-for-sale financial investments	**(89.4)**	(52.9)
Loss on sale of property, plant and equipment	**4.8**	0.2
Profit on disposal of subsidiary	**–**	(1.6)
Operating cash flows before movements in working capital	**(39.1)**	76.7
Movements in working capital		
Net decrease in net insurance liabilities	**(532.5)**	(885.4)
Net decrease in prepayments and accrued income and other assets	**9.6**	36.9
Net decrease in insurance and other receivables	**86.5**	238.4
Net increase in derivative financial instruments	**–**	(0.4)
Net (decrease) / increase in trade and other payables including insurance payables	**(253.4)**	158.3
Increase in cash contribution to retirement obligation	**(2.5)**	(2.5)
Cash used by operations	**(731.4)**	(378.0)
Taxes (paid) / received	**(232.4)**	20.7
Finance costs	**(2.0)**	(2.5)
Cash flow hedges	**(0.2)**	–
Net cash flow used by operating activities before investment of insurance assets	**(966.0)**	(359.8)
Interest received	**327.7**	440.8
Rental income received from investment property	**4.4**	7.1
Purchase of investment property	**(133.7)**	–
Proceeds on disposal of investment property	**69.5**	–
Distributions received from other investment funds	**3.1**	8.5
Proceeds on disposal / maturity of available-for-sale financial assets	**4,021.6**	6,403.4
Net decrease / (increase) in investment balances held with credit institutions	**844.6**	(422.9)
Purchases of available-for-sale investments	**(3,132.4)**	(6,398.1)
Cash generated from investment of insurance assets	**2,004.8**	38.8

37. Contingencies and guarantees

The Group did not have any contingent liabilities.

Companies within the Group have guaranteed the performance of certain contracts with insurance partners. There was a guarantee in place from 1 June 2011 until 31 January 2012 of £70 million for events occurring up to 31 January 2012, although liability under this guarantee was reduced at 31 January 2012 to £58.5 million for events occurring after that date. There are further guarantees in place which also relate to contracts with insurance partners for £90.3 million at 31 December 2012.

38. Commitments

Operating lease commitments

The Group leases vehicles under non-cancellable operating lease agreements.

The Group also leases vehicles and other assets under cancellable operating lease agreements.

	2012 £m	2011 £m
Minimum lease payments under operating leases recognised as an expense in the year	**7.5**	7.4

At the balance sheet date, the Group had outstanding commitments under non-cancellable operating leases, which fall due as follows:

	2012 £m	2011 £m
Within one year	**33.0**	8.7
In the second to fifth years inclusive	**92.3**	19.0
After five years	**250.5**	9.3
Total	**375.8**	37.0

Operating lease commitments where the Group is the lessor

Future aggregate minimum lease payments receivable under non-cancellable operating leases are as follows:

	2012 £m	2011 £m
Within one year	**7.8**	7.1
In the second to fifth years inclusive	**26.6**	28.2
After five years	**41.2**	27.4
Total	**75.6**	62.7

39. Classification of financial instruments

The following table analyses the Group's financial assets and financial liabilities in accordance with the categories of financial instruments in IAS 39. Non-financial assets and liabilities outside the scope of IAS 39 are shown separately. Other than those financial assets and liabilities stated at fair value below, the carrying value of all other financial assets and liabilities equals their fair value.

At 31 December 2012	Assets / liabilities at fair value £m	Available-for-sale £m	Loans and receivables £m	Other (amortised costs) £m	Non-financial assets / liabilities £m	Total £m
Assets						
Goodwill and other intangible assets	–	–	–	–	421.5	**421.5**
Property, plant and equipment	–	–	–	–	92.4	**92.4**
Investment property	–	–	–	–	128.9	**128.9**
Reinsurance assets	–	–	–	–	1,102.0	**1,102.0**
Deferred tax assets	–	–	–	–	22.5	**22.5**
Current tax assets	–	–	–	–	5.5	**5.5**
Deferred acquisition costs	–	–	–	–	327.6	**327.6**
Insurance and other receivables	–	–	1,164.0	–	–	**1,164.0**
Prepayments, accrued income and other assets	–	–	–	–	82.6	**82.6**
Derivative financial instruments	37.5	–	–	–	–	**37.5**
Retirement benefit asset	–	–	–	–	2.5	**2.5**
Financial investments	–	7,156.5	645.0	–	–	**7,801.5**
Cash and cash equivalents	–	–	1,508.4	–	–	**1,508.4**
Assets held for sale	–	–	–	–	1.0	**1.0**
	37.5	**7,156.5**	**3,317.4**	**–**	**2,186.5**	**12,697.9**
Liabilities						
Subordinated liabilities	–	–	–	787.5	–	**787.5**
Insurance liabilities	–	–	–	–	6,398.5	**6,398.5**
Unearned premium reserve	–	–	–	–	1,872.9	**1,872.9**
Borrowings	–	–	–	90.9	–	**90.9**
Derivative financial instruments	6.5	–	–	–	–	**6.5**
Trade and other payables including insurance payables	–	–	–	540.4	114.2	**654.6**
Deferred tax liabilities	–	–	–	–	20.9	**20.9**
Current tax liabilities	–	–	–	–	34.5	**34.5**
	6.5	**–**	**–**	**1,418.8**	**8,441.0**	**9,866.3**
Total equity						**2,831.6**
						12,697.9

39. Classification of financial instruments continued

At 31 December 2011	Assets / liabilities at fair value £m	Available-for-sale £m	Loans and receivables £m	Other (amortised costs) £m	Non-financial assets / liabilities £m	Total £m
Assets						
Goodwill and other intangible assets	–	–	–	–	365.8	365.8
Property, plant and equipment	–	–	–	–	46.9	46.9
Investment property	–	–	–	–	69.5	69.5
Reinsurance assets	–	–	–	–	741.6	741.6
Deferred tax assets	–	–	–	–	26.9	26.9
Deferred acquisition costs	–	–	–	–	310.5	310.5
Insurance and other receivables	–	–	1,252.9	–	–	1,252.9
Prepayments, accrued income and other assets	–	–	–	–	92.2	92.2
Derivative financial instruments	0.1	–	–	–	–	0.1
Retirement benefit asset	–	–	–	–	2.6	2.6
Financial investments	–	7,990.7	1,489.6	–	–	9,480.3
Cash and cash equivalents	–	–	1,379.8	–	–	1,379.8
Assets held for sale	–	–	–	–	1.0	1.0
	0.1	7,990.7	4,122.3	–	1,657.0	13,770.1
Liabilities						
Insurance liabilities	–	–	–	–	6,509.0	6,509.0
Unearned premium reserve	–	–	–	–	1,931.6	1,931.6
Borrowings	–	–	–	317.9	–	317.9
Trade and other payables including insurance payables	–	–	–	805.0	105.2	910.2
Deferred tax liabilities	–	–	–	–	12.1	12.1
Current tax liabilities	–	–	–	–	218.0	218.0
	–	–	–	1,122.9	8,775.9	9,898.8
Total equity						3,871.3
						13,770.1

40. Related parties

On 1 December 2008, the UK Government through HM Treasury became the ultimate controlling party of The Royal Bank of Scotland Group plc and is therefore the ultimate controlling party of Direct Line Group. The UK Government's shareholding is managed by UK Financial Investments Limited, a company wholly owned by the UK Government. This gives rise to related party transactions and balances, specifically in respect of tax with HMRC and debt security investments with the UK Government.

Direct Line Group's immediate holding company is The Royal Bank of Scotland Group plc which is incorporated in the United Kingdom and registered in Scotland.

At 31 December 2012, The Royal Bank of Scotland Group plc heads the largest group in which Direct Line Group is consolidated. Copies of the consolidated financial statements of The Royal Bank of Scotland Group plc may be obtained from The Secretary, The Royal Bank of Scotland Group plc, Gogarburn, PO Box 1000, Edinburgh EH12 1HQ.

The following transactions were carried out with related parties, who are all members of RBS Group.

i. Sales of insurance contracts and other services

	2012 £m	2011 £m
Parent	**(0.1)**	–
Fellow subsidiaries	**7.0**	17.6
Total	**6.9**	17.6

ii. Purchases of services

	2012 £m	2011 £m
Parent	**223.8**	287.9
Fellow subsidiaries	**46.9**	63.9
Total	**270.7**	351.8

Purchases of services are charged on an arm's length basis.

Employee costs recharged by RBS Group include the full costs of key managers and other staff in respect of share-based payments. The attribution among members of RBS Group has regard to the needs of RBS Group as a whole.

iii. Compensation of key management

	2012 £m	2011 £m
Short-term employee benefits	**5.6**	4.2
Post-employment benefits	**0.6**	0.4
Other long-term benefits	**1.5**	2.1
Termination benefits	**2.2**	0.1
Share-based payments	**0.5**	0.1
Total	**10.4**	6.9

For the purposes of IAS24 'Related party disclosures', key management personnel comprise the Directors of the Company, Non-Executive Directors and members of the Executive Committee.

40. Related parties continued

iv. Year end balances arising from cash and investment transactions with members of the RBS Group

	notes	2012 £m	2011 £m
Cash at bank held with related parties	25	**69.1**	48.4
Short-term bank deposits held with related parties	25	**28.8**	148.4
Bank overdrafts held with related parties	32	**(90.9)**	(64.2)
Derivative financial assets and liabilities	23	**23.0**	0.1
Term deposits held with related parties	24	**50.0**	147.0
Total		**80.0**	279.7

Debt securities held with related parties (note 24)

	2012 £m	2011 £m
RBS Group issuers	**75.0**	304.6

v. Year end balances arising from sales and purchases of products and services

Receivables from related parties (note 22)

	2012 £m	2011 £m
Parent	**0.3**	0.1
Fellow subsidiaries	**4.8**	7.6
Total	**5.1**	7.7

Movements in receivables from related parties were as follows:

	2012 £m	2011 £m
At 1 January	**7.7**	7.6
Transactions in the year	**68.0**	7.3
Settled in the year	**(70.6)**	(7.2)
At 31 December	**5.1**	7.7

Included in the above is an amount of £69.5 million in the year ended 31 December 2012, invoiced to and paid by RBS Group for the purchase of investment properties.

Due to related parties (note 35)

	2012 £m	2011 £m
Parent	**5.4**	75.1
Fellow subsidiaries	**29.3**	83.6
Total	**34.7**	158.7

Movements in amounts due to related parties were as follows:

	2012 £m	2011 £m
At 1 January	**158.7**	44.7
Transactions in the year	**294.6**	261.0
Settled in the year	**(418.6)**	(147.0)
At 31 December	**34.7**	158.7

Included in the above is an amount of £39.3 million in the year ended 31 December 2012, invoiced by and paid to RBS Group for the acquisition of furniture, fittings and IT hardware. Furthermore, also included is an amount of £31.3 million paid to the RBS Group pension scheme (see note 33 for further details).

vi. Loans from related parties (note 32)

	2012 £m	2011 £m
Parent	**–**	12.5
Fellow subsidiary	**–**	235.2
Total	**–**	247.7

Movements in loans to related parties were as follows:

	2012 £m	2011 £m
At 1 January	**247.7**	249.2
Loans received during the year	**–**	205.0
Loan repayments made	**(246.4)**	(205.5)
Interest charged	**2.7**	2.3
Interest settled	**(2.7)**	(2.3)
Exchange movement	**(1.3)**	(1.0)
At 31 December	**–**	247.7

During the year ended 31 December 2012, the Group repaid its loans from RBS Group in preparation for operational separation.

41. Post balance sheet events

On 8 January 2013, the Group repaid undated subordinated loans of £258.5 million to TPF.

Parent Company balance sheet

As at 31 December 2012

	Notes	2012 £m	2011 £m
Assets			
Investments in subsidiary undertakings	2	**3,226.1**	3,415.3
Other receivables	3	**521.7**	34.1
Current tax assets	4	**4.5**	1.3
Cash and cash equivalents	5	**268.3**	32.1
Total assets		**4,020.6**	3,482.8
Equity			
Share capital	6	**150.0**	1,500.0
Capital redemption reserve		**1,350.0**	–
Other reserves		**100.3**	100.0
Retained earnings		**1,661.5**	1,421.1
Total equity		**3,261.8**	3,021.1
Liabilities			
Subordinated liabilities	7	**501.7**	–
Derivative financial instruments	8	**1.7**	–
Borrowings	9	**255.4**	460.4
Trade and other payables	10	**–**	1.3
Total liabilities		**758.8**	461.7
Total equity and liabilities		**4,020.6**	3,482.8

The attached notes on pages 167 to 170 form an integral part of these separate financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 27 February 2013. They were signed on its behalf by:

John Reizenstein
Chief Financial Officer

Direct Line Insurance Group plc

Registration No. 02280426

Parent Company statement of comprehensive income

For the year ended 31 December 2012

	2012 £m	2011 £m
Profit for the year	**1,240.4**	515.9
Total comprehensive income for the year	**1,240.4**	515.9
Total comprehensive income attributable to:		
Owners of the Company	**1,240.4**	515.9
	1,240.4	515.9

Parent Company statement of changes in equity

For the year ended 31 December 2012

	Share capital £m	Capital redemption reserve £m	Other reserves £m	Retained earnings £m	Total equity £m
Balance at 1 January 2011	1,500.0	–	100.0	905.2	2,505.2
Total comprehensive income for the year	–	–	–	515.9	515.9
Balance at 31 December 2011	1,500.0	–	100.0	1,421.1	3,021.1
Total comprehensive income for the year	–	–	–	1,240.4	1,240.4
Share redemption	(1,350.0)	1,350.0	–	–	–
Dividends paid	–	–	–	(1,000.0)	(1,000.0)
Share-based payments	–	–	0.3	–	0.3
Balance at 31 December 2012	**150.0**	**1,350.0**	**100.3**	**1,661.5**	**3,261.8**

The attached notes on pages 167 to 170 form an integral part of these separate financial statements.

Parent Company cash flow statement

For the year ended December 2012

	Notes	2012 £m	2011 £m
Net cash generated from / (used by) operating activities	12	**7.4**	(39.5)
Cash flows from investing activities			
Interest received on loans to related parties		**23.8**	7.7
Dividends received from subsidiary undertakings		**1,545.0**	1,134.2
Acquisition of investments in subsidiary undertakings	2	**(105.2)**	(3,510.5)
Disposal of investments in subsidiary undertakings		**–**	1,797.1
Net cash generated from / (used by) investing activities		**1,463.6**	(571.5)
Cash flows from financing activities			
Dividends paid		**(1,000.0)**	–
Proceeds on issue of subordinated debt		**493.0**	–
Finance costs		**(23.1)**	–
Repayments of borrowings from related parties		**(322.5)**	(1,704.8)
Proceeds of borrowings from related parties		**120.9**	1,959.8
Net (increase) / decrease in loans advanced to subsidiary undertakings		**(503.1)**	388.1
Net cash (used by) / generated from financing activities		**(1,234.8)**	643.1
Net increase in cash and cash equivalents		**236.2**	32.1
Cash and cash equivalents at the beginning of the year	5	**32.1**	–
Cash and cash equivalents at the end of the year	5	**268.3**	32.1

The attached notes on pages 167 to 170 form an integral part of these separate financial statements.

Notes to the parent Company financial statements

1. Accounting policies

Basis of preparation
Direct Line Insurance Group plc, incorporated in the UK, is the ultimate parent company of the Direct Line Group. The principal activity of the Company is managing its investments in subsidiaries, providing loans to those subsidiaries and the receipt and payment of dividends.

The Company's financial statements are prepared in accordance with IFRS as issued by the IASB and are presented in accordance with the Companies Act 2006. In accordance with the exemption permitted under section 408 of Companies Act 2006, the Company's income statement and related notes have not been presented in these separate financial statements.

The accounting policies that are used in the preparation of these separate financial statements are consistent with the accounting policies used in the preparation of the consolidated financial statements of Direct Line Insurance Group plc as set out in those financial statements.

The additional accounting policies that are specific to the separate financial statements of the Company are set out below.

Investment in subsidiaries
Investments in subsidiaries are stated at cost less any impairment.

Dividend income
Dividend income from investments in subsidiaries is recognised when the right to receive payment is established.

2. Investment in subsidiary undertakings

	2012 £m	2011 £m
At 1 January	**3,415.3**	2,313.3
Additions	**105.5**	3,510.5
Disposals	**–**	(1,797.1)
Impairments	**(291.8)**	(611.4)
Exchange differences	**(2.9)**	–
At 31 December	**3,226.1**	3,415.3

The Company acquired 100% of the share capital of Direct Line Versicherung AG on 2 April 2012. The fair value of identifiable assets acquired was £368.7 million (including cash and cash equivalents of £39.7 million), and the fair value of identifiable liabilities assumed was £263.5 million. The total cash consideration paid was £105.2 million.

Full details of investments in principal subsidiaries are set out in note 19 to the consolidated financial statements.

3. Other receivables

	2012 £m	2011 £m
Loans to subsidiary undertakings	**521.4**	9.1
Receivables from subsidiary undertakings	**0.3**	25.0
Total	**521.7**	34.1
Current	**21.7**	34.1
Non-current	**500.0**	–
	521.7	34.1

4. Current tax assets

	2012 £m	2011 £m
Corporation tax recoverable	**4.5**	1.3

5. Cash and cash equivalents

	2012 £m	2011 £m
Short-term deposits with credit institutions:		
Third parties	**263.6**	–
Fellow subsidiaries	**4.7**	32.1
Total	**268.3**	32.1

6. Share capital

Full details of the share capital of the Company are set out in note 27 to the consolidated financial statements.

7. Subordinated liabilities

	2012 £m	2011 £m
Subordinated dated notes	**501.7**	–

The subordinated dated notes were issued on 27 April 2012 at a fixed rate of 9.25%. The nominal £500.0 million bonds have a redemption date of 27 April 2042. The Company has the option to repay the notes on specific dates from 27 April 2022. If the notes are not repaid on that date, the rate of interest would be reset at a rate of the six-month LIBOR plus 7.91%.

The notes are unsecured, subordinated obligations of the Company, and rank pari passu without any preference among themselves. In the event of a winding up or of bankruptcy, they are to be repaid only after the claims of all other creditors have been met.

There have been no defaults on any of the notes during the year. The Company has the option to defer interest payments on the notes but to date has not exercised this right.

The aggregate fair value of subordinated dated notes is £597.6 million (2011: £nil).

8. Derivative financial instruments

	2012		2011	
	Notional amounts £m	Liabilities £m	Notional amounts £m	Liabilities £m
Forward foreign exchange contracts[1]	**134.0**	**1.7**	–	–

Note:

1 The derivative is held with RBS Group.

9. Borrowings

	2012 £m	2011 £m
Loans from subsidiary undertakings	**255.4**	255.4
Loans from fellow subsidiary[1]	**–**	205.0
Total	**255.4**	460.4
Current	**255.4**	0.4
Non-current	**–**	460.0
Total	**255.4**	460.4

Note:

1. During the year ended 31 December 2012, the Company repaid the £205.0 million loan from RBS Group in preparation for operational separation from RBS Group.

10. Trade and other payables

	2012 £m	2011 £m
Payables to subsidiary undertakings	**–**	1.3

11. Dividends

Full details of the dividends paid by the Company are set out in note 14 to the consolidated financial statements.

12. Cash generated from operations

	2012 £m	2011 £m
Profit for the period	**1,240.4**	515.9
Adjustments for:		
Impairment in subsidiary undertakings	**291.8**	611.4
Investment revenues	**(1,578.1)**	(1,141.9)
Other operating income	**1.3**	–
Finance costs	**41.6**	6.3
Tax credit	**(5.5)**	(1.3)
Operating cash flows before movements in working capital	**(8.5)**	(9.6)
Net decrease / (increase) in related party balances	**23.4**	(24.6)
Tax received	**2.3**	0.6
Finance costs	**(9.8)**	(5.9)
Cash generated from / (used by) operations	**7.4**	(39.5)

13. Related parties

The Company's immediate parent company is The Royal Bank of Scotland Group plc which is incorporated in Great Britain and registered in Scotland.

During the year The Royal Bank of Scotland Group plc sold 520.8 million of the Company's Ordinary Shares, representing 34.7% of the total share capital of the Company.

Full details of related parties are set out in note 40 to the consolidated financial statements.

The following transactions were carried out with related parties:

i. Sales of services

	2012 £m	2011 £m
Interest received from subsidiary undertakings	**32.9**	7.7

Interest income received from deposits held with related parties were at rates ranging from 0.51% to 9.50% (2011: 0.71% to 5.94%).

	2012 £m	2011 £m
Dividend income from subsidiary undertakings	**1,545.0**	1,134.2

ii. Purchases of services

	2012 £m	2011 £m
Management fees payable to subsidiary undertakings	**8.7**	6.7
Interest payable to subsidiary undertakings	**7.1**	3.8
Interest payable to fellow subsidiary	**2.7**	2.5
Total	**18.5**	13.0

Interest charged on borrowings from related parties were at rates ranging from 0.51% to 1.92% (2011: 0.71% to 1.92%).

14. Share-based payments

Full details of share-based compensation plans are provided in note 34 to the consolidated financial statements.

15. Risk management

The risks faced by the Company are considered to be the same as those in the operations of the Group itself and details of the key risks to the Group and the steps taken to manage them are disclosed in the Risk management section of the consolidated financial statements (note 3).

16. Directors and key management remuneration

The Directors and key management of the Group and the Company are the same. The remuneration and pension benefits of the Directors, including those of the highest paid Director, are included in the Directors' remuneration report in the corporate governance section of the Annual Report & Accounts.

Additional information

Market
The Company has a primary listing on the UK Listing Authority's Official List and its Ordinary Shares are admitted to trading on the London Stock Exchange.

Share ownership
Share capital
The details of the Company's share capital is presented in note 27 to the consolidated financial statements.

Dividends
The Group aims to generate long-term sustainable value for shareholders, while balancing all operational, regulatory, rating agency and policyholder requirements. The Board has adopted a progressive dividend policy for the Company, which will aim to increase the dividend annually in real terms to reflect its cash flow generation and long-term earnings potential.

It is expected that one third of the annual dividend will generally be paid in the third quarter as an interim dividend and two thirds will be paid as a final dividend in the second quarter of the following year. The Board may revise the dividend policy from time to time.

In addition, if the Board believes that the Group has capital that is surplus to the Board's view of its requirements, it is intended that it will be returned to shareholders. The Company may consider a special dividend and the repurchase of its own shares as a means of distributing surplus capital to shareholders.

The Company pays its dividends in Pounds Sterling to shareholders registered on its principal register in the UK.

Shareholders may have their cash dividends paid directly into a bank or building society by completing a dividend mandate form, which is available from the Company's Share Registrar ("**Registrar**") Computershare Investor Services PLC in the UK. Contact details for the Registrar are set out on the inside back cover of this report. Alternatively, shareholders may access their shareholdings online and download a dividend mandate from the Investor Centre. Please see the inside back cover for details.

Shareholder enquiries
Shareholders with queries on any matter relating to their shares are invited to contact our Registrar using the contact details listed on page 176 of this Annual Report & Accounts.

Shareholders should notify the Registrar of any change in shareholding details in a timely manner.

Shareholders can also access their current shareholding details online at www.investorcentre.co.uk/directline. Investor Centre is a free-to-use, secure, self-service website where shareholders can manage their holdings online. The website enables shareholders to:

- check their holdings;
- update their records (including address and direct credit details);
- access all their securities in one portfolio by setting up a personal account;
- vote online; and
- register to receive electronic shareholder communications.

The website requires shareholders to quote their Shareholder Reference Number in order to access this information.

Shareholder warning
The Group is aware that fraudsters are placing unsolicited phone calls or engaging in correspondence concerning investment matters with a view to defrauding investors. Shareholders are warned that they may receive an approach from persons purporting to be brokers or to be representatives of the Company. These fraudsters are using increasingly sophisticated means to approach shareholders, and they can be persistent and extremely persuasive. The FSA, reports that the average amount lost by investors in a share scam is around £20,000, with as much as £200 million being lost in total in the UK each year. Even seasoned investors have been caught out, with the biggest individual loss recorded by the police being £6 million.

Shareholders are also warned to consider carefully any unsolicited offers they receive to buy their shares. Some companies make offers to shareholders for their shareholdings at prices significantly below what they could expect on the market. Although it is not against the law to make an unsolicited offer to buy someone's shares, it is illegal to mislead or deceive shareholders into accepting any offer. The offer must also comply with strict legal requirements, including prominent details of the shares' current market value. Shareholders are urged to seek independent professional advice to protect themselves against a poor deal.

If you receive an unsolicited call:

- make sure you get the correct name of the person and organisation;
- check that they are properly authorised by the FSA by visiting www.fsa.gov.uk/register/; and
- if the call persists, hang up.

For further advice and tips on how to identify and avoid investment scams, access the FSA's advice at: http://www.fsa.gov.uk/pages/consumerinformation/scamsandswindles/safe/boiler_room/index.shtml

Tips on how you can protect your shares

- Ensure all your certificates are kept in a safe place, or consider holding your shares in the UK's electronic registration and settlement system for equity, CREST, or via a nominee.
- Keep all correspondence from the Registrar that shows your shareholder reference number in a safe place and shred unwanted correspondence.
- Inform the Registrar as soon as you change your address.
- If you receive a letter from the Registrar regarding a change of address and you have not recently moved, please contact them immediately.
- Be aware of when the dividends are paid and contact the Registrar if you do not receive your dividend.
- Consider having your dividends paid directly into your bank account (you will need to fill out a dividend mandate form and send it to the Registrar); this reduces the risk of the cheque being intercepted or lost in the post.
- If you change your bank account, inform the Registrar of the details of your new account immediately.
- If you are buying or selling shares, only deal with brokers registered in the UK or in your country of residence.
- Be aware that the Company will never contact you by telephone concerning investment matters. If you receive such a call from a person purporting to represent the Group please contact the Company Secretary immediately.

Corporate website

The Group's corporate website is www.directlinegroup.com. It contains more useful information for the Company's investors and shareholders, including press releases, forthcoming events, essential shareholder information, a financial calendar and details of the Company's AGM. You may also subscribe for email news alerts.

Electronic communications and voting

The Group produces a range of communications which shareholders can receive in a range of formats. View online, download or receive a paper copy by contacting the Registrar. The contact details can be found on page 176.

Shareholders who register their email address with our Registrar or on the Investor Centre can be kept informed of events such as the AGM and receive shareholder communications like the Annual Report & Accounts and Notice of Meeting electronically.

Dealing facilities

Shareholders can buy, sell or transfer DLG shares through a stockbroker or a high street bank, or through the Registrar's share-dealing facility.

The Registrar may be contacted regarding their share-dealing facility by telephone or by email as follows:

- for telephone sales call +44 (0)870 703 0084 between 8.30 am to 5.30 pm, Monday to Friday excluding public holidays; and
- for internet sales log on to www.investorcentre.co.uk/directline. You will need your shareholder reference number as shown on your share certificate or your welcome letter from the Chairman.

Financial calendar[1]

2013	
28 February	Announcement of results for 2012
6 March	'Ex-dividend' date for 2012 final dividend
8 March	Record date for 2012 final dividend
3 May	First quarter 2013 Interim Management Statement
6 June	Annual General Meeting
11 June	Payment date for 2012 final dividend
2 August	Announcement of half year results for 2013
14 August	'Ex-dividend' date for 2013 interim dividend
16 August	Record date for 2013 interim dividend
26 September	Payment date for 2013 interim dividend
1 November	Third quarter 2013 Interim Management Statement

Note:
1. These dates are subject to change

Annual General Meeting

The 2013 AGM will be held on 6 June 2013 at The Auditorium, Allen & Overy LLP, One Bishops Square, London E1 6AD, starting at 10.00 am. All shareholders will receive a separate notice convening the AGM, which will explain the resolutions to be put to the meeting.

Glossary

Term	Definition
ABI SORP	Association of British Insurers' Statement of Recommended Practice.
Actuarial best estimate	The probability-weighted average of all future claims and cost scenarios calculated using historical data, actuarial methods and judgement.
Capital	The funds invested in the Group, which includes funds invested by shareholders and retained profits.
Claims frequency	The number of claims divided by the number of policies per annum.
Claims reserve (provision for losses and loss adjustment expense)	Funds set aside by the Group to meet the estimated cost of claims payments and related expenses that the Group calculates will ultimately be required to be paid.
Combined operating ratio ("COR")	The sum of the loss, expense and commission ratios. The ratio is a measure of the amount of claims costs and expenses compared to net earned premium generated. A ratio of less than 100% indicates profitable business.
Commission ratio	The ratio of commission expense divided by net earned premium.
Current year attritional loss ratio	The loss ratio for the current accident year excluding the impact of movement of reserves relating to previous accident years and claims relating to weather events in the Home division.
Earnings per share	The amount of the Group's profit allocated to each Ordinary Share of the Group.
Expense ratio	The ratio of operating expenses divided by net earned premium.
Commission	Amounts paid to brokers, partners and PCWs for generating business.
Finance costs	The cost of servicing the Group's external borrowings and subordinated liabilities.
FRS	Financial Reporting Standard.
Financial Services Authority ("FSA")	The independent body that regulates the financial services industry in the UK.
Gross written premium	The total premiums for the period from contracts incepted during the period.
IASB	International Accounting Standards Board.
Incurred but not reported ("IBNR")	Funds set aside to meet the cost of claims for accidents that have taken place, but have not yet been reported to us.
Incurred loss	Claims that have been paid plus claims advised by a policyholder but not paid. Does not include IBNR (see above).
ICA	Individual capital assessment.
In-force policies	The number of policies on a given date that are active and against which the Group will pay following a valid insurance claim.
Initial Public Offering ("IPO")	The first sale of shares by a previously unlisted company to investors on a securities exchange.
IFRS	International Financial Reporting Standard.
Insurance reserves	This consists of general and life insurance liabilities, unearned premium reserve and liability adequacy reserve.
Investment income yield	The annualised investment return earned through the income statement during the period, divided by the average assets under management ("**AUM**") for each asset class during the same period. The investment return excludes realised gains, impairments and fair value adjustments whilst the average AUM for the period is derived by taking the opening and closing balances for the period.
Investment return	The income earned from the investment portfolio.
Investment return yield	The total annualised investment return earned through the income statement during the period, including all one-off items such as realised gains, fair value adjustments and impairments, divided by the average AUM for each asset class during the same period.
Loss ratio	Net insurance claims divided by net earned premium.

Term	Definition
Net asset value	The net asset value of the Group is calculated by subtracting total liabilities from total assets.
Net claims	The cost of claims incurred in the period less any claims costs recovered under reinsurance contracts. It includes both claims payments and movements in claims reserves.
Net earned premium	The element of gross written premium less reinsurance premium ceded for the period that insurance cover has already been provided.
Ogden discount rate	The discount rate set by the relevant government bodies and used to calculate lump sum awards in bodily injury cases.
Operating profit	The pre-tax profit generated by the activities of the Group, including insurance and investment activity, but excluding finance costs.
Periodic payment order ("PPO")	These are payments as awarded under the Courts Act 2003.
RBS Group	The Royal Bank of Scotland Group plc and its subsidiary companies.
Reinsurance	Contractual arrangements whereby the Group transfers part or all of the insurance risk accepted to another insurer.
Relevant government bodies	The Ogden discount rate for use in England, Wales and Northern Ireland is set by the Lord Chancellor, with the rate for Scotland set by the Scottish Ministers.
Reserves	Funds that have been set aside to meet outstanding claims and IBNR.
Return on equity	Return on equity is calculated by dividing the profit attributable to the owners of the company by average ordinary shareholders' equity for the period.
Return on tangible equity ("RoTE")	Return on tangible equity is adjusted profit after tax from ongoing operations divided by the Group's average tangible shareholders' equity. Profit after tax is adjusted to exclude Run-off operations and restructuring and other one-off costs and is stated after charging tax (using the UK standard tax rate). Pro forma RoTE is based on RoTE, but assumes that the capital actions taken by the Group (£1 billion dividend payment and £500 million long-term subordinated debt issue) occurred on 1 January 2012.
Run-off	Where the Group no longer underwrites new business but continues to meet its claims liabilities under existing contracts.
SME	Small and medium-sized enterprises.
Solvency II	The proposed capital adequacy regime for the European insurance industry, which establishes a revised set of EU-wide capital requirements and risk management standards.
SOX 404	Sarbanes Oxley Act, Section 404.
Total shareholder return	Compares the movements in the share price and dividends paid over a period of time, as a percentage of the share price at the beginning of the period.
UK Corporate Governance Code (the "Code")	The UK Corporate Governance Code, dated June 2010 and issued by the Financial Reporting Council.
Underwriting profit / (loss)	The profit or loss from operational activities, excluding investment performance. It is calculated as: Net earned premium less Net insurance claims less Total expenses

Cautionary statement about forward-looking statements

This Annual Report & Accounts has been prepared for, and only for, the members of the Company as a body, and no other persons. The Company, its Directors, employees, agents or advisers do not accept responsibility to any other person to whom this document is shown or into whose hands it may come and any such responsibility or liability is expressly disclaimed.

Certain information contained in this document including any information as to the Group's strategy, plans or future financial or operating performance constitute "forward-looking statements". These forward-looking statements may be identified by the use of forward-looking terminology, including the terms "aims", "anticipates", "believes", "estimates", "expects", "intends", "may", "plans", "predicts", "projects", "seeks", "should", "targets" or "will" or, in each case, their negative or other variations or comparable terminology, or by discussions of strategy, plans, objectives, goals, future events or intentions. These forward-looking statements include all matters that are not historical facts. They appear in a number of places throughout this document and include statements regarding the intentions, beliefs or current expectations of the Directors concerning, amongst other things: the Company's results of operations, financial condition, prospects, growth, strategies and the industry in which the Group operates. Examples of forward-looking statements include financial targets which are contained in this document specifically with respect to RoTE, the Group's COR, the COR for the Group's commercial business, and cost savings. By their nature, all forward-looking statements involve risk and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future or are beyond the Group's control. Forward-looking statements are not guarantees of future performance. The Company's actual results of operations, financial condition and the development of the business sector in which the Group operates may differ materially from those suggested by the forward-looking statements contained in this document including, but not limited to, UK domestic and global economic business conditions, market-related risks such as fluctuations in interest rates and exchange rates, the policies and actions of regulatory authorities (including changes related to capital and solvency requirements or the Ogden discount rate), the impact of competition, currency changes, inflation, deflation, the timing impact and other uncertainties of future acquisitions or combinations within relevant industries, as well as the impact of tax and other legislation and other regulation in the jurisdictions in which the Group and its affiliates operate. In addition, even if the Company's actual results of operations, financial condition, and the development of the business sector in which the Group operates are consistent with the forward-looking statements contained in this document, those results or developments may not be indicative of results or developments in subsequent periods.

The forward-looking statements contained in this document reflect knowledge and information available as of the date of preparation of this document. The Company and the Directors expressly disclaim any obligations or undertaking to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise, unless required to do so by applicable law or regulation. Nothing in this Annual Report & Accounts should be construed as a profit forecast.

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Go online

Our report is supplemented by a range of other information that can be found online

www.directlinegroup.com
Our corporate website houses the most up-to-date information about the Group as well as detailed investor and media sections with the following information:

- Results and presentations
- Share price information
- Financial calendar
- Company and regulatory news

ara2012.directlinegroup.com
In conjunction with this report, we have produced a separate online version of key sections of the report for those who have opted for e-communications. This has been supplemented by video discussing our year end results.

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