Finance review *continued*

Profit for the year and return on tangible equity[1]

Profit before tax of £446.0 million was £5.4 million lower than for 2020 as the increase in operating profit was offset by a £62.1 million increase in restructuring and one-off costs as we continued to make progress in our property site strategy.

Profit for the year ended 31 December 2021 decreased by £23.5 million to £343.7 million (2020: £367.2 million) as an increase in operating profit was partially offset by a £62.1 million increase in restructuring and one-off costs and finance costs.

Return on tangible equity increased to 23.6% (2020: 19.9%) due primarily to the higher operating profit. Profit after tax was adjusted for restructuring and one-off costs and coupon payments in respect of Tier 1 notes.

Note:

1. See glossary on pages 248 to 250 for definitions and appendix A – Alternative performance measures on pages 251 to 255 for reconciliation to financial statement line items.

Earnings per share

Basic earnings per share decreased by 5.0% to 24.5 pence (2020: 25.8 pence). Diluted earnings per share decreased by 5.5% to 24.1 pence (2020: 25.5 pence) mainly reflecting a reduction in profit after tax.

Cash flow

The Group's cash and cash equivalents reduced by £271.7 million during the year (2020: £271.9 million increase) to £896.5 million.

The Group generated operating cash flows before movements in working capital of £435.9 million (2020: £394.5 million), an increase of £41.4 million; a reduction in profit for the year was more than offset by an increase in adjustments for non-cash movements. After taking into account movements in working capital, the Group generated £390.1 million (2020: £402.6 million), a decrease of £12.5 million. The Group has considerable assets under management; the cash generated from these reduced by £148.7 million to £167.2 million following reductions in the Group's assets under management, as a result of dividend payments. Net cash generated from operating activities was £439.0 million (2020: £584.7 million).

Net cash used in investing activities of £138.7 million reflected the Group's continuing investment in its major IT programmes (2021: £109.4 million, 2020: £140.7 million).

Net cash used in financing activities of £572.0 million included £317.4 million (2020: £312.5 million) in dividends and Tier 1 capital coupon payments in the year, £101.0 million in share buybacks (2020: £30.0 million) and £101.9 million (2020: £12.5 million) lease principal payments. The amount in 2020 included net proceeds of £257.2 million relating to Tier 2 subordinated debt issued in June 2020. Dividends paid in the year comprised the 7.6 pence first interim dividend announced in the half-year results in 2021 and the 14.7 pence per share final dividend announced in March 2021.

Net cash used in financing and investing activities more than offset the £439.0 million generated from operating activities and resulted in a net decrease in cash and cash equivalents of £271.7 million (2020: £271.9 million increase) to £896.5 million (2020: £1,168.2 million). The levels of cash and other highly liquid sources of funding that the Group holds to cover its claims obligations are continually monitored to ensure that the levels remain within the Group's risk appetite.

Net asset value

At 31 December	Note	2021 £m	2020 £m
Net assets[1]	16	**2,550.2**	2,699.7
Goodwill and other intangible assets	16	**(822.5)**	(786.8)
Tangible net assets	16	**1,727.7**	1,912.9
Closing number of Ordinary Shares (millions)	16	**1,317.3**	1,351.8
Net asset value per share (pence)	16	**193.6**	199.7
Tangible net asset value per share (pence)	16	**131.2**	141.5

Note:

1. See glossary on pages 248 to 250 for definitions and appendix A – Alternative performance measures on pages 251 to 255 for reconciliation to financial statement line items.

Net assets at 31 December 2021 decreased by £149.5 million to £2,550.2 million (31 December 2020: £2,699.7 million) and tangible net assets decreased to £1,727.7 million (31 December 2020: £1,912.9 million) following the payment of the 2020 final dividend, 2021 interim dividend and the completion of the share buyback programme, a reduction in available-for-sale reserves and additional expenditure on intangible assets as we continued to invest in the business.

Balance sheet management

Capital management and dividend policy

The Group aims to manage its capital efficiently and generate long-term sustainable value for shareholders, while balancing operational, regulatory, rating agency and policyholder requirements.

The Group aims to grow its regular dividend in line with business growth.

Where the Board believes that the Group has capital which is expected to be surplus to the Group's requirements for a prolonged period, it would intend to return any surplus to shareholders. In normal circumstances, the Board expects that a solvency capital ratio around the middle of its risk appetite range of 140% to 180% of the Group's solvency capital requirement ("**SCR**") would be appropriate and it will therefore take this into account when considering the potential for special distributions.

In the normal course of events the Board will consider whether or not it is appropriate to distribute any surplus capital to shareholders once a year, alongside the full-year results.

The Group expects 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. The Company may consider a special dividend and/or a repurchase of its own shares to distribute surplus capital to shareholders.

The Board has recommended a final dividend of 15.1 pence per share (2020: 14.7 pence), an increase of 0.4 pence per share (2.7%). This reflects the Board's continued confidence in the Group's capital position and the sustainability of its earnings.

After the dividend and proposed share buyback programme, the estimated solvency capital ratio was 176% as at 31 December 2021. The Group has outstanding Tier 2 debt issued in 2012 with nominal value of £250 million which can first be called from 27 April 2022. Excluding this debt, the Group's adjusted solvency ratio would have been 160% as at 31 December 2021.

The final dividend will be paid on 17 May 2022 to shareholders on the register on 8 April 2022. The ex-dividend date will be 7 April 2022.

The Group uses reinsurance extensively to mitigate the impact of individual large claims and the aggregation of claims. At the 1 January 2022 renewal for its Motor excess of loss reinsurance, the Group chose to retain additional risk and increased the retention for each individual claim to £5 million (2021: £1 million with 75% placement).

Looking forward, we have a strong balance sheet with further opportunities to reduce capital intensity and increase flexibility.

Capital analysis

The Group is regulated under Solvency II requirements by the PRA on both a Group basis and for the Group's principal underwriter, U K Insurance Limited. In its results, the Group has estimated its Solvency II own funds, SCR and solvency capital ratio as at 31 December 2021.

Capital position

At 31 December 2021, the Group held a Solvency II capital surplus of £1.03 billion above its regulatory capital requirements, which was equivalent to an estimated solvency capital ratio of 176%, after the proposed final dividend and share buyback programme. Excluding the Group's outstanding Tier 2 debt the Group would have had a Solvency II capital surplus of £0.81 billion, equivalent to a solvency capital ratio of 160%.

The Group's SCR and solvency capital ratio are as follows:

At 31 December	2021	2020
Solvency capital requirement (£ billion)	**1.35**	1.34
Capital surplus above solvency capital requirement (£ billion)	**1.03**	1.22
Solvency capital ratio after proposed final dividend and share buyback	**176%**	191%
Adjusted solvency capital ratio[1]	**160%**	172%

Note:

1. Adjusted solvency capital ratio excluding Tier 2 debt which can first be called from 27 April 2022.

Movement in capital surplus

	2021 £bn	2020 £bn
Capital surplus at 1 January	**1.22**	0.85
Capital generation excluding market movements	**0.40**	0.59
Market movements	**(0.03)**	(0.02)
Capital generation	**0.37**	0.57
Change in solvency capital requirement	**(0.01)**	(0.02)
Surplus generation	**0.36**	0.55
Capital expenditure	**(0.12)**	(0.16)
Tier 2 debt issue	**–**	0.26
Cancellation of 2019 year-end distribution and reinstatement for 2020 half-year[1]	**–**	0.12
Interim dividend	**(0.10)**	(0.10)
Final dividend[2]	**(0.20)**	(0.20)
Share buyback	**(0.10)**	(0.10)
Ineligible Tier 3 capital[3]	**(0.03)**	–
Net surplus movement	**(0.19)**	0.37
Capital surplus at 31 December	**1.03**	1.22

Notes:

1. Relates to the cancellation of the 2019 cash dividend (£197 million) and share buyback (£120 million); offset by the special dividend subsequently declared at half-year 2020.
2. Foreseeable dividends included above are adjusted to exclude the expected dividend waivers in relation to shares held by the employee share trusts, which are held to meet obligations arising on the various share option awards.
3. The amount of Tier 2 and Tier 3 capital permitted under the Solvency II regulations is 50% of the Group's SCR.

Movement in capital surplus (£bn)