Direct Line Group

Building sustainable performance

Annual Report & Accounts 2013

Direct Line Group (the "**Group**") is Britain's leading personal lines motor and home insurer[1], with motor insurance operations in Italy and Germany. We operate a multi-brand, multi-product and multi-distribution 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.

Our brands

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

www.directline.com

Direct Line for Business, an extension of the Direct Line brand, is our direct commercial insurance brand for micro and small-sized businesses in the UK that have straightforward commercial insurance requirements.

www.directlineforbusiness.co.uk

Direct Line in Italy and Germany distributes 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

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

www.privilege.com

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

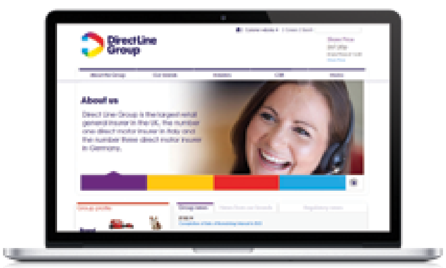
www.greenflag.com

NIG is our specialist commercial insurance brand focused towards small- and medium-sized enterprises ("**SMEs**") and micro businesses in the UK through brokers, including an in-house intermediary that arranges all of Royal Bank of Scotland ("**RBS**") and National Westminster Bank plc ("**NatWest**") commercial insurance.

www.nig.com

Brand Partners is the business-to-business arm of the 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

Note:

1. Ranked number one by total in-force policies in the motor and home markets combined, including Direct Line Group partner brands: RBS, NatWest, Nationwide, Prudential, Egg © GfK NOP Ltd 2014, Financial Research Survey (FRS) 6 months ending December 2013, 13,263 adults interviewed for motor insurance and 13,107 for home insurance.

Building sustainable performance

This has been a year of progress towards our strategic targets. We introduced new customer initiatives, including telematics; enhanced our technical pricing capability; continued the transformation of our claims capability; and increased our operating efficiency. Our strong customer focus remains integral: we aspire to provide our customers with products that best suit their evolving needs and encourage them to expect a high quality of service throughout their relationship with us.

For more on our strategy see p.18

Strategic report

Governance

Financial statements

Other information

Our strategic progress

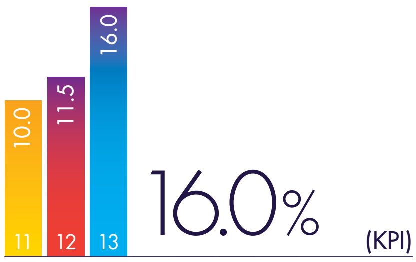
In our first full year as a listed company, we continued to make good progress in our financial performance and advance our transformation plan.

Highlights

- Operating profit from ongoing operations[1] of £526.5 million for 2013, up 14.2% (2012: £461.2 million); and total Group profit before tax of £423.9 million (2012: £249.1 million)
- Investment in improved customer-focused capabilities and propositions, launch of two telematics products and start of roll-out of smartphone and tablet optimised websites
- Extended efficiency programme particularly in head office functions and announced additional cost savings, targeting a reduced total cost base[2] of approximately £1,000 million in 2014
- Completed claims transformation for Motor and Home, extended ClaimCenter to Commercial Motor and Italy and laid the foundations for DLG Legal Services Limited
- Continued to develop Commercial and International, in particular full roll-out of eTrading and strong growth in Germany
- Combined operating ratio for ongoing operations[1] of 96.1% for 2013, an improvement of 3.1 percentage points against 2012 (99.2%), and ahead of the target 98% for 2013
- Combined operating ratio for ongoing operations[1] in 2013 included higher than expected contribution from prior-year reserve releases of 12.4 percentage points (£435.1 million) compared to 8.7 percentage points in 2012 (£322.0 million)
- Return on tangible equity[3] from ongoing operations of 16.0% for 2013 (2012: 11.5% and pro forma[4] 13.4%)
- 5.0% increase in final dividend per share to 8.4 pence per share and second special interim dividend of 4.0 pence per share taking total dividends for 2013 to 20.6 pence per share
- Strong capital position maintained with risk-based capital coverage of 148.7% post final and second special interim dividends, towards the upper end of the target range of 125% to 150%

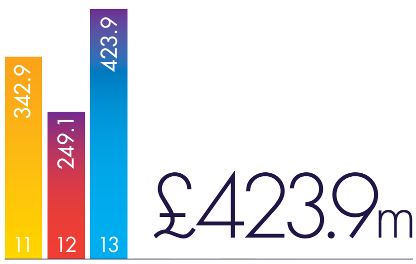
Financial highlights

Return on tangible equity[3]
(%)



13.4% pro forma in 2012[4]

Profit before tax
(£m)



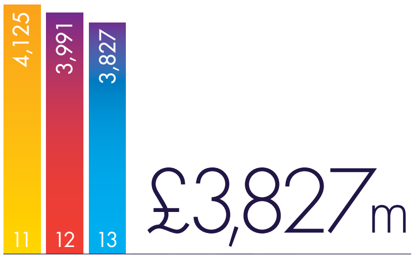
Notes:

1. Ongoing operations include the Group's ongoing divisions: Motor, Home, Rescue and other personal lines, Commercial and International. It excludes the Run-off segment, restructuring and other one-off costs and gain on disposal of subsidiary.
2. Operating expenses and claims handling expenses from ongoing operations. It excludes the Run-off segment and restructuring and other one-off costs.
3. Return on tangible equity ("**RoTE**") is adjusted profit after tax from ongoing operations divided by the Group's average tangible shareholders' equity. Profit after tax is adjusted to exclude the Run-off segment, restructuring and other one-off costs and gain on disposal of subsidiary and is stated after charging tax (using the UK standard tax rate of 23.25%; 2012: 24.5%).
4. Pro forma RoTE is based on the return on tangible equity, but assumes that the capital actions taken by the Group prior to the initial public offering (£1 billion dividend payment and £500 million long-term subordinated debt issue) occurred on 1 January 2012.

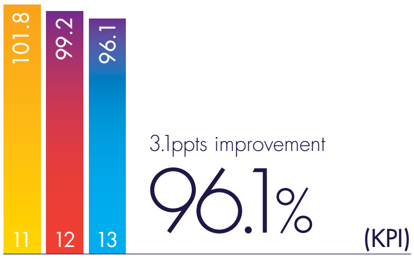
For information on our financial performance see p.34

For information on performance rewards see our remuneration report on p.76

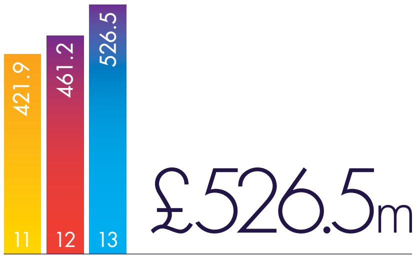
Gross written premium[1]
(£m)



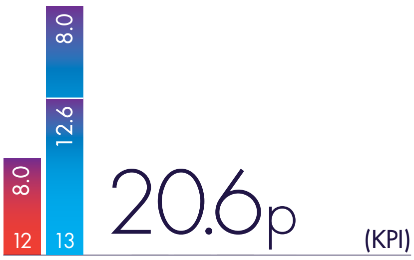
Combined operating ratio[1]
(%)



Operating profit[1]
(£m)

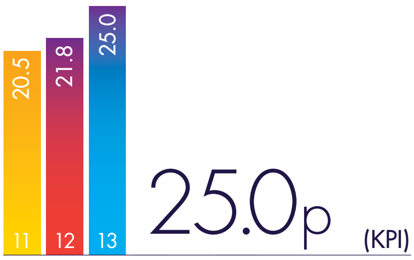


Dividend per share[5]
(pence)

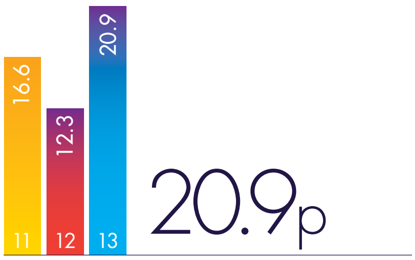


● 12.0 pence pro forma full year dividend for 2012

Adjusted earnings per share – diluted[6] (pence)



Earnings per share – basic
(pence)



5. For 2013, total special interim dividends of 8.0 pence per share were paid. For 2012, pro forma full year dividend is based on the final dividend of 8.0 pence per share representing two-thirds of the full year payout ratio.
6. Adjusted earnings per share – diluted, excludes the Run-off segment, restructuring and other one-off costs and gain on disposal of subsidiary (using UK standard tax rate of 23.25%; 2012: 24.5%).

Protecting customers

We have multiple brands, products and distribution channels that enable customers to choose the right level of cover to protect their cars, homes, holidays, businesses and pets.

Our business divisions

We tailor our products to target specific market segments.

Personal lines

Motor

We are Britain's leading personal motor insurer, with a 14% share of in-force policies[2]. Mainly represented through our highly recognised brands, Direct Line, Churchill and Privilege, we insure one in seven cars on the road, representing 3.8 million in-force policies. We also provide motor insurance for customers through partners such as Sainsbury's Bank.

Read more on p.29

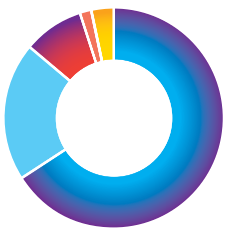
Home

We are one of Britain's largest home insurers, with a 17% share of in-force policies[2]. We reach our customers by selling home insurance products both through our own brands and through partners such as Sainsbury's Bank, RBS, NatWest, Nationwide Building Society and Prudential.

Read more on p.30

	Motor	Home
Gross written premium	£1,421.1m	£943.1m
In-force policies (thousands)	3,762	3,719
Combined operating ratio	93.2%	93.8%
Operating profit	£347.7m	£106.2m

Contribution to operating profit[1]
(£m)



- Motor 347.7
- Home 106.2
- Rescue and other personal lines 46.5
- Commercial 9.5
- International 16.6

Notes:

1. See note 1 on page 2
2. Ranked by total in-force policies in the motor and home markets, including partner brands: RBS, NatWest, Nationwide, Prudential and Egg © GfK NOP Financial Research Survey (FRS) 6 months ending October 2013, 15,260 adults interviewed for motor insurance and 15,922 for home insurance.
3. Mintel Vehicle Recovery – UK, September 2013 report
4. Mintel estimate, based on 2012 data. Mintel Pet Insurance – UK, September 2013 report
5. Mintel estimate, based on 2012 data. Mintel Travel Insurance – UK, February 2013 report
6. insurance Europe, European Insurance in Figures February 2014 report, Motor gross written premiums 2012

Multi-brand

Millions of consumers recognise many of our brands. For almost 30 years, we have sought to make it easier for our customers to obtain good value insurance cover.

direct line

churchill™

For information on our divisional performance see our operating review see p.28

Strategic report

Rescue and other personal lines

We are one of the leading providers of rescue and other personal lines insurance in the UK, with 8.8 million in-force policies. This includes providing roadside assistance and recovery for customers through Green Flag, the UK's third largest roadside recovery provider[3]. We also offer customers protection for their pets and holidays with 11%[4] and 14%[5] shares of gross written premium respectively.

Read more on p.31

Gross written premium
£383.4m

In-force policies (thousands)
8,801

Combined operating ratio
92.4%

Operating profit
£46.5m

Commercial

We protect micro, small and medium-sized businesses, through our own brands NIG and Direct Line for Business, as well as through RBS and NatWest.

Read more on p.32

Gross written premium
£474.5m

In-force policies (thousands)
583

Combined operating ratio
106.8%

Operating profit
£9.5m

International

We have operations in Italy and Germany, two of the three largest motor insurance markets in Europe[6], providing private motor insurance for customers through our Direct Line brand, and have around 1.6 million in-force policies.

Read more on p.33

Gross written premium
£604.5m

In-force policies (thousands)
1,610

Combined operating ratio
103.9%

Operating profit
£16.6m

Generating value and sustainable returns

We use a multi-brand, multi-product and multi-distribution channel business model, aiming for each of our brands to offer a specific proposition to a distinct customer segment. We believe that this approach, when combined effectively with our significant scale, should help us achieve high performance in distribution, pricing, claims and cost. In turn, this enables us to aim to generate value for customers and sustainable returns for our shareholders.

Generating value for our customers through our people

Our customers

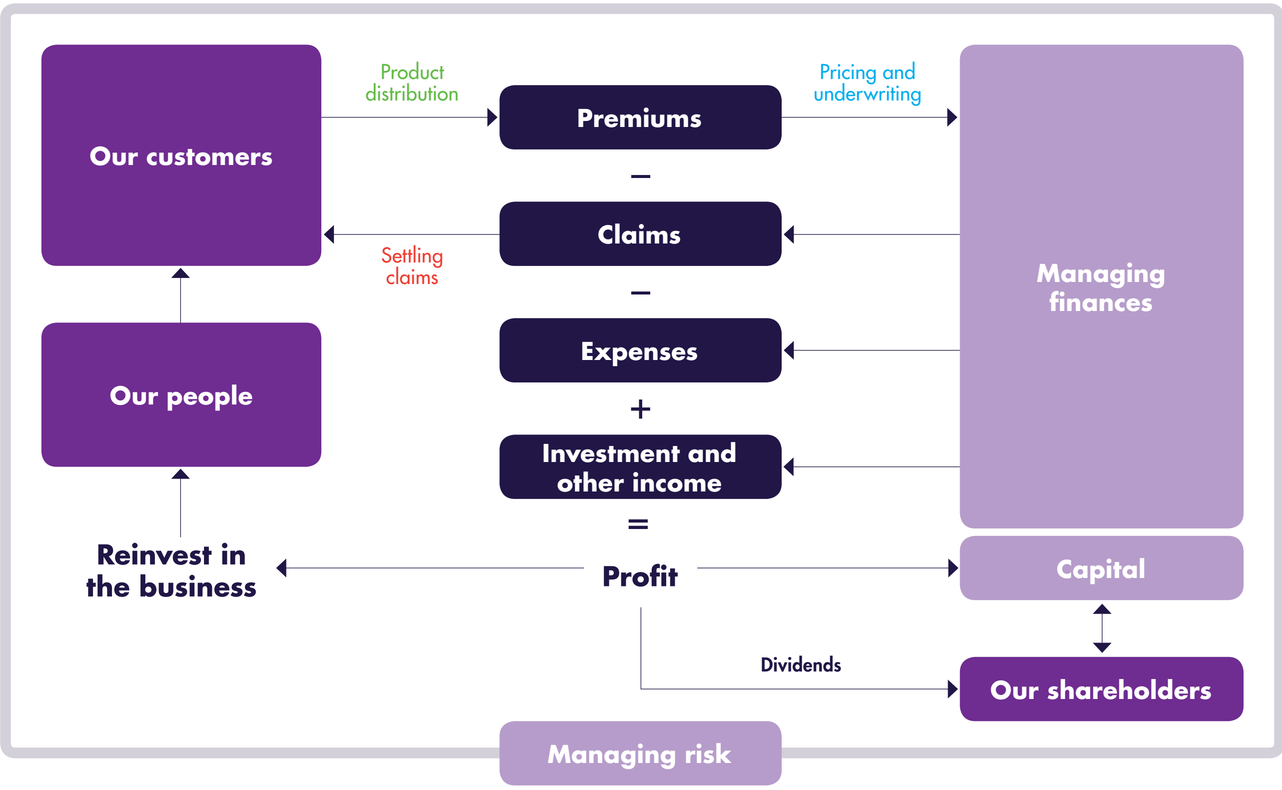
Our business model starts with our customers, whom we aim to keep at the core of what we do. We aspire to give them the products that best suit their needs and encourage them to expect a high quality of service throughout their relationship with us. We also strive to be a business that can adapt to their changing needs. We treat each phase of the customer journey as an opportunity to provide an excellent service and outcome from the moment customers select our products, through to the time they make a claim or need to resolve an unexpected event.

Our people

Everyone – from front-line staff, who interact directly with our customers, to our people in support and central functions, who run the processes that support our products and services – plays a part in ensuring we are meeting customers' needs. Without our people, we could not generate value for our customers and sustainable returns for our shareholders.

Our shareholders

Our shareholders form a crucial part of our business model by investing in us, in the expectation of achieving a return. We aim to deliver value for our shareholders by sustaining the generation of business profit, which is reinvested in the business or distributed to shareholders in the form of dividends.



For information on key performance indicators that measure the effectiveness of our business model see p.20

For information on our risk management see p.22

Our focused processes

Product distribution

We aim to make our products easy to access and to give our customers what they are looking for, to ensure they are appropriately covered when unexpected events happen.

We apply a multi-brand, multi-product and multi-distribution channel business model to sell to retail customers and businesses. Products can be purchased online, including via PCWs, by phone and indirectly through partners and in our Commercial business, via brokers. Each brand provides products targeted at one or more insurance segment: motor, home, rescue, pet, travel and commercial. By tailoring the mix of distribution channel for each product, we can offer our customers a combination of brands, products and services that best suits their needs.

Pricing and underwriting

The scale of our business, which has been operating for almost 30 years, gives us deep insight into the risks we underwrite, which enables us to improve pricing accuracy. It also allows us to invest more heavily in data and achieve efficiencies, which means we can more accurately set the appropriate price for the risks we underwrite.

Settling claims

If the time comes to make a claim, it is at that point that customers see the value of their policy. 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 and manage our claims costs.

Our disciplined approach

Managing finances

We seek to ensure that our business is well governed and controlled. We aim to manage our finances carefully by spending money on items that add the most value to our customers, balancing this with the need to generate a suitable and sustainable return to our shareholders.

We hold assets in excess of our expected liabilities in the form of capital, which is designed to absorb unexpected losses that might occur, as well as to meet regulatory capital requirements.

We have a conservative approach to reserving and this may result in significant prior-year reserve releases.

Managing risk

We ensure that our products meet regulatory standards and that customers understand what they are purchasing from us. We also aim to make sure we price our policies prudently and we invest our assets appropriately to minimise any potential losses. We mitigate risks by adopting policies and minimum standards that are regularly reviewed and updated to ensure that we are in line with the risk appetite set by the Board. Regular reviews by external experts supplement this internal control framework.

New offerings

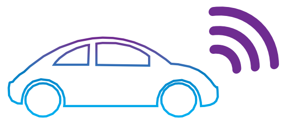
Pricing and underwriting

Our new customer offerings, such as our telematics black box and smartphone apps, are helping us to improve our pricing models.

In June 2013, we moved from a test and learn phase to launching our telematics propositions on our own motor brands, Direct Line, Churchill and Privilege. This included our black box solution for young drivers aged 17 to 25, and our downloadable app available to all ages. We are now selling approximately 400 telematics policies a week and have sold 12,000 to date. This represents a growing proportion of our new motor business and we believe telematics has an increasingly important role to play in motor insurance, not just with young drivers but across the market.

12,000
live telematics devices to date

1 Have our black box fitted to your car or download the smartphone app



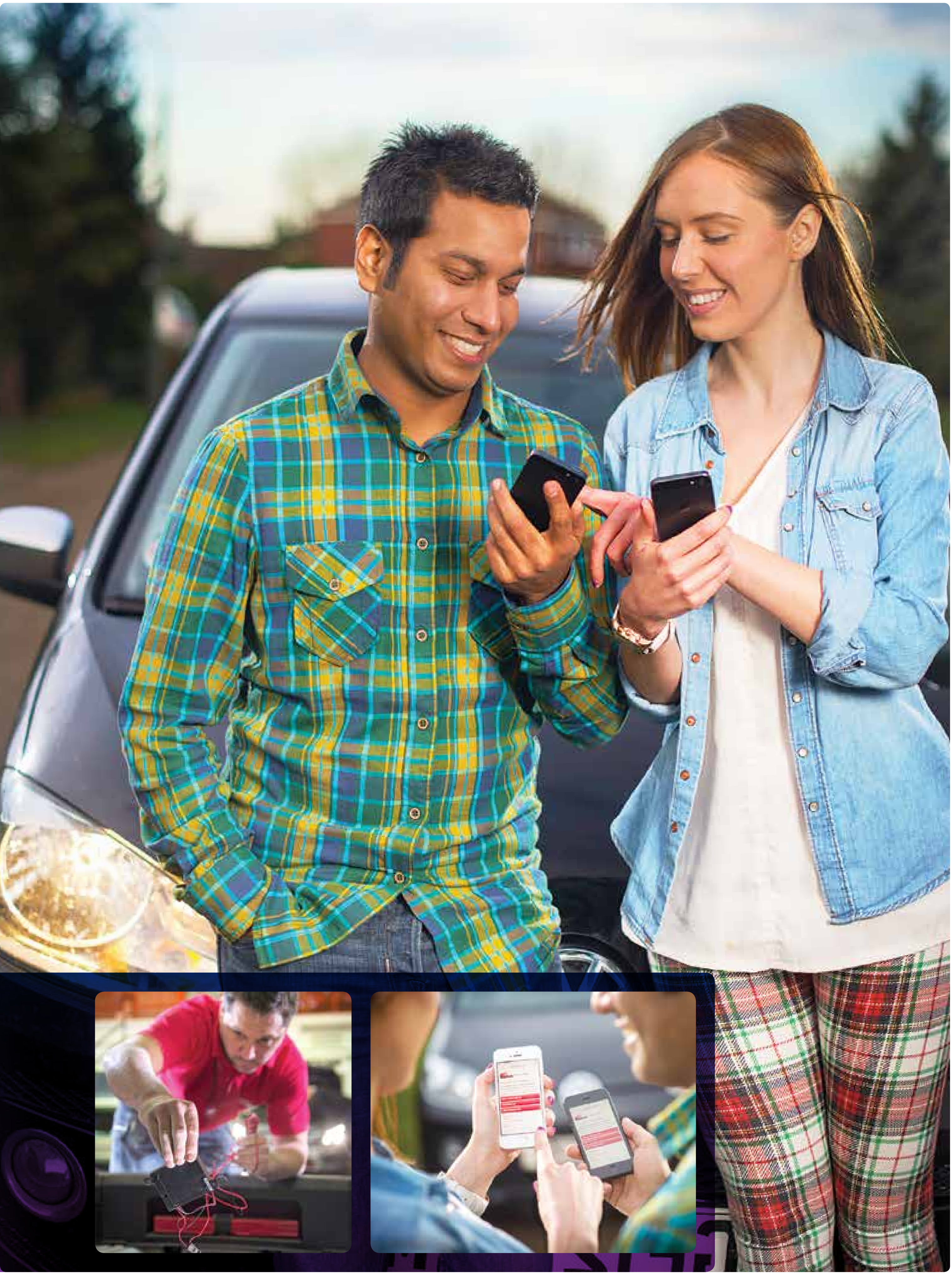
2 View feedback on how you're driving

3 Safe driving behaviour could save you money on car insurance

Benefits to young drivers

Young drivers as a high-risk, high-premium group are expected to gain the greatest benefit from telematics.

We are seeing that around one-in-five Direct Line new policies taken out by under 25s over the phone have selected telematics. This also allows feedback to customers on their driving, which is anticipated to reduce the likelihood of accidents and improve safety on our roads. This is a really positive step and will help with our ongoing campaign to the UK Government to contribute to an improvement in young driver safety. Our extensive data and large customer base mean we, alongside specialist partners, are well positioned to capitalise on this growing market. To date, we have gathered 22 million miles of customer data, giving us a more accurate picture of our customers, how they use their cars, and what cover is suitable for them. Once we have analysed this data over a period of time, we will have the ability to price and underwrite more accurately.



Timely updates

Settling claims – Motor

Our claims transformation programme is improving the way we deal with customers, making it smoother and faster.

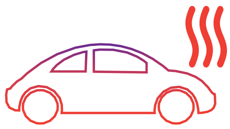
Our ongoing roll-out of ClaimCenter has passed the milestone of registering 1 million customer claims, as well as bringing Commercial and Italian motor claims onto the platform. All new customer motor and home claims for our Direct Line, Churchill and Privilege brands, as well as some of our partnership brands, are now handled through the system.

Over

1,000,000

claims on the new system

1 Notify us of your accident



2 Damage assessed

3 Your car is taken in by our garage

4 Check the progress of your car on the portal

5 Keys to your car returned

Improving our customers' experience

We identified that providing timely updates during car repairs is a key challenge in our claims business and important to our customers.

Therefore, to resolve this in our Motor business, our customers are now able to receive regular updates on when their car will be ready.

This transparency should give them peace of mind and, once active across our entire accident repair centre network, is expected to reduce call volumes and avoidable frustrations.


Job Nr
Customer
Tasks & Recorded Time
Codes
Time
Status
Current Job Status
Estimate Date
Commence Date
Required Date
Status Key:
Blank- Not Started, COMP- Task Completed, INPRG- Inprogress & IDLE
Option

Weather response

Settling claims – Home

Over the last year the UK experienced some of the worst wind and rain storms in a quarter of a century, leaving many homes damaged and without power.

Before each storm hit, we put our severe weather plans into action, making sure there were extra staff on the phones and on the ground to help our customers. On the day of greatest impact, we received more than double our normal customer call volumes. We also deployed our emergency response vehicle, CHARLIE, to the worst affected areas to help customers on the ground get on with the claims process.

1 Before the storm hits, we ensure there are extra people available to help you on the phone and on the ground

2 CHARLIE, our emergency response vehicle, is sent to the worst affected areas

3 Contact us as soon as possible to make a claim

4 Property advisers attend your home and instantly send through list of damage

5 Damage repaired and claim paid

Supporting our customers on the ground

We have been looking at how we can best use our people on the ground to support our customers when they make a home claim.

To make access to us more convenient, we are introducing the use of smartphone technology to capture and send claim details while connected to a customer services adviser. The cost of the repairs can then be priced using our home estimation tool, thereby getting the claim moving much faster.

Where the storm hit the UK in November 2013


Flood
WORKING TOGETHER
IN SEVERE WEATHER
SEVERE WEATHER RESPONSE TEAM
churchill

Good progress towards targets

Mike Biggs, Chairman

"The Board is encouraged by the progress made on the Group's transformation plan and endorses management's actions to drive efficiency in the current competitive markets.

"Over the longer term, the Board believes that a continued focus on our strategic priorities should generate sustainable value."

2013 represented another significant year for Direct Line Group. In the first full year of being listed on the London Stock Exchange, the Group achieved the 2013 combined operating ratio[1] ("COR") and cost targets set at the time of the initial public offering ("IPO") in October 2012. This resulted in a 16.0% RoTE from ongoing operations[2], ahead of its long-term target. This has been achieved despite competitive market conditions and demonstrates the improved levels of performance the Group's transformation plan is delivering.

Our shareholders have also seen a 15.3% increase in the share price to 249.6 pence per share in the year to 31 December 2013. In addition, we paid shareholders dividends totalling 16.2 pence per share during 2013. As at the date of this report (25 February 2014) the share price is 261.0 pence.

Strategy update

During 2013, the Group has continued to focus on delivering the strategic plan established in 2010 to transform Direct Line Group into 'Britain's best retail general insurer'. We have made good progress in 2013 across each of our strategic priorities and have plans for further transformation in the future.

Looking to 2014, we will continue to focus on delivering for our customers, in particular by using technology to enhance customer experience. More details of this and other strategic priorities can be found in the Chief Executive Officer's review.

We continue to target a RoTE from ongoing operations[2] of 15%. In addition, we have set specific targets for 2014, being a total cost base[3] of approximately £1,000 million and a COR in Commercial of less than 100%. Overall, we currently expect a COR for the Group of between 95% and 97% in 2014. These assume a normal level of claims from weather events and large losses.

Dividend and capital management

Through our progressive dividend policy, we aim to increase the dividend annually in real terms. The Board is recommending a final dividend of 8.4 pence per share to shareholders. If approved, the full year regular dividend of 12.6 pence per share would represent a 5.0% growth on the pro forma full year dividend[4] of 2012 (12.0 pence per share) and is in line with this policy.

For information on our corporate governance see p.50

For information on our risk management see p.22

In addition, we paid a special interim dividend of 4.0 pence per share in December and we are now declaring a second special interim dividend of 4.0 pence per share. Both these special interim dividends relate to items in 2013 that were not expected at the start of the year. First, the sale of our closed life insurance operation, Direct Line Life Insurance Company Limited (the "**Life business**"), and secondly, better than expected profit from the Run-off segment and the sale of Tracker. Due to the one-off nature of these items, the Board believes it is appropriate in this instance to return this capital to shareholders.

The Board considers that the Group is currently strongly capitalised with a risk-based capital coverage ratio at the upper end of its risk-based capital coverage target range and an 'A' rating with stable outlook from its credit rating agencies.

In determining this position, the Board has considered a number of factors that may positively and negatively affect the Group's capital position over the next 12 months. The Board will continue to review this position as clarity improves on these factors and the Group makes further progress with its transformation plan. More details can be found on page 42.

Relationship with RBS Group

Our ongoing relationship with RBS Group is principally set out in two key agreements, the Relationship and Transitional Services Agreements. The Relationship Agreement sets out that Direct Line Group is to carry on its business independently of RBS Group and entitles RBS Group to nominate a Director for appointment to the Board. The agreement will terminate once RBS Group holds less than 20% of Direct Line Insurance Group plc (the "**Company**") shares. Under the Transitional Services Agreement, RBS Group will continue to provide IT and certain other services to Direct Line Group for a transitional period of up to 36 months following the IPO in October 2012.

Subsequent to the IPO, RBS Group undertook two further placings in 2013 of 551.6 million Ordinary Shares in the Company. These represented 36.8% of the total share capital and generated additional gross proceeds of £1,135.8 million for RBS Group. Following the placings, RBS Group's shareholding in the Company was 28.5%.

Board changes and effectiveness

Following RBS Group's reduction in its shareholding in the Company to below 50%, and in accordance with the terms of the Relationship Agreement, Mark Catton stepped down from the Board on 26 April 2013. On 1 October 2013, Bruce Van Saun stepped down from the Board to focus on other projects for RBS Group and Mark Catton was reappointed. May I take this opportunity to thank Bruce for the insights and value he brought to the Board during his time as a Director. I would also like to extend this gratitude more generally to all of our Non-Executive Directors for their dedication to the Group.

The Board and its Committees undertook formal evaluations of their performance in 2013. The Company engaged the services of an external facilitator, who met with me as Chairman to agree the structure, scope and content of the evaluations. The individual Directors were subject to a review of their effectiveness and I have met with each Director to provide feedback on a one-to-one basis. Committee Chairs also received feedback on the performance of the Committees.

Summary

I have been very impressed by the commitment of our employees whenever our customers need their support. In a challenging year, they have remained determined to help our customers get back on their feet after an accident or an event in their lives. The Group is only as good as its people and everyone has contributed to this success, and I would like to thank employees and senior management for everything that has been achieved in 2013.

Michael N Biggs, Chairman

Notes:
1. See note 1 on page 2
2. See note 3 on page 2
3. See note 2 on page 2
4. See note 5 on page 3

Investing in our future

Paul Geddes, Chief Executive Officer

"Our strategic progress and successful delivery of our targets is a direct result of the hard work demonstrated throughout the business. This has enabled us to deliver benefits to our customers and returns to our shareholders."

Overview of financial performance

I am pleased that in 2013 we continued to make good progress with our strategic priorities and financial targets, while maintaining our disciplined approach to underwriting in a highly competitive and deflationary marketplace in the UK. We delivered an operating profit from ongoing operations of £526.5 million, an increase of 14.2% compared to 2012 (£461.2 million); and total Group profit before tax of £423.9 million (2012: £249.1 million).

With a COR of 96.1% we achieved our COR target of 98% for 2013. This contributed to a RoTE of 16.0%, ahead of our long-term target of 15.0%. While our results were helped by higher reserve releases than expected, the momentum of our transformation and 'self-help' agenda continued to create benefits and opportunities. We took positive steps towards reducing costs across the business and improving our operating efficiency. Within other areas of our strategy, such as pricing and claims, we continued to deliver sustainable benefits for our customers and shareholders.

Delivering value for our customers

Our focus on improving our pricing capability and claims infrastructure has particularly helped us to reduce prices for UK motor customers. In addition, we have been exploring new ways in which we can innovate to achieve better outcomes for customers. Direct Line's heritage is rooted in the revolution it unleashed by using the telephone to bypass the traditional high street insurance broker model and provide customers with more competitive products. That innovation gave way to the advent of PCWs, which emerged in response to the growing purchase of insurance via the internet.

We are on the cusp of a new era, when growing customer use of new technologies prompts them to seek a different experience from their insurer, and where nimble providers can harness technology to offer both competitive products and more personalised solutions. The strength of our data and brands, together with the operational and financial transformation of our platform, leaves us well placed to help draw the road map for this new age. For instance, we are piloting real-time online progress updates on car repairs, and we are offering telematics technology to give customers instant feedback on the quality of their driving, which can ultimately, if they drive well, improve road safety and save them money.

We have also been working hard to reduce customer complaints across the Group and for the second half of 2013 our complaint volumes decreased by 19% compared to the same period in 2012. This is a key area of focus for us. To ensure we are tracking how well we are responding to our customers' needs, we have introduced a new key performance indicator to measure the volume of customer complaints across the Group.

We recognise that, while we have made improvements in how we interact with our customers, we have not met all of our aspirations to develop and differentiate our customer propositions and brands. We have much to do to meet the evolving needs of our customers, but we are rising to the challenge with determination and energy.

Delivering for our people

Our people continue to be the main driver behind delivering better outcomes for our customers. Although we have had to remove 3,200 roles since the start of our cost savings initiatives, to ensure our organisation can operate in the most cost-efficient manner, our consistent aim has been to treat colleagues with the utmost fairness and respect throughout redeployment or redundancy processes. As we continue to drive an agenda of operational and cultural change through the organisation, we remain committed to investing in our people, which in turn will help us to deliver the products and services that our customers value.

For more on our strategy see p.18

For more on performance rewards see our remuneration report on p.76

Developing stand-alone systems

Ever since beginning our separation from RBS Group, we have made significant investments to design and started to build a stand-alone IT infrastructure capable of supporting a multi-brand, multi-product and multi-distribution channel business with 18 million in-force policies. Notwithstanding the complex operational risk associated with this task, we aim for the migration to have made substantial progress by the end of 2014. Alongside the construction of a stand-alone IT platform, we are continuing to develop our technological capabilities by investing in other systems designed to improve customer operations and business processes. The opening of our own, state-of-the-art data centres was a significant step forward in advancing our technology initiatives in 2013.

Regulatory environment

We have continued to operate within a highly dynamic and evolving regulatory landscape, particularly in the UK motor insurance market where over the past two years a number of reviews and initiatives have been announced by the UK Government, the Ministry of Justice ("**MoJ**"), the Financial Conduct Authority ("**FCA**"), and the Competition Commission ("**CC**").

The Group continues to engage proactively in new or emerging regulatory priorities. Good conduct is integral to the success of our business, which is why we decided to switch the sale of our motor legal protection product to opt in prior to the publication of regulatory guidance, and why we chose to lay the foundations for DLG Legal Services as an alternative business structure, which should help shield our existing customers from potentially excessive third-party solicitor fees.

In December, the CC published the provisional findings of its ongoing investigation into the UK private motor insurance market. We continue to work with the CC, and have always said we welcome the investigation, if it results in a level playing field and the removal of market dysfunction, to the benefit of our customers and consumers more broadly.

Strategic priorities for 2014

During 2014 we aim to progress further towards delivering the remainder of the strategic financial targets we have set ourselves. In particular, we aim to deliver our target of a total cost base[1] of approximately £1 billion, as well as our Commercial business achieving a COR[2] of less than 100%.

We will also continue to enhance our products and update our infrastructure to ensure we sharpen our customer experience, delivering what the customer has grown to expect, and doing so sustainably for all of our stakeholders, be they our customers, our people or our shareholders.

Outlook

The UK motor and home markets remain highly competitive. In this trading environment, we will continue to prioritise targeting appropriate margins, even if this is at the expense of premium or policy volumes. We continue to progress initiatives supporting our strategic priorities in order to seek to improve our competitive position and performance in the longer term.

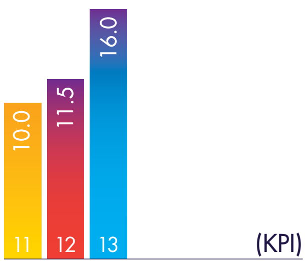
For 2014, we aim to achieve a COR in the range of 95% to 97% for ongoing operations, assuming a normal level of claims from weather events. Assuming underlying claims trends continue, a significant contribution from prior-year reserve releases is currently expected, albeit at a lower level than in 2013.

I would like to thank our people for the continuous hard work and dedication that they have demonstrated throughout the year. This has enabled us to continue to deliver benefits to our customers, shareholders, and wider stakeholders.

Paul Geddes, Chief Executive Officer

Return on tangible equity[3] (%)

16.0%

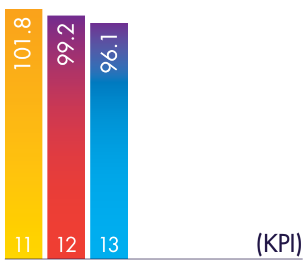


● 13.4% pro forma in 2012[4]

Combined operating ratio[5] (%)

3.1ppts improvement

96.1%



Notes:

1. See note 2 on page 2
2. This assumes a normal level of claims from weather-related events and large losses.
3. See note 3 on page 2
4. See note 4 on page 2
5. See note 1 on page 2

Delivering our strategy

We continue to transform our business to move towards our ambition to be Britain's best retail general insurer. Our strategy is based on five key priorities.

Financial targets

15%
Return on tangible equity[1]

125% to 150%
capital coverage consistent with credit rating in the 'A' range

2014 targets

£1,000m
Approximate total cost base[2]

Less than 100%
COR for Commercial division[3]

Guidance

95% to 97%
COR for ongoing operations[4,5] in 2014

Distribution

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

We seek to understand customers' needs and provide them with products that meet their needs, offer good value and are straightforward to purchase.

We employ a multi-distribution channel 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 selected partners.

2013 progress:
- Reduced marketing spend, while differentiating product offerings
- Developed and launched two telematics propositions – black box and smartphone app
- Invested in digital content platform and web tool analytics

Priorities for 2014:
- Complete the roll-out of our new smartphone and tablet optimised websites and leverage the new digital platform
- To continue to develop and differentiate the Direct Line customer proposition
- To evolve our telematics propositions based on customer feedback and performance

Pricing

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

By enhancing our pricing capabilities we can improve the assessment of the risks we are willing to accept and price these more accurately. Our customers benefit from this through more competitive prices.

2013 progress:
- Launched updated technical pricing models in Motor with further granularity
- Used improved rating models to optimise exposure in higher premium segments
- Implemented enhanced renewal management capabilities in Motor and Home

Priorities for 2014:
- 30 major programmes due to be delivered in 2014
- A number of specific pricing initiatives to enhance trading capability on PCWs
- Use telematics experience and data to support technical pricing

Notes:
1. See note 3 on page 2
2. See note 2 on page 2
3. See note 2 on page 17
4. See note 1 on page 2
5. This assumes a normal level of claims from weather events.

Claims

We aim to maintain top quartile performance by achieving efficient and effective claims management.

We have fundamentally redesigned our claims operating model with simpler processes in fewer sites, giving our people more control and our customers a better experience. By managing claims through our own professional loss adjusters and repairing cars through our own accident repair centres, we aim to give customers the benefit of our scale and strength.

We continue to invest in our capabilities to provide customers with a service that is reliable and straightforward, with improved transparency at each step of a claim.

2013 progress:

- Completed claims transformation in Motor and Home with ClaimCenter roll-out and new operating model, including the use of social networking techniques to combat fraud
- Making full use of our claims fulfilment network to offer improved customer propositions, for example car replacement service
- Laid the foundations for DLG Legal Services

Priorities for 2014:

- Continue to improve customers' experience by rolling out further claims initiatives, for example using smartphone technology
- Further enhance claims leakage and fraud identification
- Generate further efficiency

Costs

We aim to improve efficiency throughout the business to reduce costs, enable faster decision making and improve customer propositions.

We recognise the requirement to keep costs down, whatever the market conditions. We are also in the process of updating our IT infrastructure which should improve efficiency, offer us more flexibility and enable us to enhance our customers' experience.

2013 progress:

- Achieved cost reduction target set at the time of IPO and taken further steps to improve efficiency throughout the organisation, particularly in head office
- Built new data centres in conjunction with Capgemini
- Started roll-out of new voice and desktop tools to improve efficiency throughout the organisation

Priorities for 2014:

- Make substantial progress on the migration of IT applications, reducing dependency on RBS Group systems
- Build a low-cost self-service digital infrastructure
- Reduce total cost base[1] to approximately £1,000 million

Commercial and International

We focus our Commercial business on targeting the growing SME and micro segments, and are well positioned to benefit as these customers move towards direct and e-trading distribution channels.

We have 10 years of experience in Italy and Germany, two of Europe's biggest motor insurance markets, and are now reaching scale.

As the characteristics of our personal and commercial lines businesses increasingly come together, we aim to leverage our skills across the Group particularly in the areas of technical pricing, claims management, telematics and flood mapping.

2013 progress:

- Full cycle eTrading platform launched for Commercial
- Implemented ClaimCenter in Italy and for Commercial Motor
- Delivered efficiencies through consolidation of underwriting centres and separating trading activities
- Improved profitability in Italy with a lower COR
- Significantly grew premiums in Germany

Priorities for 2014:

- Achieve target for COR of below 100% for Commercial division[2]
- Embed and extract value from ClaimCenter and eTrade roll-out
- Develop van proposition, including telematics and Churchill brand
- Drive further efficiencies in International
- Implement a new rating engine in Italy
- Maintain progress in Germany with over 9% growth in in-force policies in January 2014

Notes:
1. See note 2 on page 2
2. See note 2 on page 17

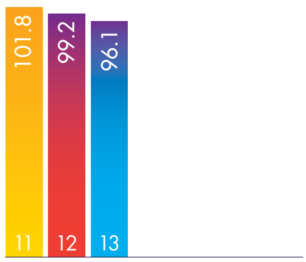
Measuring our performance

We have defined eight key performance indicators that allow us to monitor our performance against our strategic priorities. In turn, these are supported by further performance indicators monitored by management.

Combined operating ratio[1] (%)

3.1ppts improvement

96.1%



Definition

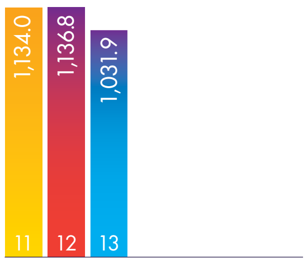
A measure of financial year underwriting profitability calculated by the sum of claims, commissions and expenses divided by net earned premium for ongoing operations. This excludes instalment and other operating income and investment return. A COR of less than 100% indicates profitable underwriting.

Aim

We aim to make an underwriting profit, and in 2013 set and achieved a target of a 98% COR. For 2014, we are providing guidance of a COR in the range of 95% to 97% for the Group. This assumes a normal level of claims from weather events.

Total cost base[2] (£m)

£1,031.9m



Definition

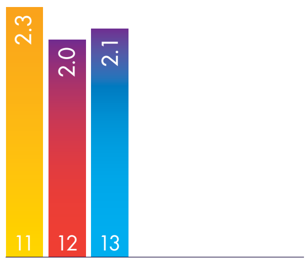
The cost of doing business, including paying our people, marketing, infrastructure and IT. This includes the costs we incur in handling claims, but excludes any commissions we pay to brokers or partners and restructuring and other one-off costs.

Aim

We aim to operate an efficient and effective organisation and are targeting our total cost base[2] for 2014 to be approximately £1,000 million.

Investment income yield (%)

2.1%



Definition

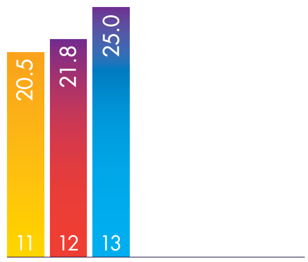
The return generated by investing the assets we hold. These investments are held to pay out future claims and to support our capital base. It is calculated by dividing investment income (excluding net realised gains) by average investment assets under management ("AUM").

Aim

We aim to maximise investment income subject to the risk appetite set by the Board. The investment portfolio assets are currently invested in credit and sovereign debt securities, cash and property.

Adjusted earnings per share – diluted[3] (pence)

25.0p



Definition

We adjust earnings to exclude restructuring and other one-off costs, the result of our Run-off segment and other one-off items. These adjusted earnings, which reflect the ongoing operations, are divided by the average number of shares in issue adjusted for dilutive potential Ordinary Shares.

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.

Notes:

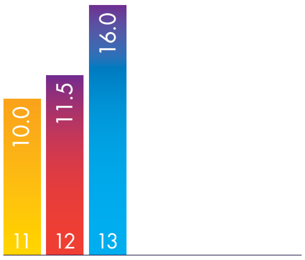
1. See note 1 on page 2
2. See note 2 on page 2
3. See note 6 on page 3

For more information on our financial performance see p.34

For information on our performance rewards see our remuneration report on p.76

Return on tangible equity[1] (%)

16.0%



● 13.4% pro forma in 2012[2]

Definition

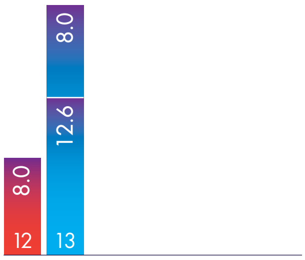
The return generated on the capital shareholders have in the business. This is calculated by dividing adjusted earnings by average tangible equity.

Aim

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

Dividend per share[3] (pence)

20.6p



● 12.0 pence pro forma full year dividend for 2012

Definition

The amount of cash paid to shareholders out of the profit of the Group. The comparative amount shown excludes dividends paid prior to the IPO.

Aim

We have adopted a progressive dividend policy and aim to grow the dividend in real terms each year. In addition, we look to return excess capital to shareholders when appropriate.

Risk-based capital coverage[4] (%)

148.7%

Definition

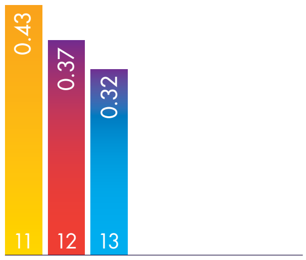
A measure to show the level of capital held compared to the level that is required, taking into account the risks faced by the business.

Aim

We target risk-based capital coverage of 125% to 150% which is consistent with our aim to maintain a rating in the 'A' range from our credit rating agencies.

Complaints (%)

0.32%



Definition

The number of complaints received during the year as a proportion of the average number of in-force policies.

Aim

This measure indicates the level of customer service provided and over time we aim to improve this.

Notes:

1. See note 3 on page 2
2. See note 4 on page 2
3. See note 5 on page 3
4. Adjusted for final and second special interim dividends

Managing risk

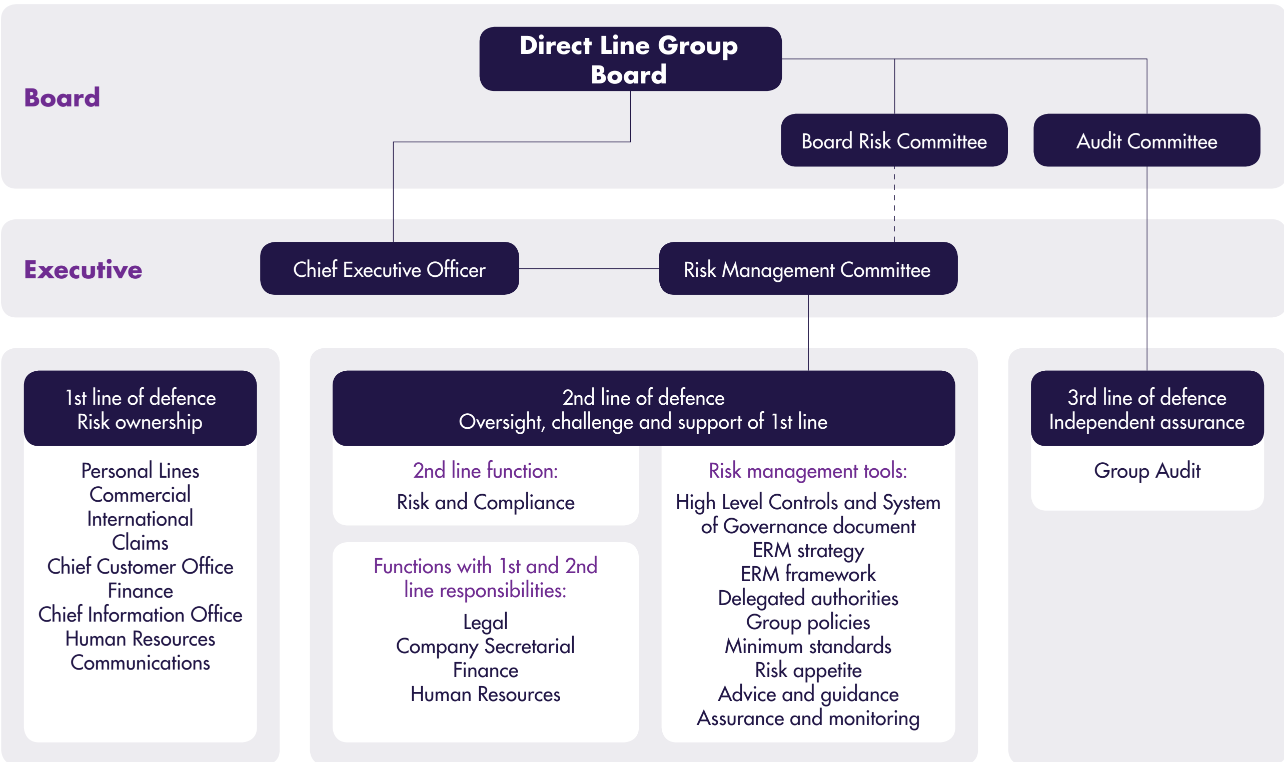
We have a robust and integrated risk management framework. This framework sets out and enables the monitoring of the responsibilities and accountabilities for risk management and internal control for the whole business.

"Our risk and compliance strategy is designed to support our goal to become Britain's best retail general insurer."

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.

Our risk governance structure



Notes:

1. The 1st line of defence is provided by line managers who are responsible for ownership and management of the risks to the achievement of business objectives on a day-to-day basis.
2. The 2nd line of defence is provided by specialist control functions, including Risk and Compliance, which are responsible for the provision of proportionate oversight of the business and related or emerging risks.
3. Group Audit delivers the 3rd line of defence through the provision of an independent view for the Board on the effectiveness of risk management.

The Chief Risk Officer is a member of the Executive 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 Risk Management Committee, which reviews material policies for the effective management of risk across the Group.

Managing risk in line with Group strategy

Group strategy development is the responsibility of management and ultimately the Board.

Our strategic planning process aims to ensure that we have developed a clear set of objectives and targets and have identified the action plans necessary to deliver them. These must be consistent with our overall objective of a 15% RoTE and be delivered in line with our risk appetite. For information on our strategy see page 18.

Delivering a strategic plan will, by its very nature, result in taking risk. Management of this risk is therefore a key aspect of the strategic planning process and it is important that the link between strategy and its impact on capital is clear. We place Enterprise-wide Risk Management ("**ERM**") at the very heart of our approach.

We recognise that our long-term sustainability depends on having sufficient funds to meet our liabilities as they fall due. This protects our reputation and the integrity of our relationship with customers and other stakeholders. For information on our allocation of capital by risk type see page 42.

Risk strategy and appetite

The risk appetite statements are expressions of the level of risk we are prepared to accept to achieve our business objectives. In order to monitor whether we are within risk appetite, we have aligned the statements to key business metrics, such as volumes of business or levels of exposure. These metrics form key risk indicators, which are both qualitative and quantitative and forward and backward looking, and our risk profile is monitored regularly using these indicators to ensure we remain within appetite.

We have an appetite for general insurance risk, with a focus on personal lines and commercial SME insurance in the UK and direct motor insurance in selected overseas countries. To support our primary activity of insurance, we have an appetite for appropriate non-insurance risks.

Risk appetite should not be static and we are committed to performing, as a minimum, an annual review of the risk appetite to ensure it remains suitable to support the Group. Such a review was undertaken in the second quarter of 2013 and resulted in Board approval of the risk appetite statements outlined in the table. We would also review risk appetite if the Group's strategy changed, ensuring risk management remains aligned to the Group strategy.

The risk appetite statements are aligned with the Board's strategic risk objectives.

Over the last 12 months, to help achieve these strategic risk objectives, we have:

- Strengthened financial risk oversight by developing the risk management function through tailored recruitment
- Enhanced the ERM framework to reflect our operation as a stand-alone Group
- Realigned risk management and oversight responsibilities as part of the 'three lines of defence' model
- Increased our focus on customer conduct risks in line with our Group objectives as well as with the objectives of the FCA.

Our ERM framework

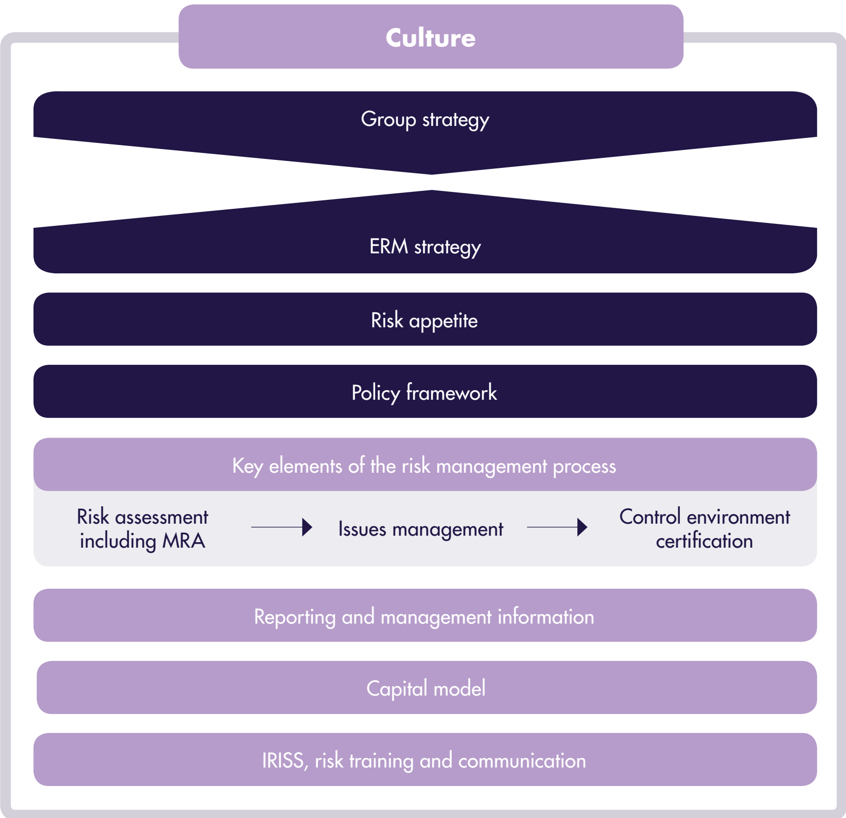
Strategic risk objective	Risk appetite statement
Maintain capital adequacy	Maintain sufficient economic capital consistent with the aim of achieving a stand-alone credit rating in the 'A' range.
Stable and efficient access to funding and liquidity	Meet all cash outflow requirements, including those that arise following a 1 in 200 year insurance, market or credit risk event.
Maintain stakeholder confidence	No appetite for material risks leading to reputational damage, regulatory or legal censure, fines or prosecutions and other types of operational risk losses associated with the firm's conduct and activities.

ERM is the process of organising and controlling the activities of the whole Group so as to ensure the Group remains within risk appetite. To enable ERM we have developed a framework comprising a number of components which are fundamental to good risk management. These are set out in the graphic overleaf.

A central component of the ERM framework is our policy framework, consisting of policies and minimum standards. These inform the business how it needs to conduct its activities so as to remain within risk appetite.

The policies cover the key risks to which we are exposed. Policies are supported by minimum standards which set out the minimum level of risk management and other corporate and personal behaviours that must be complied with. Where appropriate, these minimum standards are in turn supported by detailed guidance documents.

We also employ a number of risk tools to manage and monitor our risks, the output of which is tested and reported upon both internally and externally.



Our culture and ERM framework are mutually supportive. Our culture encompasses all risk management activity and helps embed risk management within our business.

Our ERM strategy supports our Group strategy.

Group strategy, ERM strategy, risk appetite and policy framework are approved by the Board.

The ERM strategy is enabled using risk management tools such as risk appetite and the capital model.

Underpinning these tools are IRISS, our specialist risk management software, comprehensive risk management training and communication.

Notes:
MRA – Material risk assessment
IRISS – Internal Risk Intelligence Software System facilitates a robust and consistent approach to the way we capture risk information.

Our ERM framework has been made stronger during 2013 as a result of:

- The linking of risk strategy and governance to our risk appetite and policy frameworks, documented in our High Level Controls and System of Governance document
- Improvements to our internal control environment self-certification process
- The development of our Own Risk and Solvency Assessment ("ORSA") which supports the achievement of our strategic objectives
- The introduction of a risk culture which helps our understanding and measurement of how well risk is embedded within the Group

The ERM framework: enhanced by an effective risk and control culture

Risk culture is about how the principles, processes and tools of the risk framework are applied in day-to-day behaviour. A good risk culture is one where risk management is a significant part of the way we work. Our Group values align to the risk culture and seek to promote proactive risk management.

Our risk culture focuses on the key areas of strategy, employees, promoting good governance, communication, systems and reporting. We believe that the ERM framework is made stronger by the promotion of a good risk culture across the Group.

Solvency II

Making use of Pillar I models, the PRA has developed the Individual Capital Adequacy Standards Plus ("ICAS+") process to enable UK insurers to make use of capital models developed under Solvency II programmes.

The ICAS+ process will also enable firms to obtain feedback on their progress towards Solvency II. U K Insurance Limited has engaged with this ICAS+ process and has used the new internal model for this purpose. This ICAS+ submission included Pillar II elements which are currently in development. The Group's internal model produces Solvency II, Individual Capital Adequacy and economic capital requirements for the UK general insurance business.

The Group's risk management system, including the automated risk management tool, is being embedded and the Solvency II data warehouse implementation is continuing to progress. The Group expects Solvency II to be in force on 1 January 2016 with the Internal Model Approval Process taking place in 2015. As a result, the risk management team is developing a revised timeline for progress towards internal model approval and engaging with the PRA about the Group's self-assessment of its progress towards Solvency II.

In addition, the requirement under Pillar III will result in additional reporting requirements both to the PRA and to external stakeholders. The Group continues to make progress to ensure all requirements will be met in line with developing best practice.

Principal risks and uncertainties

Risks are always present in our business. The key role of the Risk function is to ensure that these risks have been identified and measured and are monitored and reported throughout the business on an ongoing basis. The Risk function also monitors changes in these risks over time. We believe that these risks are broadly unchanged over the last 12 months.

Principal risks	Management and mitigation examples
Strategic risk The external environment could put at risk our ability to meet our strategic objectives through the five key strategic priorities of distribution, pricing, claims, costs and Commercial and International.	• We have agreed strategic targets which are monitored and managed • Risk assessment of projects designed to enhance pricing and claims capability • Our multi-channel approach provides diversification, which mitigates this risk • Monitoring of cost savings to ensure they remain on track • The Chief Executive Officer owns and manages this risk
Insurance risk: underwriting and pricing We are subject to the risk that inappropriate business could be written (or not specifically excluded) and inappropriate prices charged. Underwriting risk 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.	• We have set underwriting guidelines for all business transacted, restricting the types and classes of business that may be accepted • Pricing is refined through analysis of comprehensive data • Catastrophe reinsurance is purchased, limiting our exposure to large losses. We also purchase excess of loss cover on our Motor portfolio, as well as other selected reinsurance covers • We invest in enhanced external data to mitigate exposures, for example flood and individual underwriting risk through Geospatial • The Managing Directors of each division own and manage this risk
Insurance risk: reserving 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. Reserving risk is our biggest risk, generated by our large Motor portfolio. Reserving risk is heightened in the case of periodic payment orders ("**PPOs**") because of their long-term nature and is discussed further in the finance review on page 39 and in notes 2.1 and 3 to the consolidated financial statements on pages 120 and 123 respectively. Reserving generates both upside and downside risk, with the potential for outcomes to be in our favour, generating reserve releases.	• We estimate the technical reserves using a range of actuarial and statistical techniques. Projections of ultimate claims cost involve assumptions across a range of variables, including estimates of trends in claims frequency and average claim amounts. These are based on facts and circumstances at a given point in time • We ensure that management's best estimate of reserves is not less than the actuarial best estimate • The Chief Financial Officer owns and manages this risk
Counterparty risk We partner with many suppliers and the failure of any of these to perform their financial obligations in a timely manner could result in a financial loss. Our principal area of counterparty risk is our use of reinsurance against underwriting risk, sometimes called reinsurance risk or reinsurer default risk.	• We set credit limits for each counterparty • Our reinsurance is purchased only from reinsurers that hold a minimum credit rating of 'A-' at the time cover is purchased • The business actively monitors broker credit exposures • The Chief Financial Officer owns and manages this risk
Market risk We are subject to the risk that, as a result of market movements, we may be exposed to fluctuations in the value of our assets or the income from our assets. For the Group this includes: interest rate risk, spread risk, currency risk and property risk.	• We manage and control our investment portfolio through: – Investment strategy and guidelines proposed to the Board by the Investment Committee and monitored by the Asset and Liability Committee – Diversity in the types of assets held, including by geography, sector and credit rating • We use risk reduction techniques such as hedging foreign currency exposures with forwards and hedging foreign interest rates with swaps • The Chief Financial Officer owns and manages this risk

Principal risks	Management and mitigation examples
Operational risk We potentially face the risks of direct or indirect losses resulting from inadequate or failed internal processes or fraudulent claims; from systems and people; or from external events. In particular we have IT systems risk, including that we are highly dependent on the use of RBS Group's information technology, software, data and service providers. Migrating IT systems away from RBS Group introduces different operational risks; there is increased likelihood of system failure at the point that functions are moved onto new infrastructure. Further, if the migration fails to stay on schedule, we will incur charges for remaining on RBS Group IT infrastructure. IT migration also introduces people risk, as management may be distracted away from day-to-day activities. Operational risk includes cyber risk, the risks relating to the use of computers, other IT and the storage of data. Within this category, we also consider the risk of the Group not recruiting and retaining suitable talent. This risk is particularly important during the Group's current period of change.	• We have strong operational processes and systems, including fraudulent claims detection systems. Our risk, business and capital strategies are integrated • We maintain a robust internal control environment • We have developed a bespoke risk capture, management and reporting system (IRISS) • Ongoing migration of IT away from RBS Group on to a new enhanced platform is continually monitored and managed by experienced personnel • We have strong recruitment processes to help our aim of ensuring that the right people are recruited and placed into the right roles • In addition to mandatory training, employees are encouraged to use the large number of training tools available to enhance their abilities • Specific members of the Executive own and manage the different aspects of operational risks
Regulatory risk Regulatory risk arises if changes in law and regulations are not identified or understood, or are inappropriately and incorrectly interpreted or adopted. In particular, Solvency II regulations are currently being introduced. Solvency II requirements are still uncertain and subject to the outcome of discussion between UK and European regulators. The outcome and impact of the ICAS+ process is also uncertain. These uncertainties increase our level of risk. Regulatory risk also includes the risk that business practices are not efficiently modified following a regulatory change. Further, there is a risk that current legal or regulatory requirements are not complied with.	• We have a constructive and open relationship with our regulators • In addition, we use specific risk management tools and resources, such as our upstream risk team, to help manage our exposure to regulatory risk • We exercise risk-based monitoring to ensure our resources are used to greatest impact • The Chief Risk Officer owns and manages this risk
Conduct risk We are subject to the risk of failing to deliver the appropriate treatment for our customers throughout all stages of the customer journey and the risk that our people fail to behave with integrity. This includes the risk that our organisational culture is not appropriate, with a failure to communicate the correct tone from the top.	• 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 • The Chief Executive Officer owns and manages this 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.	• Our brand and reputational risk is regularly reviewed through our governance framework • We undertake substantial marketing activities to protect and build our brands, and regularly measure their effectiveness • Specific members of the Executive own and manage this risk

Evolving risks

Risks can emerge and evolve over time, often as a result of changes in the environment in which we operate. As part of our risk management framework, we aim to identify these risks as they first emerge, working efficiently to mitigate their potential impact on the business. Set out below are examples of current significant evolving risks and the way in which we monitor and mitigate these risks.

Evolving risk details	Our actions
Insurance risk: claims costs Bodily injury claims costs are a key source of uncertainty with several regulatory, legal and market pressures facing the Group, including: • Underlying trends in bodily injury claims frequency and average cost per claim inflation • The results of the MoJ consultation into the discount rate used to value certain types of bodily injury claim awards • The propensity for large injury claims to settle as PPOs, and the inflation and longevity assumptions used to value PPOs • The impact on claims costs of the MoJ consultation and Transport Committee investigation into whiplash injuries.	• Monitoring claims costs to identify trends in the settlement of bodily injury claims • Investigating proposed changes in regulation and legislation and using risk fora to discuss these changes and develop a business response • Investigating asset-liability matching opportunities that would mitigate this risk
Regulatory risk: regulatory environment The UK insurance market is subject to several regulatory reviews and potential areas of focus which are sources of uncertainty, including: • The CC investigation into aspects of the private motor insurance market • The FCA's market study of general insurance add-on products • The FCA's thematic review of complaints and claims handling • The impacts of Flood Re and the proposed levy on home insurance premiums There is also uncertainty around the way in which the FCA may apply the principles underpinning behavioural economics to the insurance industry and the impact that this has on our business. The EU is currently developing new EU Data Protection Regulations which will replace the UK Data Protection Act. This may impact our ability to use and benefit from our stored data. Specifically, restrictions or bans on profiling may impact our ability to identify the most appropriate products or solutions for our customers. The Italian regulatory landscape is changing which could lead to greater regulatory intervention.	• Investigating proposed changes in regulation and legislation and using risk fora to discuss these changes and develop a business response • Regular contact with the regulator to ensure the business is kept abreast of changes in expectations • Where appropriate, participation in lobbying
Strategic risk: business transformation and project delivery The Group is carrying out initiatives to improve its operational efficiency as part of the implementation of its business transformation plan. There is a strategic risk of the potential failure to execute the plan, or that the expected benefits of the plan may not be achieved on time or to the extent targeted. There is also a large potential for upside risk should initiatives provide benefits that are greater than those planned, or if the expected benefits are felt by the business sooner than planned. Uncertainties include the potential changes in the market around use of PCWs, changes in customer behaviour and the increasing use of telematics.	• Having a detailed transformation plan • Monitoring of the project milestones ensures we remain on track and enables us to make adjustments where appropriate • Ensuring that the projects are managed by the right people with the ideal skills • Using 'lessons learnt' exercises to ensure later projects are improved by our experiences

Risks can emerge over the very long term as a result of significant changes in the environment including technology, weather patterns and socio-economic behaviours. Examples of these risks would include driverless cars, new types of competitor entering the market and climate change.

A specific example of an emerging risk we have considered during 2013 is the failure of a competitor. A competitor failing may lead to an industry levy which we would be subject to. This risk could also impact our relationships with both investors and regulators, depending on the cause of the competitor's failure. There is also potential upside should the failure of a competitor enable us to increase the number of policies we issue.

Group performance

Achieved our combined operating ratio[1] target of 98% and this contributed to a return on tangible equity[2] 16.0%, ahead of our long-term target of 15.0%.

Operating profit from ongoing operations[1] improved by 14.2% to £526.5 million (2012: £461.2 million) and COR[1] by 3.1 percentage points to 96.1% (2012: 99.2%). These were driven by an improved underwriting profit, including higher prior-year reserve releases of £435.1 million (2012: £322.0 million), and were partially offset by lower investment return and instalment and other income. A lower loss ratio[1], reflecting our continued choice to focus on value of business over volume and helped by pricing and claims efficiencies, together with lower costs contributed to the improved underwriting result and COR. Benefiting from the capital actions taken in 2012 and the improved operating performance, the Group achieved a RoTE for ongoing operations[2] of 16.0% (2012: 11.5% and pro forma[3] 13.4%). Total Group profit before tax delivered of £423.9 million (2012: £249.1 million).

Summary income statement

For the year ended 31 December	**2013 £m**	2012 £m
Ongoing operations[1]		
Gross written premium	**3,826.6**	3,990.6
Net earned premium	**3,520.6**	3,708.7
Underwriting profit	**138.2**	28.2
Instalment and other operating income	**180.2**	198.3
Investment return	**208.1**	234.7
Operating profit – ongoing operations[1]	**526.5**	461.2
Run-off segment	**63.6**	6.1
Restructuring and other one-off costs	**(140.5)**	(189.5)
Operating profit	**449.6**	277.8
Finance costs	**(37.7)**	(28.7)
Profit on disposal	**12.0**	–
Profit before tax	**423.9**	249.1
Adjusted earnings per share – diluted (pence)[4]	**25.0**	21.8
Basic earnings per share (pence)	**20.9**	12.3
Return on tangible equity – ongoing operations[2]	**16.0%**	11.5%
Pro forma return on tangible equity – ongoing operations[3]	**n/a**	13.4%
Return on equity – total Group	**11.1%**	5.7%

Ongoing operating profit by division[1]

For the year ended 31 December	**2013 £m**	2012 £m
Motor	**347.7**	261.8
Home	**106.2**	93.3
Rescue and other personal lines	**46.5**	84.4
Commercial	**9.5**	2.2
International	**16.6**	19.5
Total	**526.5**	461.2

Notes:
1. See note 1 on page 2
2. See note 3 on page 2
3. See note 4 on page 2
4. See note 6 on page 3

Personal lines

"UK Personal Lines delivered good results within a competitive market and a changing regulatory landscape. We continue to develop compelling customer propositions, deepen customer relationships and enhance our capability."

Tom Woolgrove, Managing Director of Personal Lines

Motor

Highlights

- Retained position as Britain's leading personal motor insurer with a 14% share of in-force policies[1]
- Improvement in risk selection and claims capability contributing to reserve releases and reduced loss ratio
- COR improved significantly by 8.4 percentage points
- Operating profit up 32.8%, despite significant reduction in other operating income
- Laid the foundations for DLG Legal Services

Performance highlights

	2013	2012
In-force policies (thousands)	**3,762**	4,050
Gross written premium	**£1,421.1m**	£1,623.5m
Loss ratio	**65.1%**	74.6%
Commission ratio	**2.5%**	2.0%
Expense ratio	**25.6%**	25.0%
Combined operating ratio	**93.2%**	101.6%
Operating profit	**£347.7m**	£261.8m

Market

In the UK, an economic recovery appears to have been taking hold, and it is expected to gather pace[2]. Consistent with this, car registrations recorded their highest monthly total for many years in September[3], while higher petrol prices are anticipated from oil price inflation.

The motor insurance market in the UK was again highly competitive, with another year of insurance premium deflation. PCW sales continue to rise and their media advertising remains high. Customers are shopping around more and there is a greater market focus towards retention and cross-selling products. There has also been a relatively benign claims experience during 2012 and 2013, alongside the positive effects of a series of government interventions to reduce the costs of bodily injury claims. In particular, a package of reforms, including the Legal Aid, Sentencing and Punishment of Offenders ("LASPO") Act measures and the banning of legal referral fees, were introduced during 2013.

These reforms are intended to reduce the average cost of bodily injury claims, largely due to lower legal costs. However, it is too early to say whether they will also have a material benefit in terms of the frequency of bodily injury claims. Furthermore, improved fraud detection capabilities are expected to help reduce false declarations of driving experience and convictions. Also, the FCA continues to review all aspects of conduct risk through a series of thematic reviews, including motor legal expenses insurance, which we, and our distribution partners, continue to engage with proactively.

Following the implementation of the EU Gender Directive, some young drivers, particularly males, have seen reductions in premiums. The growth of telematics has supported this, as drivers of all ages and genders are able to receive discounts. This follows installation of a device to their car or the download of a smartphone app, and the display of safer driving behaviour.

Performance

Given the highly competitive market, we continued to make choices to optimise value and prioritise underwriting margin over volume growth. Furthermore, the results reflected previous actions taken to reduce risk and manage claims costs, which together contributed to significant prior-year reserve releases. We have enhanced our pricing engines, delivered claims efficiencies and improved our customer propositions, including the roll-out of telematics propositions. These have helped to successfully manage the business through a period of regulatory change.

Gross written premium of £1,421.1 million fell 12.5% compared with 2012, as we maintained pricing discipline. Average premium per policy was down over the year by approximately 7% due to market competitiveness, the channel shift to PCWs and a reduction in risk mix, but also our focus on value and retaining customers. We seek to pass on lower premiums to customers based on our observed claims experience and during 2013 reduced motor prices by 3%. In-force policies were also slightly lower.

There was an improvement in underwriting result driven by the attritional loss ratio and reserve releases, as a result of actions taken on pricing and claims. These reserve releases, which were higher than expected, were driven by both small and large bodily injury claims. The expense ratio rose by 0.6 percentage points following reduced net earned premium, which more than offset the lower cost base. However, the significant improvement in the operating profit was partially offset by reduced other income, from the cessation of solicitors' referral fee income, and a lower investment return. In February 2014, the Group sold its stolen vehicle recovery business, Tracker. Operating loss from this business was £1.4 million in 2013.

Outlook

The UK motor market remained highly competitive in the first quarter of 2014 and gross written premium is expected to be approximately 10% lower than the same period in 2013. We continue to focus on protecting underwriting margins, rather than prioritise policy volumes. During 2014, we aim to develop initiatives to support our strategic priorities further including the rolling out of new customer websites, enhancing our trading capability, evolving our telematics-based propositions and continuing to evolve technical pricing sophistication.

Notes:

1. Direct Line Group including partner brands: RBS, NatWest, Nationwide, Prudential and Egg © GfK NOP Financial Research Survey (FRS) 6 months ending October 2013, 15,260 adults interviewed for motor insurance.
2. Bank of England
3. Society for Motor Manufacturers and Traders

Home

Highlights

- Retained position as one of Britain's largest home insurers with a 17% share of in-force policies[1]
- Continued to improve our technical pricing models, which contributed to increased retention in 2013
- Customer initiatives rolled out, such as the claims' home estimation tool
- Improvement in the COR by 2.8 percentage points to 93.8%, following fewer claims from major weather events

Performance highlights

	2013	2012
In-force policies (thousands)	**3,719**	4,239
Gross written premium	**£943.1m**	£989.0m
Loss ratio	**53.9%**	58.4%
Commission ratio	**19.6%**	16.2%
Expense ratio	**20.3%**	22.0%
Combined operating ratio	**93.8%**	96.6%
Operating profit	**£106.2m**	£93.3m

Market

The UK housing market remained flat for the majority of 2013, and ongoing limited mortgage availability has caused an increase in the number of people renting. Lower disposable incomes have also driven price sensitivity. However, there have been indications of a UK economic recovery.

Britain's home insurance market size has been stable, but become more competitive, with new business premiums reducing in the year[2]. PCWs' shares of sales are growing, albeit from a lower base than Motor, and have facilitated the growth of lesser known brands, as well as increasing price competitiveness. Retail banking distribution arms continue to review branch sales processes. Meanwhile, there is growth in the adoption of new technology by customers, including the use of mobile technology and online servicing. Providers are maximising customer value, increasing cross-selling activity and retention capabilities. A lack of mortgage demand has contributed to providers finding other routes to source new customers. In the flat housing market, the increase in the renter population is causing a decline in the demand for combined building and contents covers.

The Association of British Insurers ("**ABI**") and the UK Government arrived at the Flood Re solution, which is intended to ensure the availability of affordable home insurance in the highest flood risk affected parts of Britain. As with the motor market, the FCA continues to review all aspects of conduct risk through a series of thematic reviews, which we continue to engage with proactively.

Performance

The Home business experienced another strong result in 2013, which benefited from lower weather claims than 2012, despite the significant flooding and storm claims in December. Customer retention improved on last year as we optimised technical-pricing models. The product range was also rationalised from 30 products to three across the brand portfolio to simplify the customer proposition. The number of policies sold through the PCW channel increased by 8.0% on last year. Promising initial results have been experienced from the launch of the Home estimation tool, which allows more accurate assessment of claims to facilitate speedier claims adjustment and payment.

Gross written premium of £943.1 million declined by 4.6%, reflecting competitive market conditions. In-force policies fell by 12.3% since the start of the year, mainly as a result of the removal of Home Response[3] policies (around 420,000) from certain packaged bank accounts no longer sold through partners. Excluding this effect, the underlying in-force policies were broadly similar year-on-year.

The loss ratio improved, reflecting fewer claims from major weather events and continued reserve releases. On an underlying current-year attritional basis, it was in line with last year at 51.3%. The commission ratio rose due to profit-share payments reflecting higher profitability of partnership business, mainly as a result of the lower loss ratio. Underwriting profit improved on last year mainly due to the fewer claims from major weather events. The expense ratio improved by 1.7 percentage points due to cost improvements across the Group. Overall, operating profit improved by 13.8%, reflecting fewer major weather events across 2013 in the UK.

Outlook

In a competitive UK home market, we continue to focus on maintaining our underwriting performance through further pricing and claims initiatives. Adverse weather conditions experienced in the fourth quarter of 2013 have continued in the first quarter of 2014 resulting in further storm damage and severe flooding. While it is too early to assess with accuracy, the Group's preliminary estimate for the cost of Home claims from this event up to 22 February 2014 is in the range of £70 to £90 million. This compares to an expectation in an average year of £80 million of claims from major weather events.

Notes:

1. Direct Line Group including partner brands: RBS, NatWest, Nationwide, Prudential and Egg © GfK NOP Financial Research Survey (FRS) 6 months ending October 2013, 15,922 adults interviewed for home insurance.
2. Consumer Intelligence
3. Insurance policy giving customers access to vetted tradesmen for home emergencies and repairs.

Rescue and other personal lines

Highlights

- New customer Rescue propositions and refreshed Green Flag marketing campaigns
- Gross written premium broadly stable at £383.4 million reflected rise in direct sales offset by reduced cross sales
- Loss ratio increased and operating profit reduced due to the non-repeat of 2012 one-offs, primarily in the legacy creditor book
- Completed sale of the Life business for £62 million enabling payment of a special interim dividend

Performance highlights

	2013	2012
In-force policies (thousands)	**8,801**	9,431
Gross written premium	**£383.4m**	£389.8m
Loss ratio	**60.1%**	50.9%
Commission ratio	**7.5%**	6.0%
Expense ratio	**24.8%**	25.8%
Combined operating ratio	**92.4%**	82.7%
Operating profit	**£46.5m**	£84.4m

Market

The economic trends are the same as in the Motor and Home operating reviews.

The roadside assistance market is similarly showing signs of recovery, with the overall market size increasing. Three major providers, including Green Flag, account for the majority of the market and competition is increasing, with service and price being important aspects for customers. Products are bought direct from providers, as part of linked motor sales, as part of packaged bank accounts, and via PCWs.

The pet population and market penetration rates remain stable; however, average premiums have been rising. The premiums increase in recent years is due to higher claims severity, driven by treatment and drug advances, while price competition continues to increase. Insurance providers are focused on recommendations by, and distribution through, vets as an important channel to customers; however, PCW visits are gradually increasing. The travel insurance market has been stable, and characterised by high volumes and penetration rates, the latter being the uptake of insurance by travellers. Medical claims represent the largest component of claims severity and continue to grow, followed by cancellation claims. Distribution is moving away from travel agents and brokers, with travel insurance being offered through packaged bank accounts and PCWs.

Performance

We focused on new Rescue customer propositions and a refreshed marketing campaign, with Green Flag's one hour response commitment, which aimed to differentiate the brand. A positive contribution continued to be received from the pet insurance line, while the travel business experienced a loss due to increased claims frequencies from packaged bank accounts. In November, we completed the sale of the closed Life business for £62 million, and returned the proceeds of sale to shareholders by way of a special interim dividend in December.

Gross written premium of £383.4 million was broadly stable to last year. This reflected increased direct sales of Green Flag products offset by reduced linked sales. Pet gross written premium increased by 3.7% from rate increases and travel gross written premium decreased by 0.8% driven by volume decreases.

Underwriting profit reduced to £27.9 million from last year while the loss ratio increased 9.2 percentage points as 2012 benefited from positive one-offs relating to legacy creditor business. The expense ratio improved by 1.0 percentage point due to cost improvements across the Group, partially offset by increased Green Flag marketing costs. Overall, operating profit decreased to £46.5 million following the non-repeat of certain one-offs, primarily in the legacy creditor business, which benefited 2012. Of the total operating profit, £38.1 million was delivered by Rescue and £6.4 million by the closed Life business. The Rescue contribution was £9 million lower than in 2012, due to the increased marketing spend and the non-repeat of certain one-off items.

Outlook

Rescue and other personal lines continues to represent an opportunity to create value for the Group, and meet customers' broader insurance needs. Investment in distribution and propositions will support further contribution, offset by the disposal of the Life business, and lower Creditor premiums as the business runs off.

Commercial

"With a continued focus on the SME sector, we have improved our COR for the third year running. We are on track to achieve a sub-100% COR in 2014, helped by driving our efficiencies and delivering improvements in our underwriting."

Jon Greenwood, Managing Director of Commercial

Highlights

- Continued to grow in-force policies, particularly in Direct Line for Business
- Gross written premium up 8.9% to £474.5 million
- Continued roll-out of NIG's broker eTrading platform 'The Hub' to new products
- Continue to rationalise the back office, improve efficiency and streamline the operating model
- Improvement in operating profit of £7.3 million, despite adverse weather in the fourth quarter and a high level of large losses

Performance highlights

	2013	2012
In-force policies (thousands)	**583**	466
Gross written premium	**£474.5m**	£435.6m
Loss ratio	**62.3%**	63.1%
Commission ratio	**21.2%**	21.6%
Expense ratio	**23.3%**	23.5%
Combined operating ratio	**106.8%**	108.2%
Operating profit	**£9.5m**	£2.2m

Market

UK economic growth has continued to strengthen in 2013 and optimism is increasing about the general business situation. Interest rates remain at low levels, reducing investment returns. There has been some evidence of insurers exiting historically unprofitable business.

Insurers are also seeking to reduce costs and there have been instances of insurers reviewing their regional structures and branch networks. Furthermore, there is a desire for brokers and insurers to adopt e-trading solutions for SME and micro-sized businesses, in order to reduce costs and speed up the underwriting process.

Performance

We continued to grow in-force policies, particularly in Direct Line for Business. NIG's full cycle broker e-trading platform 'The Hub' continued to be rolled out across the year to new products. Where business has been migrated to the new platform, broker take up has been encouraging. We have established two online newspaper partnerships aimed towards small businesses and social media channels have been introduced to interact directly with customers. Proposition development continues to be a strength for Direct Line for Business, with a number of new initiatives launched. Furthermore, to streamline our operating model, we separated our trading and operational functions, and restructured the regional functions to enhance new business focus and improve efficiency.

Gross written premium increased by 8.9% compared to 2012 due to the transfer of the van business from the Motor division and growth in Direct Line for Business. In 2013, some components of the portfolio were de-risked.

The COR improved by 1.4% to 106.8%; however, when normalised for weather this would have been 103.7%, showing good progress towards the 2014 target. The loss ratio improved modestly by 0.8 percentage points to 62.3% despite higher than normal claims relating to weather events, the majority of which were in the fourth quarter, and a high level of large losses. We continued to experience reserve releases, similar to the level of 2012, but remain prudently reserved. An improvement in current-year loss ratio was led by an improvement in the underwriting profit of £3.5 million. A marginal improvement in the expense ratio of 0.3 percentage points reflected cost improvements across the Group. The regional restructure undertaken in Commercial was implemented in the second half of the year and is expected to deliver cost savings in 2014. Overall, operating profit increased by £7.3 million to £9.5 million for the year.

Outlook

Normalising the 2013 performance for claims from weather events, the division made progress towards its 2014 COR target of sub-100%. Actions taken during 2013 on pricing, risk selection and the cost base are expected to continue to flow through in 2014 and the division's target for this year is unchanged. This assumes a normal level of claims from weather-related events and large losses. Up to 22 February 2014, approximately £20 million of such claims have been received.

International

"The International division has continued to develop in line with our plans. We maintained profit in Italy and increased gross written premium in Germany, where profitability was affected by hailstorms."

Jamie Brown, Managing Director of International

Highlights

- In-force policies grew by 10.1% on 2012 and now exceed 1.6 million
- Gross written premium, in local currency, grew by 4.9% reflecting strong growth in Germany offset by a modest decline in Italy
- Loss ratio improved marginally by 0.8 percentage points despite £8 million of higher than normal hailstorm claims in Germany
- Implemented ClaimCenter in Italy and continue to evolve technology to deliver efficient digital platform

Performance highlights

	2013	2012
In-force policies (thousands)	**1,610**	1,462
Gross written premium	**£604.5m**	£552.7m
Loss ratio	**77.3%**	78.1%
Commission ratio	**15.8%**	12.1%
Expense ratio	**10.8%**	13.1%
Combined operating ratio	**103.9%**	103.3%
Operating profit	**£16.6m**	£19.5m

Market

Italy's economy continued to decline in 2013. In 2014, it is expected gradually to return to growth[1]. Household consumption is stagnant[1] and the number of new car registrations is declining[2]. The number of road accidents, injuries and deaths has contributed to a reduction of claims frequency, which has led to a decrease in average price of around 5%[3].

Recent insurance sector reforms, especially the ending of a requirement for policyholders to advise their insurer if they do not wish to renew their motor policies, together with the increase in PCWs, has increased the level of switching. This increases the potential market for Direct Line, while also increasing the number of our customers who shop around at renewal. Going forward, we expect growth in the number of customers accessing insurance products via smartphone and tablet devices.

The economic conditions in Germany are different, with the recovery continuing[4] and growth expected to rise slightly faster[4]. Household consumption continues to strengthen[4] and the number of registered vehicles is rising, while petrol costs decline[4]. Motor average premiums, which have risen over the previous two years, are expected to remain stable, taking account of claims inflation[5]. The severe hailstorms in June and July 2013 may result in increased average premiums.

In Italy, the use of telematics to collect information at the claims stage is already fairly extensive. As a consumer proposition it is continuing to develop. We have a number of pilots to understand how best to operate in this area. In Germany, the first introduction has recently occurred.

Performance

We continue to focus on extracting value from the Italian and German businesses. Growth arose from Germany where we benefited from positive market conditions allowing our efficient platform to enable us to grow our share of year-end business without significant additional cost. We remain cautious in Italy given the uncertain economic environment and competitive conditions. We implemented ClaimCenter in Italy and continue to evolve technology to deliver an efficient digital platform. Italy, Germany and the UK continued to share and leverage best practice, for example on claims processes and telematics.

In-force policies grew by 10.1% and gross written premium increased by 4.9% in local currency terms. These were driven by Germany where we expanded our share of business renewing on 1 January 2013. PCWs, while still small in both markets, continued to grow their share of new business. Direct Line is present on PCWs in both countries.

The COR remained broadly stable at 103.9%, with higher than normal hailstorm claims in Germany which resulted in a COR of 109.8%, offset by lower claims frequency in Italy with a COR of 101.6%. The loss ratio in Germany similarly reflects the £8 million of claims relating to the severe hailstorms. A higher commission ratio was attributable to a change in mix towards PCWs and partners. Total operating profit of £16.6 million was split £14.1 million from Italy and £2.5 million from Germany. Operating profit, in local currency, was €20.4 million a decrease of 16.7% on the previous year (2012: €24.5 million).

Outlook

In Italy, more competitive market conditions and increased customer switching during 2013 have lowered premium growth expectations for 2014. With this more cautious stance, we will continue to focus on creating value through improving operating and pricing efficiency. Germany has once again experienced a good start to the year, which has increased in-force policies to approximately 628,000 at the end of January 2014. Following average premium rate increases over the last two years, an increase in competition is now expected to place pressure on average premiums.

Notes:

1. Instituto Nazionale di Statistica
2. Automobile Club Italia
3. Associazione Nazionale fra le Imprese Assicuratrici
4. Bundesministerium der Finanzen
5. Gesamtverband der Deutschen Versicherungswirtschaft

Delivering performance

John Reizenstein, Chief Financial Officer

"In our first full year as a stand-alone listed Group, we showed good progress towards our targets and delivered improved returns to shareholders."

Against a backdrop of competitive markets, the Group made progress on its financial targets, achieving a COR for ongoing operations[1] of 96.1% and a 16.0% RoTE[2]. We maintained a strong capital position, with a conservative approach to reserving and a high-quality investment portfolio.

Highlights

- Operating profit[1] of £526.5 million for 2013, up 14.2% (2012: £461.2 million) and total Group profit before tax of £423.9 million (2012: £249.1 million)
- Gross written premium[1] 4.1% lower for 2013, reflecting competitive market conditions in UK personal lines, partially offset by growth in International and Commercial
- Combined operating ratio[1] of 96.1% for 2013, an improvement of 3.1 percentage points against last year (2012: 99.2%). This arises from improved underwriting and lower costs
- Prior-year reserve releases for ongoing operations[1] amounted to £435.1 million (2012: £322.0 million)
- Return on tangible equity[2] from ongoing operations of 16.0% for 2013 (2012: 11.5% and pro forma[3] 13.4%)
- Net asset value per share of 186.6 pence and tangible net asset value per share of 153.2 pence
- Final dividend proposed of 8.4 pence per share

For the year ended 31 December	**2013 £m**	2012 £m
Ongoing operations[1]		
In-force policies (thousands)	**18,475**	19,648
Gross written premium	**3,826.6**	3,990.6
Net earned premium	**3,520.6**	3,708.7
Underwriting profit	**138.2**	28.2
Instalment and other operating income	**180.2**	198.3
Investment return	**208.1**	234.7
Operating profit – ongoing operations[1]	**526.5**	461.2
Run-off segment	**63.6**	6.1
Restructuring and other one-off costs	**(140.5)**	(189.5)
Operating profit	**449.6**	277.8
Finance costs	**(37.7)**	(28.7)
Gain on disposal of subsidiary	**12.0**	–
Profit before tax	**423.9**	249.1
Tax	**(111.1)**	(64.8)
Profit after tax	**312.8**	184.3
Of which is ongoing operations[4]	**375.2**	326.5

Key metrics – ongoing operations[1]		
Loss ratio	**62.6%**	67.1%
Commission ratio	**11.2%**	9.1%
Expense ratio	**22.3%**	23.0%
Combined operating ratio	**96.1%**	99.2%
Adjusted earnings per share[5] – diluted (pence)	**25.0**	21.8
RoTE[2]	**16.0%**	11.5%
Pro forma RoTE[3]	**n/a**	13.4%

Key metrics – total Group		
Investment income yield	**2.1%**	2.0%
Investment return	**2.5%**	2.8%
Basic earnings per share (pence)	**20.9**	12.3
Net asset value per share (pence)	**186.6**	189.1
Tangible net asset value per share (pence)	**153.2**	161.0
Dividend per share		
– interim (pence)	**4.2**	4.0
– final (pence)	**8.4**	8.0
– regular (pence)	**12.6**	8.0
– first special (pence)	**4.0**	n/a
– second special (pence)	**4.0**	n/a
– total (pence)	**20.6**	8.0
– pro forma[6] regular (pence)	**n/a**	12.0

Performance

Operating profit – ongoing operations

For the year ended 31 December	2013 £m	2012 £m
Underwriting profit	**138.2**	28.2
Instalment and other operating income	**180.2**	198.3
Investment return	**208.1**	234.7
Operating profit	**526.5**	461.2

Overall operating profit from ongoing operations[1] of £526.5 million represented a 14.2% increase on 2012 (2012: £461.2 million). There was a significant improvement in the underwriting result, driven by higher than expected reserve releases of £435.1 million (2012: £322.0 million), in part due to management actions to improve the risk profile of the book and initiatives relating to claims, and despite poor weather in the last quarter, fewer claims from major weather events in Home in 2013. This more than offset a lower investment return, lower instalment and other operating income and higher than normal weather-related claims in Commercial and International.

In-force policies and gross written premium

In-force policies – ongoing operations (thousands)

As at 31 December	2013	2012
Motor	**3,762**	4,050
Home	**3,719**	4,239
Rescue and other personal lines	**8,801**	9,431
Commercial	**583**	466
International	**1,610**	1,462
Total ongoing	**18,475**	19,648

In-force policies for ongoing operations[1] decreased by 6.0% during 2013 to 18.5 million. The fall related primarily to Rescue and other personal lines and Home. The Rescue and other personal lines reduction arose mainly from travel policies from packaged bank accounts. Home in-force policies fell mainly as a result of the removal of Home Response[7] policies (around 420,000) from certain packaged bank accounts no longer sold through partners. Excluding this effect, which had little impact on gross written premium, Home in-force policies have decreased by 2.6% during 2013.

Notes:

1. See note 1 on page 2
2. See note 3 on page 2
3. See note 4 on page 2
4. Ongoing operations, adjusted for finance costs excluding gain on disposal of subsidiary and stated after charging tax (using the standard rate of 23.25%; (2012: 24.5%))
5. See note 6 on page 3
6. See note 5 on page 3
7. Insurance policy giving customers access to vetted tradesmen for home emergencies and repairs.

The fall in Motor in-force policies of 7.1% reflects the Group's focus on maintaining its underwriting discipline in a competitive marketplace, particularly for new business. The reclassification of van business to Commercial (around 70,000 in-force policies) from 1 January 2013 represented 1.7 percentage points of the reduction.

International growth arose from Germany where the Group has benefited from improved market conditions. Commercial continued to grow in-force policies, particularly in Direct Line for Business and also benefited from the reclassification of van business from Motor.

Gross written premium – ongoing operations

For the year ended 31 December	2013 £m	2012 £m
Motor	**1,421.1**	1,623.5
Home	**943.1**	989.0
Rescue and other personal lines	**383.4**	389.8
Commercial	**474.5**	435.6
International	**604.5**	552.7
Total ongoing	**3,826.6**	3,990.6

Gross written premium of £3,826.6 million fell 4.1% compared with the prior year (2012: £3,990.6 million). This reflects the impact of a competitive market, particularly in UK motor, together with the Group's continued focus on maintaining its underwriting discipline.

Gross written premium for Commercial of £474.5 million increased by 8.9% (2012: £435.6 million) due to the transfer of van business and growth in Direct Line for Business.

International gross written premium of £604.5 million was 9.4% higher than the previous year (2012: £552.7 million) as a result of strong growth in Germany more than offsetting subdued trading in Italy. Gross written premium in local currency terms increased by 4.9%, broadly in line with the growth of in-force policies.

Underwriting profit – ongoing operations

For the year ended 31 December	2013	2012
Underwriting profit (£ million)	**138.2**	28.2
Loss ratio	**62.6%**	67.1%
Commission ratio	**11.2%**	9.1%
Expense ratio	**22.3%**	23.0%
Combined operating ratio	**96.1%**	99.2%

The Group's COR for ongoing operations improved by 3.1 percentage points to 96.1% (2012: 99.2%), resulting in an increase in underwriting profit for ongoing operations to £138.2 million (2012: £28.2 million).

The improvement was primarily the result of a 4.5 percentage points reduction in the loss ratio. This arose from two main factors: significant reserve releases partly due to management actions to improve the risk profile of the book and initiatives relating to claims; and despite poor weather in the last quarter, fewer claims from major weather events in Home across the year. In 2013, the Home division incurred approximately £69 million of claims from major weather events (2012: approximately £105 million). This was partially offset by higher than normal weather-related claims in International (German hailstorms in June and July 2013) and in Commercial (storms and floods in the fourth quarter of 2013).

Current-year attritional loss ratio – ongoing operations

For the year ended 31 December	2013	2012
Reported loss ratio	**62.6%**	67.1%
Prior-year reserve releases	**12.4%**	8.7%
Major weather events – Home[1]	**(2.0%)**	(2.8%)
Current-year attritional loss ratio	**73.0%**	73.0%

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

Overall, the current-year attritional loss ratio remained unchanged at 73.0% in 2013, despite competitive market conditions and higher than expected weather-related claims in International and Commercial.

Prior-year reserve releases – ongoing operations[2]

For the year ended 31 December	2013	2012
Motor	**291.9**	174.3
Home	**43.3**	37.4
Rescue and other personal lines	**9.0**	23.9
Commercial	**51.6**	56.2
International	**39.3**	30.2
Total ongoing	**435.1**	322.0

Overall prior-year reserve releases from ongoing operations increased to £435.1 million (2012: £322.0 million), equivalent to 12.4% of net earned premium (2012: 8.7% of net earned premium). Although the Group expects to continue to see significant reserve releases, the overall level experienced in 2013 is higher than would normally be expected. Assuming claims trends continue, a significant contribution from prior-year reserve releases is currently expected in 2014, albeit at a lower level than in 2013.

The commission ratio increased by 2.1 percentage points to 11.2% (2012: 9.1%), partly due to profit-share payments, reflecting the higher profitability of partnership business in the Home division. This is mainly attributable to fewer claims from major weather events.

The expense ratio improved 0.7 percentage points to 22.3% (2012: 23.0%), reflecting the benefits of cost reduction initiatives and reduced parallel running costs, but these benefits were partially offset by the effect of lower net earned premium.

Combined operating ratio by division – ongoing operations

	Reported basis	
For the year ended 31 December	**2013**	2012
Motor	**93.2%**	101.6%
Home	**93.8%**	96.6%
Rescue and other personal lines	**92.4%**	82.7%
Commercial	**106.8%**	108.2%
International	**103.9%**	103.3%
Total ongoing	**96.1%**	99.2%

On a segmental basis, the COR improved in Motor, Home and Commercial compared with 2012. Rescue and other personal lines COR increased in 2013 as positive one-off benefits in 2012 mainly from the creditor business were not repeated. The International COR remained broadly stable.

Current-year attritional loss ratio by division – ongoing operations

For the year ended 31 December	2013 £m	2012 £m
Motor	**85.3%**	85.4%
Home	**51.1%**	51.3%
Rescue and other personal lines	**62.5%**	57.2%
Commercial	**74.1%**	77.0%
International	**88.0%**	86.9%
Total ongoing	**73.0%**	73.0%

In Motor, the 8.4 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. Reserve releases of £291.9 million in 2013 were driven primarily by favourable bodily injury experience for recent accident years, partly attributable to better risk selection and benefits arising from the Group's claims transformation programme. Assuming underlying claims trends continue, a significant contribution from prior-year reserve releases is currently expected in 2014, albeit at a lower level than in 2013. The current-year attritional loss ratio was in line with 2012.

Notes:

1. Home claims from major weather events, including inland and coastal flooding and storms.
2. This excludes Run-off segment reserve releases of £52.1 million (2012: £67.5 million).

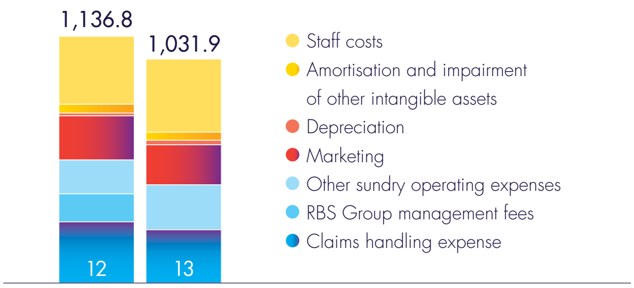
The Home COR improved to 93.8% in 2013 from 96.6% in 2012. The improvement was almost entirely driven by reduction in claims from major weather events. In 2013, claims from major weather events totalled approximately £69 million compared with approximately £105 million in 2012. The current-year attritional loss ratio was in line with the prior period, reflecting stable underwriting margins, albeit in a more competitive operating environment. Reserve releases were broadly in line with 2012.

The COR for Rescue and other personal lines increased to 92.4% (2012: 82.7%). The 2012 result benefited from positive one-offs (relating primarily to the run-off of the legacy creditor business) that were not repeated in 2013. The performance was also affected by higher claims frequency on the travel book and increased Green Flag marketing costs. The Life business, which contributed £6.4 million to operating profit in 2013 (2012: £8.1 million), was sold in November 2013.

The Commercial division improved its COR to 106.8% from 108.2% principally as a result of better underlying underwriting performance and a lower expense ratio. The current-year attritional loss ratio improved despite higher weather-related claims demonstrating the positive effect of recent management actions. The division continues to experience significant reserve releases. Excluding the impact of weather-related claims above normal levels, the COR would have been approximately 104%.

International COR in 2013 increased to 103.9% from 103.3% in 2012. The increase was due to claims relating to hailstorms in Germany in June and July. For 2013 as a whole, weather-related net claims were approximately £8 million more than expected. Reserve releases increased to £39.3 million (2012: £30.2 million) although are not expected to continue at these levels.

Total cost base[1]
(£m)



The expense ratio improved by 0.7 percentage points to 22.3% due to a reduction in operating expenses compared with 2012, partially offset by the impact of lower net earned premium.

Ongoing operating expenses of £786.4 million were reduced by 8.0% from the prior year (2012: £854.8 million). The reduction was principally due to the benefits from the Group's cost savings plan announced in 2012, tight cost control and the non-repeat of certain expenses under the historic RBS Group recharge.

From 1 July 2012, the Group no longer paid a management fee to RBS Group and this was replaced by directly paying third-party suppliers for the majority of services that RBS Group had previously provided. 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.

The Group is targeting a total cost base[1] of approximately £1,000 million in 2014 and the total cost base[1] in 2013 of £1,031.9 million showed good progress towards this target.

Instalment and other operating income – ongoing operations

For the year ended 31 December	**2013 £m**	2012 £m
Instalment income	**117.8**	125.4
Other operating income	**62.4**	72.9
Total ongoing	**180.2**	198.3

Breakdown of underlying other operating income – ongoing operations

For the year ended 31 December	**2013 £m**	2012 £m
Solicitors' referral fee income	**6.9**	21.1
Vehicle replacement referral income	**15.7**	17.2
Revenue from vehicle recovery and repair services[2]	**31.8**	25.9
Fee income from insurance intermediary services	**1.7**	1.9
Other income	**6.3**	6.8
Total ongoing	**62.4**	72.9

Instalment and other operating income from ongoing operations reduced by 9.1% from 2012. This was primarily as a result of the cessation of solicitors' referral fee income from 1 April 2013 and lower instalment income.

Instalment income, representing interest charged on insurance premiums paid by instalments, of £117.8 million reduced by £7.6 million compared with the prior year (2012: £125.4 million) as a result of lower in-force policies in Motor and Home and changes to business mix.

In February 2014, the Group sold its stolen vehicle recovery business, Tracker. In 2013, Tracker's revenue was £18.4 million (2012: £18.2 million) which was included in the above. Operating losses from the business were £1.4 million (2012: £3.9 million).

Notes:
1. See note 2 on page 2
2. Vehicle recovery includes post-accident and pay on use recovery and vehicle tracking. Repair services constitute the provision of non-insurance related services.

Strategic report

Investment return

For the year ended 31 December	Total Group 2013 £m	Total Group 2012 £m	Ongoing operations 2013 £m	Ongoing operations 2012 £m
Investment income	**188.6**	199.3	**175.5**	179.9
Net realised and unrealised gains	**32.5**	82.5	**32.6**	54.8
Total investment return	**221.1**	281.8	**208.1**	234.7

Investment yields – total Group

For the year ended 31 December	2013	2012
Investment income yield[1]	**2.1%**	2.0%
Investment return[2]	**2.5%**	2.8%

The total investment return reduced to £221.1 million compared with 2012, due to a decrease in realised gains and lower investment income resulting from lower AUM.

During 2013, the investment asset base decreased by 8.5% to £8.6 billion. Key reasons for the reduction include the repayment of the £258.5 million Tesco loan note and investment outflows resulting from a net reduction in insurance liabilities.

Investment income was £188.6 million, a 5.4% decrease on 2012, as a result of a lower average investment asset base, which was partially offset by an increase in investment income yields.

Net realised and unrealised gains recognised in 2013 were £32.5 million compared with £82.5 million in 2012. Realised gains in 2012 reflected significant portfolio restructuring actions. Total realised gains at 31 December 2013 were £58.8 million net of deferred tax (2012: £158.8 million).

The investment income yield on the total portfolio for 2013 was 2.1% (see page 41), an improvement on 2012 driven primarily by management actions to increase the credit and property weighting within the target investment mix.

Operating profit – ongoing operations

For the year ended 31 December	2013 £m	2012 £m
Motor	**347.7**	261.8
Home	**106.2**	93.3
Rescue and other personal lines	**46.5**	84.4
Commercial	**9.5**	2.2
International	**16.6**	19.5
Total ongoing	**526.5**	461.2

In the year ended 31 December 2013, all divisions were profitable, with all except Rescue and other personal lines and International improving profit versus 2012.

Notes:
1. Investment income yield excludes net gains
2. Investment return includes net gains

Reconciliation of operating profit

For the year ended 31 December	2013 £m	2012 £m
Ongoing operations	**526.5**	461.2
Run-off segment	**63.6**	6.1
Restructuring and other one-off costs	**(140.5)**	(189.5)
Total Group	**449.6**	277.8

Run-off
The Run-off segment made a profit of £63.6 million in 2013 compared with a profit of £6.1 million in 2012. Similar to the ongoing operations, the Run-off segment also benefited from higher prior-year reserve releases from the recognition of improved claims experience, in particular relating to large bodily injury claims. Going forward, it is currently expected that the Run-off segment will contribute positively to operating profit, albeit at a lower level than in 2013.

Restructuring and other one-off costs
Restructuring and other one-off costs for 2013 fell to £140.5 million (2012: £189.5 million) as a result of the non-repeat of costs associated with separation and divestment from RBS Group. This includes £60.2 million relating to IT migration and £80.3 million relating to the Group's cost saving initiatives. The Group currently expects that restructuring and other one-off costs in 2014 will be approximately £80 million.

Finance costs
Finance costs increased to £37.7 million (2012: £28.7 million), primarily reflecting a full year of interest on the £500 million of long-term subordinated debt issued in April 2012.

Gain on disposal of subsidiary
On 8 October 2013, the Group announced an agreement with Chesnara plc for the sale of the Life business. Total sale proceeds of £62.3 million, which include a pre-closing dividend of £23.0 million, represent 85% of the embedded value of the business at 30 June 2013. The sale completed on 28 November 2013 and the profit on disposal was £12.0 million.

Taxation
The Group has an important responsibility to its stakeholders to manage its tax position effectively to ensure that the Group is fully compliant with all laws and regulations; and to meet all its obligations as both a contributor of taxes and a collector of taxes on behalf of the tax authorities.

The effective tax rate for 2013 was 26.2% (2012: 26.0%) compared with the standard UK corporation tax rate of 23.25% (2012: 24.5%). This is driven primarily by earnings from the International operations which are subject to higher corporation tax rates, re-measurement of deferred tax asset, disallowable expenses, non-taxable disposal of subsidiary, and adjustments to provisions in respect of prior-year tax.

Profit for the year and return on tangible equity
Profit for the year amounted to £312.8 million (2012: £184.3 million), an increase of 69.7% on 2012.

RoTE from ongoing operations increased to 16.0% (2012: 11.5% and pro forma 13.4%) as a result of both the improved operating result and the capital actions taken to improve the efficiency of the Group's capital position.

Earnings per share

Basic earnings per share of 20.9 pence increased 69.9% (2012: 12.3 pence), reflecting the improved operating profit from ongoing operations and the Run-off segment, and a decrease in Restructuring and other one-off costs. Diluted earnings per share were 20.8 pence (2012: 12.3 pence).

Adjusted basic earnings per share, which excludes the Run-off segment, Restructuring and other one-off costs and gain on disposal of subsidiary, increased by 15.1% to 25.1 pence (2012: 21.8 pence). Diluted adjusted earnings per share were 25.0 pence (2012: 21.8 pence).

Dividends

The Board is proposing a final dividend of 8.4 pence per share making a total regular dividend for 2013 of 12.6 pence per share. This represents 5.0% growth over the pro forma[1] 2012 regular dividend and is in line with the Group's aim to grow dividends annually in real terms.

In addition, the Board is also declaring a further special interim dividend of 4.0 pence per share, in addition to the 4.0 pence per share paid in December 2013. This second special interim dividend reflects the better than planned performance in the Run-off segment and the proceeds from the recently announced sale of Tracker. Both these items are considered to be one-off in nature and as a result the Board believes it is appropriate in this instance to return this capital to shareholders.

Cash flow

Net cash used by operating activities before investment of insurance assets reduced to £307.0 million (2012: £966.0 million). This reflected a reduction of cash used by operations of £226.7 million (2012: £731.4 million) and reduction of taxes paid of £80.2 million (2012: £232.4 million). The reduction of cash used by operations resulted from an increase in trade and other payables and in payments of current and prior-year claims, partially offset by a decrease in insurance and other receivables.

Cash generated from investment of insurance assets reduced to £433.0 million in 2013 (2012: £2,004.8 million). Proceeds on the disposal and maturity of available-for-sale financial assets reduced to £3,147.8 million (2012: £4,021.6 million) and investment balances held with credit institutions decreased by £209.3 million (2012: £844.6 million). For 2012, amounts primarily reflected the funding of dividend payments to RBS Group of £1,000.0 million prior to the IPO, and investment portfolio restructuring.

Overall, net cash generated from operating activities totalled £126.0 million (2012: £1,038.8 million).

Net cash used by investing activities of £145.3 million (2012: £154.2 million), primarily comprised £115.5 million purchase of intangibles relating to ongoing software investment (2012: £96.6 million).

Dividends paid amounted to £242.7 million (2012: £1,000.0 million) with the 2012 balance representing payment of dividends to RBS Group prior to the IPO. The Group repaid borrowings during the year representing the Tesco loan note of £258.5 million with the 2012 repayment (£246.4 million) representing loans with RBS Group. Following these, net cash used by financing activities totalled £544.7 million (2012: £774.5 million).

Note:

1. See note 5 on page 3

Overall, cash and cash equivalents decreased by £564.0 million (2012: £110.1 million increase) across the year to £853.2 million (31 December 2012: £1,417.5 million) representing the rebalancing of the investment portfolio including the reduction of cash holdings.

Net asset value

For the year ended 31 December	**2013 £m**	2012 £m
Net assets	**2,790.0**	2,831.6
Goodwill and other intangible assets	**(500.1)**	(421.5)
Tangible net assets	**2,289.9**	2,410.1
Net asset value per share (pence)	**186.6**	189.1
Tangible net asset value per share (pence)	**153.2**	161.0

The net asset value at 31 December 2013 was £2,790.0 million (31 December 2012: £2,831.6 million) with tangible net asset value of £2,289.9 million (31 December 2012: £2,410.1 million). This equates to 186.6 pence and 153.2 pence per share respectively as at 31 December 2013 (31 December 2012: 189.1 pence and 161.0 pence, respectively).

The reduction in net asset value and tangible net asset value principally reflects the payment of the final 2012, interim and first special interim 2013 dividends, a reduction in the level of unrealised gains in the debt securities portfolio, and increased investment in intangible assets offset by profit for the period.

Significant accounting policies

Except as disclosed in note 1 to the consolidated financial statements, the same accounting policies and basis of recognition and measurement have been followed in the consolidated financial statements as applied in the Group's previous annual audited financial statements for the year ended 31 December 2012.

Where new or revised standards have been adopted in the year, these have not had a material impact on the Group's financial statements.

Financial management

The Group's long-term sustainability depends on having sufficient funds to meet its liabilities as they fall due. This protects the reputation of its brands and the integrity of the Group's relationship with customers and other stakeholders. The principal financial risks that are present in the Group are reserving, market risk connected to the investment portfolio and counterparty risk.

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 the 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 conservative approach to the assessment of liabilities. This conservative 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 153 and 154. The triangles demonstrate that, for all accident years, the estimated ultimate claims cost has reduced over time from the year of first validation. Reductions in ultimate claims cost have fluctuated over the period, with the accident years from 2003 to 2006 and 2010 showing the largest decreases. The 2009 accident year has shown the lowest reduction; this followed 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 the number of 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 historical variability inherent in the claims data and other short- and long-term risks not reflected in the actuarial data.

Claims reserves net of reinsurance

For the year ended 31 December	**2013 £m**	2012 £m
Motor	**2,606.3**	3,026.6
Home	**398.1**	403.8
Rescue and other personal lines	**77.4**	77.1
Commercial	**637.9**	588.3
International	**438.2**	429.7
Total ongoing operations	**4,157.9**	4,525.5
Run-off segment	**682.2**	856.4
Total Group	**4,840.1**	5,381.9

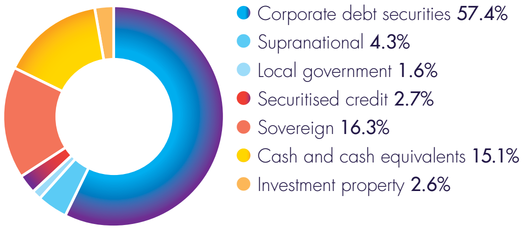
Investment portfolio

The Group's investment portfolio comprises primarily of investments in sovereign debt securities, investment grade fixed income securities and cash. The strategy ensures adequate liquidity is always available to meet customers' claims, particularly in periods of stress (for example, natural disasters). It is also designed to ensure that asset and liability durations match closely where possible; and that risk is diversified and return maximised relative to the Group's risk appetite and capital allocated to investment risk.

During 2013, key achievements included:

- Undertaking a major asset and liability management study on U K Insurance Limited, which reconfirmed liquidity requirements and proposed some changes to the current asset mix to deliver a better overall risk adjusted return
- Transferring the management of 'AAA' fixed-income credit in-house to improve the overall cost effectiveness of the operating model
- Increasing the benchmark allocation to investment grade credit and the sub-allocation to 'BBB' rated assets
- Investing into externally managed securitised credit, with the focus on investment into the highest-quality debt tranches and having a well-diversified range of collateral types and pools backing such investments
- The continuing selective purchase of assets for the UK commercial property portfolio. The asset brings portfolio return diversification and long-term returns to support inflation-linked liabilities

Investment portfolio as at 31 December 2013
(%)



Investment portfolio as at 31 December 2012
(%)

Derivatives are permitted for risk management purposes within the investment portfolio. These include interest rate swaps to change the liability to a floating basis on the debt issuance and US Dollar credit mandates and forward currency contracts to manage currency risk.

Total debt securities are £7,045.3 million (2012: £7,164.3 million), of which 12.9% are rated as 'AAA' and a further 70.5% are rated as 'AA' or 'A'. Corporate, local government and supranational debt securities account for 63.2% of the portfolio.

The total value of the investment portfolio as at 31 December 2013 was £8,557.6 million, 8.5% lower than as at 31 December 2012. AUM provide adequate access to liquidity, with 15.1% of the funds held in cash and cash equivalents at the year end.

The duration as at 31 December 2013 of total investment assets was 2.0 years, with the breakdown being: UK 1.9 years; Italy 3.3 years; and Germany 2.4 years (2012: 1.8 years; UK 1.7 years; Italy 2.8 years; and Germany 2.5 years).

The internally managed gilt and 'AAA' credit portfolios have intentionally been held at a shorter duration than benchmark given the expectation of improvements in the interest rate environment. In addition, to minimise further interest rate risk the Group has increased its investment allocation to floating rate instruments, for example securitised credit. The US credit portfolios have been swapped to a floating basis since inception in 2012.

Investment property holdings shown as at 31 December 2013 comprised 20 properties. The primary sector exposures are industrial warehouses (26.5%) and supermarkets (19.7%).

Asset and liability management

Asset and liability management influences the Group's investment strategy through the matching of assets and liabilities, for further information please see the table below:

	Liabilities	Asset	Characteristics
Long term >10 years	PPOs	Property, infrastructure debt[1]	Inflationary linked or floating
Short and medium term	All other claims	Investment grade credit	Key rate duration matched
Debt	Tier 2 sub debt (swapped fixed to floating)	Securitised credit and cash	Floating
Surplus	Tangibles	Investment grade credit, cash and government debt securities	Fixed or floating

Note:

1. Infrastructure debt is a new asset class which the Group plans to invest in 2014.

Asset allocation and benchmarks

	UK			Germany			Italy		
	Current benchmark holding	**2013 Year end**	2012 Year end	Current benchmark holding	**2013 Year end**	2012 Year end	Current benchmark holding	**2013 Year end**	2012 Year end
Credit[1]	63%	**63%**	54%	88%	**81%**	67%	100%	**100%**	93%
Securitised credit[2]	6%	**2%**	–	12%	**19%**	17%	–	**–**	–
Sovereign	19%	**18%**	21%	–	**–**	8%	–	**–**	–
Total debt securities	**88%**	**83%**	75%	**100%**	**100%**	92%	**100%**	**100%**	93%
Cash[3,4]	7%	**14%**	23%	Min €35m	**€61m**	8%	Min €45m	**€47m**	7%
Investment property	5%	**3%**	2%	–	**–**	–	–	**–**	–
Total	**100%**	**100%**	100%	**100%**	**100%**	100%	**100%**	**100%**	100%

Asset studies for the UK portfolio resulted in the introduction of securitised credit as a new asset class in 2013. The benchmark holding for fixed income credit was increased during the year from 60% to 63%. Further investment properties were acquired during the year to bring the holding closer to the allocated level. Following an asset liability management review, the Group plans to start investing into infrastructure debt in 2014.

Investment holdings and yields – total Group

	2013		2012	
As at 31 December	**Asset allocation**	**Income**	Asset allocation	Income
Corporate debt securities[5]	**4,915.8**	**128.7**	4,483.4	121.9
Supranational	**365.7**	**6.5**	521.8	8.8
Local government	**134.5**	**2.9**	271.1	2.7
Credit	**5,416.0**	**138.1**	5,276.3	133.4
Securitised credit[5]	**229.8**	**1.1**	45.2	3.4
Sovereign	**1,399.5**	**30.7**	1,842.8	38.8
Total debt securities	**7,045.3**	**169.9**	7,164.3	175.6
Cash and cash equivalents[6]	**1,288.9**	**7.3**	2,062.5	19.3
Investment property	**223.4**	**11.4**	128.9	4.4
Total Group	**8,557.6**	**188.6**	9,355.7	199.3
Corporate debt securities[5]	**57.3%**	**2.7%**	47.9%	2.9%
Supranational	**4.3%**	**1.5%**	5.6%	1.7%
Local government	**1.6%**	**1.5%**	2.9%	1.4%
Credit	**63.2%**	**2.6%**	56.4%	2.7%
Securitised credit[5]	**2.7%**	**0.8%**	0.5%	2.1%
Sovereign	**16.4%**	**1.9%**	19.7%	1.6%
Total debt securities	**82.3%**	**2.4%**	76.6%	2.4%
Cash and cash equivalents[6]	**15.1%**	**0.4%**	22.0%	0.8%
Investment property	**2.6%**	**6.5%**	1.4%	4.4%
Total Group	**100.0%**	**2.1%**	100.0%	2.0%

Notes:

1. Credit in Italy allows a maximum holding of €25.0 million of Buoni del Tesoro Poliennali, Italian government debt securities and as at 31 December 2013 this stood at £24.1 million.
2. Pfandbrief holdings in the German portfolio are overweight as a result of legacy holdings, which are in the process of being run down.
3. Awaiting investment into securitised credit and property (UK)
4. During the year the cash holdings for the International business was set to a minimum holding for liquidity purposes rather than as a percentage of AUM.
5. Asset allocation at 31 December 2013 includes investment portfolio derivatives, which have been netted and have a mark-to-market value of £39.8 million, split £37.7 million in corporate debt securities and £2.1 million in securitised credit (31 December 2012: £7.8 million in corporate debt securities).
6. Net of bank overdrafts and including term deposits with financial institutions with maturities in excess of three months.

Capital management

Capital management policy

The Group seeks to manage its capital efficiently, maintaining an appropriate level of capitalisation and solvency, while aiming to grow its dividend annually in real terms.

In determining the appropriate level of capitalisation and solvency the Group considers capital on a number of metrics, including risk-based capital, regulatory capital and rating agency capital. The Group targets holding capital in the range of 125% to 150% of risk-based capital and holding capital sufficient to maintain a credit rating in the 'A' range.

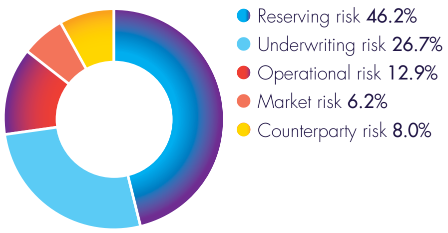
Where the Board believes the Group has capital which is surplus to requirements, for example if it had an expectation that the risk-based capital coverage would be significantly above the 125% to 150% target range for a prolonged period, it would look to return capital to shareholders.

Risk-based capital

For its principal UK general insurance underwriter, U K Insurance Limited ("**UKI**"), the Group uses its own risk-based capital model to determine the level of capital required to operate within its risk appetite. The internal model is calibrated to a 99.5% confidence interval and considers both earned business and future business written over a one-year period. Furthermore, the model allows for uncertainty on this business until ultimate settlement. This approach is consistent with the ICA methodology set by the PRA.

For UKI, the major part of its required capital is held against reserve risk (approximately 46%) followed by underwriting risk (approximately 27%) and operational risk (approximately 13%). The high level of reserve risk reflects the size of the claims reserves still held against business written when the Group's premium base was larger, including the Run-off segment, and the Group's exposure to PPOs which carry a high capital requirement.

Capital allocated by risk type – U K Insurance Limited (%)



The Group's International entities, in Italy and Germany, hold capital in excess of that required by their local regulators.

Current capital position and outlook

The Board considers the Group is currently strongly capitalised with a risk-based capital coverage ratio at the upper end of its risk-based capital coverage target range and an 'A' rating with stable outlook from its credit rating agencies.

In determining this position, the Board has considered a number of factors that may positively and negatively affect the Group's capital position over the next 12 months. In particular, the Group's UK regulated general insurance underwriters are currently going through the new ICAS+ process with the PRA to assess the Group's future individual capital guidance. The ICAS+ process will also enable firms to obtain feedback on their progress towards Solvency II. This process is more involved than previous years and includes a detailed assessment of the Group's internal risk-based capital model. In addition, the introduction of Solvency II from 2016 and changes to capital requirements and reporting are still being confirmed, especially in the area of long-term guarantees.

During 2013, the Group updated its investment target asset mix and in 2014 is developing further its asset and liability management solutions for longer tail insurance liabilities. This includes investing in infrastructure debt. As these changes take affect, it is expected that there will be an increase in the capital allocated to market risk. Furthermore with current bond yields remaining low, the Group expects to continue to see its level of unrealised bond gains reduce as bonds mature and are reinvested.

The Group continues to invest in its operations and is likely to see an increase in intangible assets that may not qualify fully towards the Group's capital base.

Taken together the Board believes that it is appropriate to maintain capital at the upper end of its risk-based capital coverage range. The Board will continue to review this position as clarity improves on the factors mentioned above and the Group makes further progress on its transformation plan.

Dividends

In relation to 2013, the Group has paid, or is recommending, dividends amounting to £308.7 million and 20.6 pence per share. This consists of a regular dividend of 12.6 pence per share, representing 5.0% growth on the pro forma 2012 full year dividend, and two special interim dividends totalling 8.0 pence per share. The regular dividend is consistent with the Group's policy to aim to raise dividends annually in real terms.

The two special interim dividends relate to specific items in 2013 that the Board considers to be one-off in nature – the disposal of its closed Life business and the higher than planned profit in the Run-off segment. Total dividends are equivalent to 98.6% of post-tax profit. The regular dividend represents 50.4% of post-tax profit from ongoing operations.

Capital position and leverage

The Group is well capitalised with key capital metrics within the Group's risk appetite and significantly above regulatory minima.

As at 31 December	2013 £m	2012 £m
Consolidated statutory solvency capital		
Shareholders' equity	**2,790.0**	2,831.6
Goodwill and other intangible assets	**(500.1)**	(421.5)
Regulatory adjustments	**6.2**	(73.5)
Total Tier 1 capital	**2,296.1**	2,336.6
Lower Tier 2 capital[1]	**496.9**	495.5
Regulatory adjustments	**(28.9)**	(23.7)
Total regulatory capital	**2,764.1**	2,808.4
Insurance Group Directive ("IGD")		
IGD required capital[2]	**947.9**	1,005.0
IGD excess solvency	**1,816.2**	1,803.4
IGD coverage ratio	**291.6%**	279.4%
Risk-based capital coverage ratio	**158.7%**	151.4%
Risk-based capital coverage ratio (adjusted for final and second special interim dividends)	**148.7%**	145.4%

Notes:

1. Includes that element of the subordinated dated notes applicable for regulatory capital purposes.
2. Based on the IGD for the Group and 2012 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 2013.

At 31 December 2013, the Group had an estimated risk-based capital coverage ratio of 158.7% (31 December 2012: 151.4%) which reduces to 148.7% after deducting the recommended final and second special interim dividends (31 December 2012: 145.4%). On an IGD basis, the coverage is 291.6% (31 December 2012: 279.4%).

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

As at 31 December	2013 £m	2012 £m
Shareholders' equity	**2,790.0**	2,831.6
Undated subordinated loan[1]	**–**	258.5
Subordinated dated notes	**486.6**	529.0
Total financial debt	**486.6**	787.5
Total capital employed	**3,276.6**	3,619.1
Financial leverage ratio[2]	**14.9%**	21.8%

Notes:

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

The Group's leverage ratio remains conservative with a financial leverage of 14.9% at 31 December 2013 (31 December 2012: 21.8%). The main change during 2013 was the repayment of the Tesco loan note in January. Excluding this the leverage ratio 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 principal 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.

Embedded in our values

Jane Hanson, Chair of the Corporate Social Responsibility Committee

"During 2013, the Corporate Social Responsibility Committee has overseen the development of the Group's approach to CSR, taking care to embed it in Direct Line Group's core purpose and values. This ensures CSR is relevant to every employee, creating a clear value chain – doing the right thing builds trust, trust builds reputation, and reputation builds value – and weaving it into business processes.

"This approach reflects the way the Group and I believe our customers want us to do business, and ensures our strategy mirrors the themes of empowerment and trust which the Board actively leads in the Group's relationships with its stakeholders.

"Against the backdrop of a challenging operating environment, I am pleased to report that good progress has been made in establishing solid foundations to enable us to live up to our broad responsibilities as Britain's leading personal lines motor and home insurer."

Our approach and priorities drive a clear value chain; doing the right thing builds trust, trust builds reputation, and reputation builds value.

Approach and priorities

Working in partnership with the business-led charity Business in the Community ("**BitC**"), we were able to make exciting headway in rolling out our corporate social responsibility ("**CSR**") initiatives. Blending input from employees at all levels, representing a wide range of stakeholder interests, together with BitC's expertise in the issues material to our business, we advanced our CSR programme through four key strands – sustainable business practices, employee experience, community, and energy and environment. These strands continue to provide the framework for our CSR activity, against which our key performance targets and sustainability metrics are tested and monitored. An absolute priority for the Group is to sustain a high rate of employee engagement, and we were pleased that in spite of the significant amount of continuing change in the business, 71% of our employees reported themselves as favourably engaged in our Employee Opinion Survey conducted in October.

Governance

To ensure the delivery of our CSR programme, we have established a robust governance structure, with clear roles and responsibilities. This comprises the CSR Committee, see page 70, which has complete oversight of our strategy, policy and programme, and a CSR Advisory Group, formed of senior managers and chaired by a member of the Executive Committee, which leads CSR within the business. The Group Communications team has functional responsibility for executing the strategy and managing the CSR programme on a day-to-day basis. In addition, a clear policy framework has been developed and, in keeping with best practice, our policies are published on our website.

Sustainable business practices

Our products, services, business processes and supply chain have a tangible impact on each of our many stakeholders. By aiming to embed CSR in all our enterprise's activity, we hope to deliver better outcomes for our customers and our wider stakeholders across society.

Working with Government

The Department for Environment, Food and Rural Affairs has cited flooding as one of the key risks facing Britain. As one of Britain's largest home insurers, we want to help address this risk. In June 2013, the UK Government and the ABI published a Memorandum of Understanding on flood insurance, which Direct Line Group played a key role in negotiating, as well as preparing for the creation of Flood Re. This is a vital step in seeking to make insurance affordable and accessible to high risk customers. We are pleased the UK Government has made significant commitments to help prevent and mitigate the effects of flooding, most notably not to reduce spending on flood defences.

The industry has compromised to reach agreement and, although there remain a number of issues that need to be overcome, it is committed to continuing to work closely with the UK Government with the objective of ensuring these can be resolved. In the meantime, we will meet our flood-related commitments to our customers under the existing Statement of Principles.

In June 2013, we hosted a debate in Westminster to discuss the topical issue of insurance for young drivers. Young drivers aged between 17 and 24 represent 12% of licence holders, but account for 25% of all UK motor accidents where someone is killed or seriously injured. As a result, this demographic group of motorists face higher insurance premiums. The debate brought together Members of Parliament, national and trade press, road safety practitioners, academics and trade bodies to discuss how to improve road safety among young drivers. Ideas included a graduated driver's licence, a minimum learning period, a lower tolerance limit to alcohol, and restrictions on passenger numbers and night-time driving. We encourage the Government to release its Young Driver consultation paper.

A number of our Executives are actively involved in various industry bodies, including the ABI, FCA Practitioner Panel and Financial Ombudsman Service ("**FOS**") Insurance Industry Steering Group; and Tom Woolgrove was elected President of the Chartered Insurance Institute. This involvement informs our policy insights.

We recognise that there is a general concern that lobbying can have an inappropriate influence on government policy and therefore we engage only in public policy debates that have an impact on our business or our stakeholders. We do not support party political interests or make political donations.

600,000

new car parts saved through our 'repair not replace' initiative

Innovation

We believe that ultimately customers determine our future. That is why we are investing in technology to help give our customers the products and services they want and need.

We have developed an Optimum Repair Process ("**ORP**"). ORP is a new, environmentally sustainable approach to modern vehicle crash repair, which cuts waste and emissions by encouraging the practice of 'repair, not replace'. This dramatically reduces the volume of new parts used. ORP has been supported by our research partner, Thatcham, which provides technical training courses for vehicle damage assessors.

On average, it used to take 10 days and 16 hours' labour to complete a repair. In working time, a vehicle could be in a body shop for 64 hours awaiting repair, preventing other cars from being serviced. Much of that time was wasted waiting for parts. The repair industry had become accustomed to replacement rather than repair, creating an over-reliance on expensive new parts and the accompanying deskilling of many technicians. This, in turn, increased both repair times and costs, which affected customer satisfaction.

As a result of ORP, we are using around 200,000 fewer new car parts per annum.

Telematics

In response to improving technology and customer interest, during the year Direct Line launched various telematics propositions. This technology allows us to gather information about customers' driving, recording speed patterns and distance travelled, which can be connected to the types of roads used and at what time. It also monitors braking and cornering to build up a picture of a customer's driving style so that we can better assess each person's individual risk. This should lead to greater pricing granularity for drivers opting for telematics.

For higher risk motorists, such as young drivers between the ages of 17 and 24, who tend to pay higher premiums, telematics provide a way for these customer groups to pay only for how they drive, rather than also pay for how other drivers behave on the roads.

Above all else, we believe the use of telematics technology encourages safer and more considerate driving, which will ultimately lead to safer roads for all. It is an excellent way of encouraging drivers to manage their speed – one of the biggest causes of collisions on European roads.

Other initiatives

Other initiatives to make things better and easier for our customers include piloting the capability to use smartphones to send us live footage of their home claims so we can settle their claim far quicker. Smartphones can also be used to give claimants a live view of progress on their car repair as it moves through the accident repair centre process.

Supply chain

Last year, we began a significant piece of work to ensure we were properly managing the risks and improving the sustainability of our supply chain. We reviewed and republished our Ethical Code for Suppliers and reworked the selection criteria and contract terms for new suppliers. Our focus in 2014 is on developing our supplier management programme. We were also proud to sign up to the Prompt Payment Code advocated by the Department for Business, Innovation and Skills, which is aimed specifically at alleviating the pressure of delayed customer payments on smaller businesses that tend to be more vulnerable to experiencing cash flow problems. Signatories to the code commit to pay suppliers on time (the default period being within 30 days), give clear guidelines on payment procedures, and encourage lead suppliers to adopt the code in their own supply chains.

Living Wage

While not accredited to the Living Wage Foundation, we ensured that all our employees were paid at or above the Living Wage. We are also factoring the Living Wage into contract renewal discussions with external suppliers.

Responsible investment

During the year, we set out our approach to responsible investment. The asset classes in which we invest are cash, government and corporate debt securities, and commercial property. We do not hold equities or have direct equity investments and are therefore unable to use share ownership to influence other companies. Although we do not set ethical parameters for our asset managers regarding the issuers in which they can or cannot invest, we have, however, committed to mandating only those external asset managers who demonstrate a strong commitment to using their market leverage to support social, environmental and ethical ("SEE") objectives. We favour those managers with an active, ongoing demonstrable engagement in local or global SEE initiatives and expect, at a minimum, our managers to be signatories[1] to the UN Principles of Responsible Investment. We will meet with each of our asset managers annually to review in detail the initiatives they have taken and successes accomplished.

Employee experience

Our focus continues to be on our people strategy, to build the future capability required to achieve our strategic objectives and fulfil our people. We are committed to strong employee engagement, which we believe underpins the quality of service we offer our customers.

Engagement

We continue to transform our business. Since the start of our cost saving initiatives there has been a reduction of 3,200 roles. While necessary in order to sustain our business in a highly competitive market, such initiatives inevitably impact on the engagement of our employees. In line with our values, we have worked hard to ensure that as much information as possible was communicated, confirmed that our redundancy terms would remain unchanged during this initiative, and fully consulted our employee representatives.

Anyone at risk of redundancy had access to our redeployment support and where redundancy resulted, individuals had access to both redeployment and outplacement support.

Clearly this was a very difficult time for those leaving the business, but also unsettling for those remaining. Not surprisingly, it had an impact on morale, as evidenced in this year's Employee Opinion Survey, although it was pleasing that overall engagement remained high at 71% relative to historical results. This survey also showed that there is a high degree of

Note:

1. One fund manager was selected before this new policy was adopted and our approach is to encourage them to move towards becoming signatories in due course.

employee understanding of the strategic direction in which the business is travelling and how individual roles relate to that journey. At the same time, despite the significant amount of business change, our employees have maintained a strong customer focus and still want to make a positive difference to the experience we give our customers.

Recognition
Recognition is an important element of engagement. The Group has established a number of initiatives to recognise the efforts and contribution of our employees. These range from formal reward arrangements to informal recognition programmes. Examples of the latter include our Service Awards, which were relaunched in 2013, to recognise loyalty; and our Excellence Awards, which recognise employees for outstanding service, innovation, relationship building or leading by example. We also run a Chief Executive Awards programme. These awards recognise those individuals who clearly demonstrate behaviours in line with our corporate values, which are at the very heart of our culture and demonstrate the great things our people do for each other, our customers, and our business every day. Last year, there were a record 6,000 nominations. Those shortlisted attended an awards event where the entertainment was provided by our own people, in the form of 'Direct Line Group's Got Talent'.

Development
Our Leadership Framework sets the expectation for leaders at all levels. We believe everyone can show leadership in their role. With the help of our employees, we have created a framework which outlines the behaviours, personal qualities, skills and knowledge needed for individuals to be successful in their role. The Leadership Framework is specific to Direct Line Group and helps drive the performance of our people.

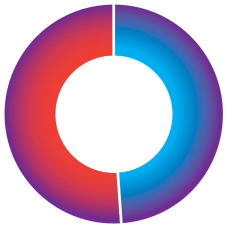
For our people managers, there was significant focus this year on creating an environment where continuous and flexible development opportunities were made available. This challenged the traditional learning methodologies, reducing the dependency on face-to-face delivery, and has been built around a self-directed learning model where the emphasis is on the job development.

Over 1,000 people in our Claims business have been supported in embracing new ways of working to provide them with the skills and knowledge to handle claims in a more pro-active and efficient way.

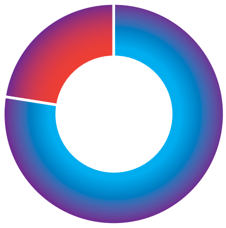
Diversity
As a Group, we actively celebrate the diversity of our employees. Our Diversity Network Alliance aims to represent the full range of populations within our business and seeks to ensure we have a workforce reflective of society and our customer base. The network is still in its infancy, but we remain hopeful of encouraging 10% of our workforce to become members by the end of 2014.

Last year, the network had a particular focus on gender and working families. The ratio of female to male employees as at 31 December 2013 is shown in the charts along with a year on year comparison by headcount.

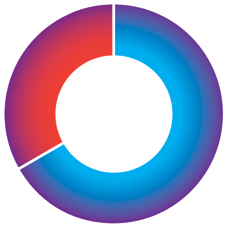
Gender diversity of all employees



Gender diversity of senior managers



Gender diversity of Board members



Gender diversity

	2013		2012	
As at 31 December	**Female**	**Male**	Female	Male
Directors	**3**	**6**	3	7
Senior managers	**34**	**117**	38	141
Employees	**6,510**	**6,256**	7,578	7,257

Our analysis has shown that we need to increase the number of female applicants for senior management positions and we shall look at ways in which we might achieve this in 2014.

Human rights
Our diversity and inclusion practices are in line with the Universal Declaration of Human Rights and we continue to work towards an environment that is based on meritocracy and inclusion, where all employees can develop their full potential, irrespective of their age, belief, disability, ethnic or national origin, gender, gender identity, marital or civil partnership status, political opinion, race, religion or sexual orientation.

Our Employee Opinion Survey indicated that 89% (2012: 92%) of respondents felt that we provide a working environment that is inclusive and accepting of differences in cultural backgrounds and lifestyles.

Through our Ethical Code for Suppliers we adhere to the core International Labour Organization standards.

Recruitment
We are actively supporting a range of initiatives to help alleviate youth unemployment, a continuing legacy of the financial crisis. During 2013, we joined the UK Government's Wage Incentive scheme and will recycle any funds received into schemes to help young people into work. We have also provided partner funding to an online resource and careers platform for 11 to 24 year olds, entitled Plotr, which helps the young get into employment through supporting internships and mentoring. Additionally, we are working with Generation Talent, a joint initiative between the UK Government and BitC, to tackle the issues surrounding youth unemployment and to support young people into work.

Community
Our aim is to build Britain's best retail general insurer. We recognise that achieving this aim requires us to play an active role in our local communities.

26%

of employees volunteered or fundraised in company time

Volunteering
Aligned to our core business, our focus is on Making Communities Safer through improving road safety and reducing crime and anti-social behaviour. In 2013, we worked with four charities focused on these themes: Brake, RoadSafe, Catch22, and The Prince's Trust. Activities undertaken included: Community Space Challenges, which brought together our employee volunteers with young people to improve neglected community spaces; Speedwatch programmes, where we worked with local police and councils; and 'Walking Buses', which encourage children to walk to their school in an organised and safe environment. We also sponsor Brake's Giant Walking Bus initiative, which this year saw 70,000 children from 350 schools march for safer streets while they walk to school.

Best CSR Initiative
Our initiative, 'Get into Car Repairs', won 'Best CSR Initiative' at the British Insurance Awards 2013. Record levels of youth unemployment mean the young miss out on vital work experience, which may hold them back throughout their careers. It also creates the risk of a rise in anti-social behaviour and crime, which has a direct impact on our business and wider society. 'Get into Car Repairs' had a positive impact on the lives of a group of disaffected unemployed young people in Wakefield, Yorkshire, where one in three 16 to 24 year olds are unemployed. It gave 15 young people first-hand experience of repairing cars in a body shop at our local accident repair centre. They also received training on CV writing and interview techniques, as well as soft skills such as communication and team building.

675

employees took pledges for Comic Relief and Children in Need

For Comic Relief and Children in Need, 675 employees were proud to offer their time to take calls from the public wanting to pledge donations. At a local level, our Community and Social Committees also arranged and coordinated a significant amount of charity activity.

According to our Employee Opinion Survey, last year, 26% of our staff volunteered or fundraised in company time.

Supporting employees
We align our charitable giving with the interests of our employees in two ways. We match employee donations up to £50 per month through our Give As You Earn scheme ("**GAYE**"); and we provide individual grants of £250 to organisations for which our employees regularly volunteer or raise funds in their own time. In 2013, we donated £115,000 through GAYE and a further £48,500 in grants. Our employees also undertake their own fundraising at work, typically for local causes, but also for major fundraising events.

Strategic partnerships
Now that our volunteering programme is established, our focus is on supporting our network of Community and Social Committees to develop their relationships with local charities and authorities. Centrally, we will focus on two strategic partnerships. The first is a continuation of our well-established partnership with Brake, with whom we plan a series of campaigns on road safety issues, for example on the introduction of 20 mph speed limits in certain urban environments. The second is with Groundwork, who deliver local community projects, improving community spaces and getting people back into work. We will look to work with them on programmes to help 16 to 24 year olds, not in employment, education or training, onto schemes which give skills and work experience, principally through social enterprises.

Energy and environment
We aim to manage our operations in a sustainable way. We seek to reduce waste and make efficient use of resources; and we aim to cut emissions, as part of the transition to a low carbon economy.

Emissions
We have established historical data records on energy use which has helped us better understand trends in our associated greenhouse gas ("**GHG**") emissions. Group-wide GHG emissions in 2013 were 30,624 tonnes of carbon dioxide equivalent ("**CO_2e**"), of which 95.1% related to our UK operations. Emissions are calculated in accordance with the Greenhouse Gas Protocol and include Scope 1 and Scope 2 emissions. More details on our emissions are given in the Directors' report on page 100.

Our emission data has been externally verified by Ecometrica. The verification statements can be found on the Group's website (www.directlinegroup.com).

During 2013, 94.9% of the Group's purchased electricity was from renewable sources on green tariffs purchased from GDF Energy and SSE in the UK, and LichtBlick and Naturstrom in Germany.

British Independent Utilities ("**BIU**") was appointed as our Energy Partner to advise us on procuring the energy supply for our offices and accident repair centres from 2014. Part of the agreement is for BIU to work with us to reduce our power and gas consumption over the next three years, through environmental surveys and improvement plans for our buildings. We have set a target of a 10% reduction in our gas and electricity usage by the end of 2016, against our 2013 annual consumption figures.

In 2014, we are targeting a reduction of 3% of our UK GHG emissions measured by tonnes of CO_2e.

Waste
We retendered our waste management services contract, excluding paper, for our main office sites and appointed SITA as provider in October. SITA has already significantly increased the percentage of our general office waste we recycle. Our longer-term aim is to increase recycling year on year and eliminate waste to landfill by 2016. Iron Mountain collects and recycles 100% of our waste paper. In 2013, we generated 1,355 tonnes of waste from our main office sites of which we recycled 55%. SWR collects waste from our accident repair centres. In 2013, these centres generated 1,085 tonnes of waste of which 86% was recycled or reused.

500,000

litres of water per annum saved at our head office in Bromley

Resource use
Through our desktop and printing transformation programme we are replacing our old hardware. This is expected to bring a significant reduction in both energy and paper use. Last year, we consumed some 416 tonnes of copier paper. Our default office paper has a 100% recycled content.

We are currently establishing an accurate measure for our water usage for the Group.

We have a number of local initiatives to improve our environmental performance, supported by a network of environmental champions. For example, we have made changes to the way in which we consume water in our restrooms in Bromley, resulting in a significant saving of half a million litres of water annually.

Charlton House was appointed as our new catering supplier in 2013. Significant in their selection was their sustainability credentials, including a commitment to healthy eating, a focus on sourcing local and seasonal produce, and membership of the Red Tractor Scheme (an industry recognised Kitemark covering animal welfare, food safety and environmental protection).

Business travel
We continue to seek ways to reduce business travel, including better use of technology for video and conference calls, as well as enabling colleagues to work more smartly. We appointed a new travel management company, Capita Travel and Events, in October 2013 and will work with them to establish a baseline for reporting future travel-related emissions.

Mike Biggs, Chairman

"Direct Line Group believes that the combination of a good governance structure, a strong values-based culture and the highest standards of corporate behaviour stimulates value creation."

Dear shareholders and other stakeholders

At Direct Line Group, we are committed to meeting the high standards of corporate governance rightly expected of a Group such as ours. Having complied with the UK Corporate Governance Code in relation to the key Board structure and processes by the time of the IPO in 2012, we undertook a governance review in 2013. This was designed to further test whether we have the most appropriate governance framework fit for a stand-alone listed company, with clarity as to accountabilities and responsibilities.

Our objective of good corporate governance influences everything that we do at Direct Line Group and is the responsibility not only of the Board and the executive management but of every member of staff.

Our Code of Business Conduct governs our interactions with our various stakeholders and ultimately helps with our goal of becoming Britain's best retail general insurer. This is set out alongside.

Our Code of Business Conduct

The Board requires that all employees adhere to the highest possible standards of professional and ethical conduct – and this applies equally to the Board itself. Each function within the Group operates with policies and minimum standards and the following principles:

- Business practices
  We shall engage in honest, professional and ethical conduct and maintain effective procedures to prevent confidential information being misused
- Dealing with customers
  We shall treat customers fairly, openly and honestly and operate an effective complaints process to address any perceived departure from these standards
- Dealing with shareholders and other stakeholders
  We shall seek to maximise shareholder value over time, recognising that wealth generated also benefits customers and employees as well as the communities where we operate
- Dealing with employees
  We shall maintain a working environment that attracts, motivates and retains employees and shall be intolerant of any type of discrimination, harassment or victimisation
- Dealing with suppliers of goods and services and business partnerships
  We shall maintain the highest possible standards of integrity in business relationships with suppliers and partners by treating them honestly and with respect and avoiding compromising offers of gifts and hospitality[1]
- Dealing with communities and the environment
  We shall contribute to the social and economic well-being of those communities where we are an employer and encourage employees to participate in projects and initiatives to strengthen those communities
- Dealing with competitors
  We shall compete with competitors honestly and in accordance with competition law
- Dealing with regulators
  We shall maintain a constructive and open relationship with our regulators to foster mutual trust, respect and understanding and shall not offer anything to officials in return for favourable treatment

Note:

1. You may view our ethical code for suppliers on our website (www.directlinegroup.com).

Our values

Do the right thing

For our people, our customers, our shareholders and our wider stakeholders; make decisions based on what is right, not what is easy; demonstrate personal and professional integrity; do what's right for the long-term sustainability of our business.

Aim higher

Strive to be the best in every area of the business; be ambitious, courageous and innovative; relentlessly challenge and improve; seek and embrace change; learn from our mistakes; persevere, always deliver our promises and don't settle for second best.

Work together

Collaborate across all levels and across all functions; leverage the skills, knowledge and experience, irrespective of hierarchy, to deliver the best possible results; develop relationships based upon trusting each other, partnerships and win-wins; recognise and celebrate success.

We also place great emphasis on the values set out below that underpin these business principles. As we reported to you last year, the executive management engaged with employees to shape these, with the intention that they become central to our approach and behaviours. In line with those values, we seek to maintain an environment where everybody feels responsible for the future success of the business and is empowered to do the right thing.

Board composition

The Board comprises myself as Chairman (independent upon appointment to the Board), five independent Non-Executive Directors, one Non-Executive Director nominated by RBS Group and therefore not independent, and two Executive Directors.

The changes in directorate during 2013 were in respect of the Directors nominated by RBS Group. Mark Catton stepped down from the Board when RBS Group ceded control of the Company in March 2013 (whereupon RBS Group became entitled to nominate only one and not two Directors to the Board). In October 2013 he was reappointed when Bruce Van Saun resigned in order take up an appointment as RBS Group's Chief Executive Officer, Citizens and Head of Americas in the United States. Mark Catton will step down as a Director when RBS Group's holding in the Company falls below 20%.

Governance review

To help meet our goals of efficiency and strong governance, the Board undertook a planned post-IPO review of the Group's governance arrangements.

Its aims were to clarify and simplify the governance framework, so as to help improve our day-to-day business operations while maintaining appropriate controls.

As a result of the review, we have re-engineered the High Level Controls and System of Governance Document, Enterprise-wide Risk Management Framework, Group Policies and Minimum Standards to remove unnecessary content, close gaps, reduce duplication and give greater focus and accountability to each element. Further details are provided in this report on page 60.

Consequently, individual components of the governance framework are now more clearly articulated and aligned to the expectations of the Board. The framework as a whole is considered fit for purpose to support our strategic priorities as a dynamic retail general insurance business, rather than as a division within a large bank.

I believe that this exercise will increase ownership and oversight and that our governance arrangements have become more transparent and effective.

Diversity

We are strongly committed to the merits of diversity at Board level and throughout the Group. 33% of the Board are women and we are keen to maintain this representation at around the current level. During the year, the proportion of women on the Executive Committee increased from 10% to 20% – that is, two women on a Committee of 10, namely Sara Gomez, Group Human Resources Director, and Angela Morrison, Chief Information Officer.

Board effectiveness review

Our intended practice is to conduct a thorough review of the effectiveness of the performance of the Directors, the Board as a whole and its committees on an annual basis, with the input of an external facilitator at least once every three years.

Given that the Board was largely new to the Company last year in the run up to the IPO, I felt it was appropriate to assess its performance at the same time as reviewing the main elements of the Company's governance architecture. Accordingly, the Company appointed Edis-Bates Associates to assist us as independent external facilitators. A description of the process and the findings of the evaluation are set out on page 63.

Michael N Biggs, Chairman
25 February 2014

Take ownership
Treat it like it's OUR business; take the initiative, if you can see a better way, go make a difference; take decisions, be accountable for your actions in whatever role you carry out; take responsibility for your own personal development and performance.

Say it like it is
Be real, authentic and true to self; have adult to adult conversations with all audiences; listen, seek to understand and respect diversity of views; be open, call out issues we see; share information and keep things as simple as possible.

Bring all of yourself to work
Be the best you can be, the real and whole you; celebrate our diversity of skills, experiences and personalities; be a role model to others, demonstrate 'can do' spirit, have fun and make this a great place to be; be excited about our Company and our future; believe in yourself, feel confident and empowered.

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 over 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 latterly the Chairman of Resolution Limited until May 2013 when he stepped down following the combination of the boards of Resolution Limited and Friends Life Group. 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 61.

External appointments

None

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 44.

External appointments

Paul is a member of the ABI Board, a member of the FOS's insurance industry steering group, and a member of the FCA 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 an Executive Director at the Co-operative Insurance Society, CIS General Insurance and The Co-operative Bank. He was Chief Financial Officer of these businesses between 2003 and 2007, and subsequently Managing Director, Corporate and Markets. Prior to that, John spent more than 20 years in investment banking with UBS and Goldman Sachs. John is an Economics graduate of the University of Cambridge. John is 57.

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, I, N and +)

Senior Independent Non-Executive Director

Appointment

Glyn joined the Board in September 2012 and is Chair of the Investment Committee.

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 61.

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 rejoined the Board in October 2013, having previously served as a Non-Executive Director of the Company from September 2012 to April 2013.

Experience and qualifications

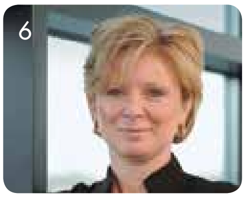
Mark rejoined the RBS Group in August 2007 as a Managing Director in corporate banking, having previously worked for NatWest. Prior to joining the RBS Group, Mark was a Senior Executive at Barclays from 2001 to 2007, responsible for a number of its clients and product businesses, and in the latter period as Managing Director in European investment banking and debt capital markets at Barclays. Mark is an Associate of the Chartered Institute of Bankers and Association of Corporate Treasurers. Mark is 47.

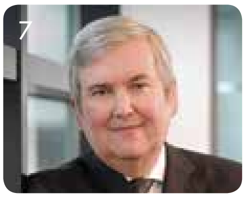
External appointments

Mark sits on the RBS Group management committee and is Chief Executive Officer of UK Corporate and Institutional Banking at RBS, a position he has held since 2008.

Key strengths and contribution

Mark is a Non-Executive Director nominated by RBS Group. He has over 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 Director responsible for delivery of corporate governance, internal audit and risk management services in the North of England. Jane has also held executive roles including 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 46.

External appointments
Jane is Chair of the Audit and Risk Committee and Non-Executive Director at Reclaim Fund Ltd and Chair of the Board Risk Committee and Non-Executive Director of Old Mutual Wealth Management Limited. She is an Independent Member of the Fairness Committee at ReAssure Ltd. 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.

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 Accountants in England and Wales. Andrew is 60.

External appointments
Andrew resigned from his position as Senior Independent Director of Segro plc, the British and European Industrial Real Estate Investment Trust Company in April 2013. Andrew continues to hold a number of external positions. He is a Trustee of the Royal School of Needlework, a Trustee and Treasurer of Cancer Research UK, a Non-Executive Director of Royal London Mutual Insurance Society Limited and a member of the Financial Reporting Review Panel of the Financial Reporting Council ("**FRC**").

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 FRC. Accordingly, he is able to advise the Group on its governance framework and financial reporting policies and can draw on his experience in the insurance sector.

8 Clare Thompson (A, B, C, I, 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 59.

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 56.

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.

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

"Bringing a single, clear and consistent voice to what we say to all audiences, saving time and aiming to prove the shared interests of our customers, our people and our shareholders"

Appointment

Rob joined as Director of Communications in February 2012.

Experience and qualifications

Rob has 20 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

"Targeting the delivery of core corporate growth and profit as well as aiming to deliver a sustained increase in shareholder value"

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, 24 years in the insurance industry with AIG, Churchill and Direct Line and six years in other industries.

3 Darrell Evans

Chief Customer Officer

"Aiming to improve our customer experience across all our channels, by making it easy for our customers to do business with us"

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 Sara Gomez

Group Human Resources Director

"Ensuring that we have capable and engaged people to deliver the business strategy, both now and in the future"

Appointment

Sara joined the Group in March 2007 and became Group Human Resources Director in May 2013.

Experience and qualifications

Previously, Sara worked in a number of different industries from retail, to travel to financial services, including M&S, TUI and RBS/Direct Line Group. The early part of her career was in commercial and sales management, giving a broad general management and leadership background. She worked in management development culminating in a role as Head of Learning for First Choice Holidays. In 2008, she moved into generalist HR and her route to her current role has been through HR Business Partnering in a wide range of functions within Direct Line Group.

5 Jonathan Greenwood

Managing Director of Commercial

"Focusing on the micro and SME sector, where we have a long history, allows us to leverage Group assets such as geospatial risk mapping and the claims systems and processes"

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 Building Society, later HBOS, where he held a variety of senior product and operational roles in the general insurance division.

6 Steve Maddock

Managing Director of Claims and Business Services

"Aiming to achieve upper quartile claims cost performance and maximise value for our shareholders, while providing exceptional service to our customers"

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.

7 Angela Morrison

Chief Information Officer

"Providing a value driven, easy and reliable experience for our customers and employees, which meets their ever increasing digital needs within a clear regulatory framework"

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

"Providing governance, company secretarial, legal risk management and other legal advice and services to the Board, the Executive and the Group"

Appointment

Humphrey joined the Group in November 2011.

Experience and qualifications

Humphrey is a solicitor with over 20 years' experience including advising on corporate and commercial matters, a wide range of corporate transactions in the UK and internationally, legal risk management and corporate governance issues, with RSA, 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

"Continuing to provide risk management leadership to support strong commercial performance and good customer outcomes"

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

"Continuing to drive improved value from our UK personal lines' franchise, meeting the needs of, and deepening relationships with, our customers"

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 was elected President of the Chartered Insurance Institute in July 2013 and is a member of the ABI General Insurance Committee. 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, where he was a Fulbright Scholar.

The UK Corporate Governance Code

The following report details how the Board has applied the principles and provisions in the FRC's UK Corporate Governance Code 2012 (the "**Code**") as required by the UK Listing Rules. See also the statement on page 100 of the Directors' report.

Throughout the year, Direct Line Insurance Group plc (the "**Company**") has complied with the principles and provisions of the Code. A copy of the Code is available from www.frc.org.uk .

Leadership

The role of 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 shareholders as a whole. It has oversight of the Group's operations, ensuring it is effectively managed and that there are appropriate controls in place to assess and manage the Group's risks.

The Board has set the Group's strategy of continuing on the transformation path required to bring us closer to our ambition to be Britain's best retail general insurer. Set out on page 58 are the Board's objectives for 2013, the actions the Board has undertaken during the year and our objectives for 2014.

The specific duties of the Board are clearly set out in the Schedule of Matters Reserved to the Board (the "**Schedule**") within the Board's terms of reference. The Schedule lists those items that are specifically reserved for consideration and decision by the Board. These include:

- the establishment of the Group's strategy and oversight of the business and affairs of the Group;
- the raising and allocation of capital;
- setting the Group's risk appetite;
- ensuring the maintenance of a sound system of internal control and risk management;
- approval and oversight over execution and delivery of major capital projects, contracts which are material strategically and major investments;
- communication and meetings with shareholders;
- changes to the structure, size and composition of the Board and Board Committees, following recommendations from the Nomination Committee;
- determining the remuneration policy for Directors and Senior Executives and the introduction of new share incentive plans or major changes to existing plans;
- delegation of authority;
- corporate governance matters; and
- approval of formal Group policies.

The Board is the main decision-making forum for the Group.

Division of responsibilities

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 approved by the Board on 21 September 2012.

The Chairman's responsibility is to provide leadership of the Board and ensure its effectiveness, whilst the Chief Executive Officer develops and delivers the Group's strategy within the policies and values established by the Board.

The Non-Executive Directors provide constructive challenge and help to develop proposals on strategy.

In addition, the Senior Independent Director's role is to provide a sounding board for the Chairman and to serve as an intermediary for the other Directors when necessary. His responsibilities include the evaluation of the performance of the Chairman and he is also available as an additional point of contact for shareholders.

The Board of 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 one non-independent Non-Executive Director, Mark Catton. Mark Catton is not an independent Non-Executive Director under the Code by virtue of being nominated by The Royal Bank of Scotland Group plc. However, he demonstrates a level of independent challenge at Board meetings, which has led the Nomination Committee to determine that he is independent in character and judgement.

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 52 to 53.

There were no new appointments during the year; however, Mark Catton resigned from the Board in April 2013 and re-joined the Board in October 2013 when Bruce Van Saun resigned. The respective dates are shown in the notes to the table opposite.

Meetings of the Board

The Board met regularly during 2013; no further ad hoc meetings were required in addition to the 11 scheduled meetings. The Directors received Board papers and had the opportunity to comment on them in advance. Details of attendance at Board and Board Committee meetings by Directors during the year are set out below and on pages 65 to 74.

	Scheduled meetings[1]
Chairman	
Mike Biggs	11 of 11
Senior Independent Non-Executive Director	
Glyn Jones[4]	10 of 11
Non-Executive Directors	
Mark Catton[2]	8 of 8
Jane Hanson[4]	10 of 11
Andrew Palmer	11 of 11
Clare Thompson	11 of 11
Priscilla Vacassin	11 of 11
Bruce Van Saun[3,4]	7 of 8
Executive Directors	
Paul Geddes	11 of 11
John Reizenstein	11 of 11

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. Mark Catton resigned as a Director of the Board on 26 April 2013 and rejoined the Board on 1 October 2013.
3. Bruce Van Saun resigned as a Director of the Board on 1 October 2013.
4. Glyn Jones, Jane Hanson and Bruce Van Saun were each unable to attend a scheduled Board meeting during 2013 due to other commitments.

The Board programme for 2013, achievements and objectives for 2014

What did the Board say it would do?	What has the Board overseen, challenged and supported?	What will the Board focus on?
Our objectives for 2013	Highlights of 2013	Our objectives for 2014
• Support the vision of becoming Britain's best retail general insurer	• Continued oversight of the development of claims capability, including the roll-out of initiatives to Home and approved the establishment of DLG Legal Services • Approved the Group's commercial strategy and received regular progress reports from each of the principal businesses • Considered capital management policy • Approved capital allocation to the Group's investment strategy • Considered the technology environment in which the Group operates • Considered the impact of emerging global economic conditions, regulatory developments and the outlook for the industry • Considered and approved the sale of the Life business	• Continue to pursue improvements in our claims and pricing capabilities • Consider the strategic development of Commercial and International in the context of the Group's RoTE target • Oversee the substantial migration of Direct Line Group's IT infrastructure away from RBS Group • Monitor change from regulatory, legal and market pressures facing the industry and mitigate against potential risk of adverse reserve development • Monitor implementation of the Group's transformation plan • Review the appropriateness of the Group's capital basis in the context of the current environment
• Oversee the Group's progress in pursuit of its targets, including those relating to COR and RoTE	• Oversaw the £100 million cost transformation plan delivered by management • Supported decisions enabling COR and RoTE targets to be met	• Oversee the Group's pursuit of its strategic objectives • Oversee the Group's total cost base[1] reduction to approximately £1,000 million in 2014
• Set the tone and culture of the Group, focusing on behaviours to help achieve the strategic objectives • Review the Board's policy on gender diversity to consider how more women can be promoted to senior and executive management roles	• Reviewed the results of an Employee Opinion Survey and challenged management on the actions to be taken • Considered the means by which cultural indicators can be measured and improved • Board at 33% women	• Oversee programmes to invest in the Group's people and culture
• Give our customers fair outcomes	• Oversaw new customer propositions, including the launch of telematics products in June • Approved the next phase of the Group's transformation plan, in particular, focusing on customer facing systems • Considered metrics to show performance for customers • Supported the ABI's negotiations with Government to create a not-for-profit fund to insure the highest flood risk properties in the UK	• Promote a focus on better customer experience • Introduce new customer metrics
• Review the main elements of governance architecture to ensure that they are fit for purpose for the newly listed entity	• Reviewed and sharpened the Group's corporate governance arrangements • Reviewed the Group's risk appetite statements	• Embedding the corporate governance arrangements of the Group
• Conduct a full Board evaluation, since the Board will have been in place for sufficient time to make such a review appropriate	• Undertook a performance evaluation of the Board and its Committees and reviews of the Matters Reserved to the Board and Committees' terms of reference	

Note:
1. See note 2 on page 2

Board Committees

The Board has established its Committees to assist it in meeting its responsibilities. Each Committee plays a vital role in ensuring that the Board operates efficiently and gives appropriate consideration to matters. The governance structure illustrating the relationship between the Board and its Committees is set out below. The composition, attendance, role and focus of each Committee are set out on pages 65 to 74.

The Board and Committee governance structure

Authority delegated to the Chief Executive Officer

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.

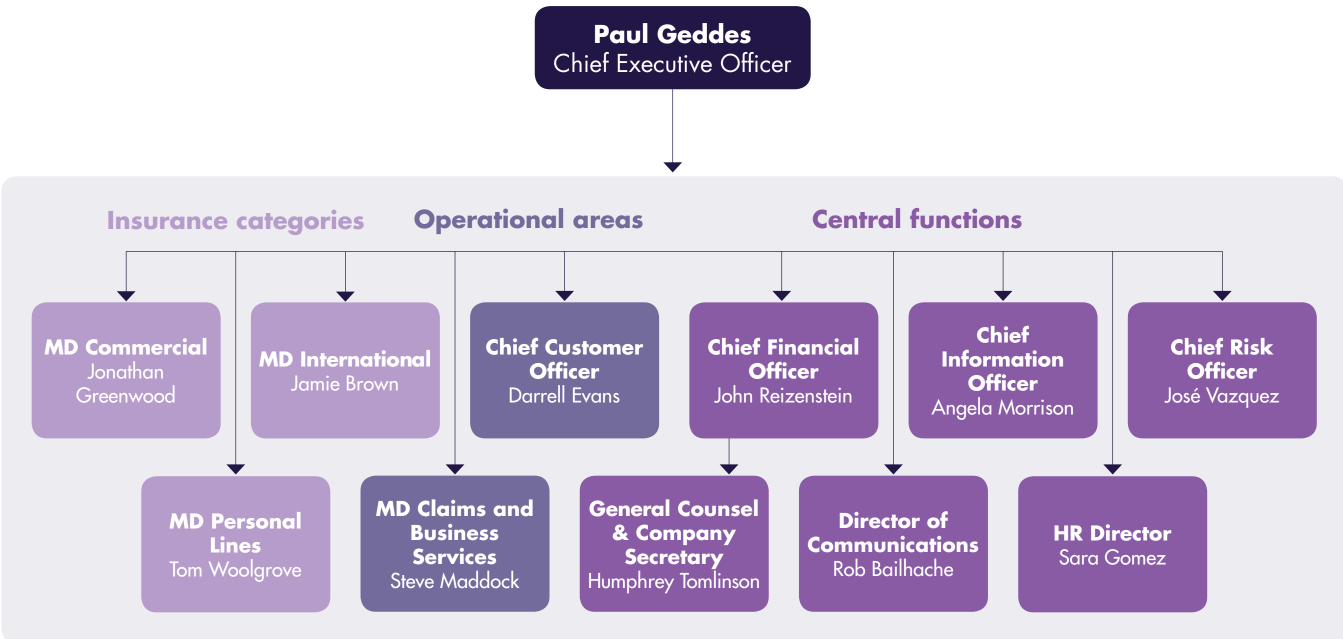
Paul Geddes and these senior executives are supported by the functional departments of the Group.

Executive Committee

The Executive Committee is the principal management committee that assists the Chief Executive Officer in the day-to-day management of the Group 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 meet 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.

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

Direct Line Group's Executive Committee



Governance review

During 2013, the Board oversaw a review of the governance framework within which the Group operates, taking into account that the Company had listed on the London Stock Exchange and the shareholdings in the Company by RBS Group had decreased significantly.

Whilst this review confirmed that the Group's governance framework dealt with such areas as would be expected and necessary, nonetheless the opportunity was taken to improve the control environment whilst making its administration and operation more transparent and cost effective.

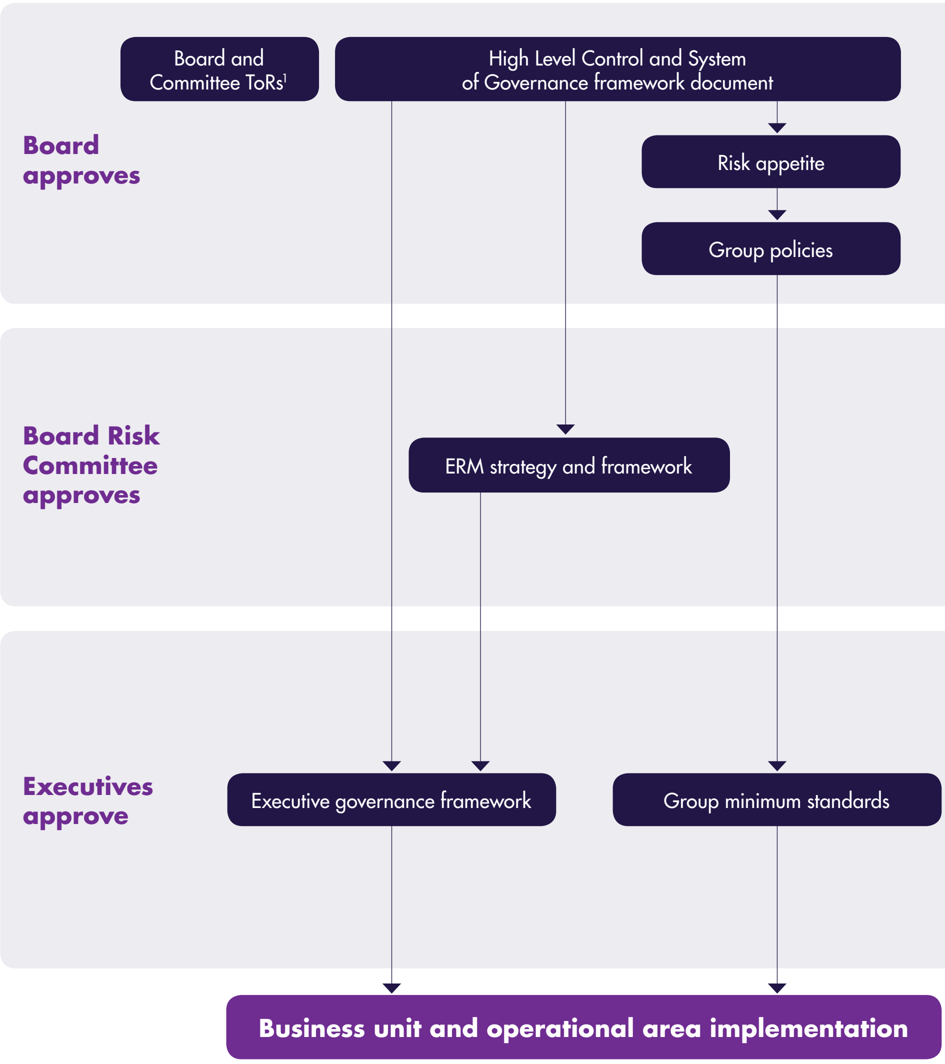
The review covered the entire Group and was primarily led by the Company Secretariat, Legal and Risk functions.

The overall objective of the project was to clarify and simplify the Group's governance framework in order to help and improve its day-to-day operation whilst maintaining appropriate controls.

The review resulted in a significant revision to the High Level Controls and System of Governance Document, the creation of an Enterprise-wide Risk Management framework and an Executive Governance framework. In addition Policies and Minimum Standards were revised and clarified and various business and project approval processes and procedures were also reviewed in conjunction with the Delegated Authority framework.

The diagram below summarises the split of responsibilities for the different aspects of the governance framework.

Direct Line Group overall governance and policy framework



Board

High Level Governance framework, risk appetite and Group policies are set by the Board, following review by the Board Risk Committee, for implementation by the Executive.

Board Risk Committee

Enterprise-wide risk management framework approved by the Board Risk Committee, following review by the Risk Management Committee. Policies are drafted by Executive policy owners.

Risk Management Committee

Developed by Executives with the framework approved by the Board. Minimum standards are drafted by the Group's minimum standard owners. Review by the policy and minimum standard owners review forum. Approved by Executives via the Risk Management Committee.

Note:
1. Terms of reference

Board effectiveness

Structure of the Board

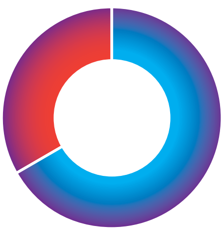
As part of the process of helping to ensure a Code-compliant Board, the Company focused on obtaining the elements considered necessary to maximise the Board's effectiveness. Consequently, the Board and its Committees have been constructed with a view to ensuring that an appropriate balance of skills, 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 "Appointment of Directors" for the desired attributes of our Directors and a description of the selection process.

In addition, the Company employs a 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 General Counsel and Company Secretary and regularly reviewed by the Board. Mark Catton is a non-independent Non-Executive Director by virtue of being nominated for appointment to the Board by RBS Group, the Company's largest 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 has reduced its shareholding in the Group to 28.5% and must divest its entire interest by the end of 2014.

Gender diversity of Board members



Balance of Board members

Appointment of Directors

The Company did not appoint any new members to the Board in 2013 as all Non-Executive Directors were appointed very recently. Mark Catton, who had been a Non-Executive Director until April, re-joined the Board as the nominated Director of RBS Group upon the resignation of RBS Group's nominated Director Bruce Van Saun. The Group's key competencies for Board members are as follows:

Experience

- Significant Board experience in major listed businesses (perceived as advantageous)
- Extensive knowledge and operational experience in insurance at a senior level (perceived as advantageous)
- 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 his or her 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 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.

Duration of appointment

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, the 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 Directors will be subject to re-election by shareholders at our Annual General Meeting ("**AGM**") on 15 May 2014.

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.

Commitment from Board members

All our Directors, including the Chairman, have indicated that they are able to allocate sufficient time to the work of the Group to enable them to discharge their respective duties and responsibilities effectively. Directors' appointment letters contain a provision to this effect.

Our Directors have had a considerable workload during 2013 and showed great commitment to meeting the requirements of the business in a year of transformation. In all, 11 Board meetings were held during the year, all of which were scheduled meetings.

Board induction

On appointment, each Director takes part in a tailored induction programme, which is designed to give him or her an understanding of the Company's business, governance and shareholders. Mark Catton resigned as Non-Executive Director in April 2013 and was subsequently re-appointed in October 2013. As there was only a short time between his resignation and re-appointment, it was not considered necessary for Mark Catton to undergo an additional induction programme on his re-appointment.

Resources and training provided to the Board

The Chairman, with the aid of the Company Secretary, ensures that the Board is kept abreast of any changes in the legal and regulatory environment in which the business operates. 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 received training and education to help them understand their duties, responsibilities and develop knowledge of the business as quickly as possible. These sessions were developed to supplement the comprehensive technical acclimatisation programme conducted in 2012 and specifically to meet the needs of the Directors, with individual Directors provided with bespoke training, as indicated in the following diagram.

Our 2013 training and education programme included

Internal sessions focusing on the following topics

- Strategy and change
- Risk appetite, compliance risk and capital management
- Capital modelling, ICAS+ and Solvency II
- Pricing conduct
- Engagement and culture within the workforce
- Periodic payment orders
- Telematics

Site visits

- Bristol – customer relations, telephony trading operations, business support, commercial
- Bromley – the impact of digital technology
- Glasgow – fraud, home claims, field force technology
- Italy and Germany – International market overview, international operations, international strategy, international risk, legal and compliance
- Leeds – customer relations, complaint management, claims and call centre handling

External training sessions

- Accounting and corporate governance developments
- Home and motor insurance markets – overview including regulatory reforms

30 During the year in excess of 30 training sessions, including site visits and Internal sessions on the Group's divisions and functions, were held. In addition, the Non-Executive Directors had a number of meetings with members of the Executive committee throughout the year.

Board effectiveness review

Review of the effectiveness of the Board and its Committees

We conducted our first Board effectiveness review in 2013 to evaluate the effectiveness of the Board, its six committees and individual Directors. The evaluation process was initiated by the Chairman and facilitated by Edis-Bates Associates Limited, an independent corporate governance consultancy, with no other connection with the Company.

Each of the Company's Executive and Non-Executive Directors, together with the General Counsel and Company Secretary, participated in the effectiveness review process, which involved questionnaires, one-to-one interviews and a review of Board processes.

The process took place between September and December 2013. The review of the Board included:

- the role of the Board (including Directors' input into group strategy and risk management);
- information provided to Directors (including induction, continuing professional development and familiarity with group businesses);
- people issues (including Directors' skills, Board and committee composition, diversity, succession planning and time commitment); and
- Board environment and processes (including working relationships, Board papers and Board support).

Similar themes were raised in relation to the Board's committees, as well as committee-specific questions.

Following the conclusion of the evaluation process, the responses and comments were analysed and summarised in a report. The report was discussed initially with the Chairman and then circulated to the full Board. The report concluded that the Board is operating effectively.

The Chairman held one-to-one meetings with each of the other Directors, providing them with feedback on their performance and contributions. Feedback on his own performance and contribution was provided by the Senior Independent Director, who had previously held discussions with the remaining Non-Executive Directors.

Based on the Board effectiveness review report, the Directors are satisfied that the Board has operated effectively during 2013. The Board considered the review in the December Board meeting and matters arising from the report will be further considered and where appropriate actions will be implemented in 2014.

Direct Line Group's approach to diversity

The Board carefully considered the diversity of its 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 Group deliver its strategy.

As the composition of the Board shows, with three of its nine members being women, the Company is committed to the merits of diversity. However, whilst the Board will take care to consider gender diversity of its members when selecting new members, it is committed to appointing the most appropriate candidate and therefore no targets have been set against which to report.

To improve the governance of our gender-diversity programme, the Company has 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. Further information regarding this diversity policy may be found in the Nomination Committee report on page 72.

Also, the Corporate Social Responsibility Committee considers 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. Numerical data relating to the gender diversity of the Board, senior managers and the employees may be found on page 47.

Accountability

Financial and business reporting

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 103. The statement by our auditors explaining their responsibilities is on page 107.

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 is included within the business model on page 6 and the strategy for delivering Company objectives on page 18;
- how the Board has concluded that the business remains a going concern is discussed on page 102;
- the arrangements established by the Board for the application of risk management and internal control principles are detailed below; and
- the Board has delegated to the Audit Committee oversight of the management of the relationship with the Company's auditors. The Audit Committee report on page 65 provides details of its role, activities and relationship with the internal and external auditors.

Risk management and internal control system

The Board acknowledges that 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 Group, whose assertions are independently challenged by the 2nd line of defence and 3rd line of defence.

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.

Internal systems of control

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 divisions 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 Group 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 Audit Committee, on behalf of the Board, regularly reviews the effectiveness of the Group internal control systems. Its monitoring covers all material controls, based principally on reviewing reports from management, the Group Audit function and external auditors, so that it may consider how to manage or mitigate risk in line with the Group's risk strategy. The Committee did not identify or report any serious failings or weaknesses to the Board in 2013.

Remuneration

The Board has delegated responsibility to the Remuneration Committee for the remuneration arrangements of the Executive Directors and senior executives of the Group. Please refer to the Directors' remuneration report on page 76.

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 and regulatory reporting and other internal controls. The Committee reviews the adequacy and effectiveness of the Group's internal financial controls and internal control systems, as well as the procedures for monitoring their effectiveness. 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

	Scheduled meetings[1]	Ad hoc meetings[1]
Committee Chair		
Andrew Palmer	6 of 6	1 of 1
Non-Executive Directors		
Jane Hanson	6 of 6	1 of 1
Glyn Jones[2]	4 of 6	1 of 1
Clare Thompson	6 of 6	1 of 1

Other attendees include

- Chief Executive Officer
- Chief Financial Officer
- Chief Risk Officer
- Group Financial Controller
- General Counsel and Company Secretary
- Group Head of Audit
- External Auditor

Minimum number of meetings per annum

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

What did the Committee say it would do in 2013?

- Provide oversight of the actuarial reporting process; a review of the Group's control environment and processes
- Provide oversight of the Group Audit programme of activity to ensure that Group Audit continues to meet the expectations of the Board and satisfy emerging regulatory and industry standards for internal audit
- Ensure the provision of training and development within the Group, particularly in relation to new legislation and regulation

What have we achieved?

- Reviewed the interim report for the half year ended 30 June 2013 issued in August and the interim management statements issued in May and November
- Reviewed the draft preliminary statement and draft Annual Report & Accounts for the year ended 31 December 2013, with particular focus on accounting policies and critical estimates and judgements to confirm that it is fair, balanced and understandable
- Reviewed a number of specific items including:
  - an update on flood insurance;
  - the planned migration of the Group's IT systems from RBS Group;
  - a consultation with the Chartered Institute of Internal Auditors on the role of Internal Audit functions;
  - reserving policy;
  - updates on the tender process relating to the appointment of external actuaries; and
  - the financial reporting control framework in a non-US Sarbanes Oxley ("**SOX**") environment following separation from RBS Group.
- Agreed the scope of the audit work to be undertaken by the external auditor and Group Audit
- Considered the adequacy of the resources available to Group Audit and the results of the effectiveness review of the function and concluded that they were adequate
- Monitored Group 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 external auditors and Group Audit and noted mitigating actions proposed by management where required
- Monitored key control issues reported by Group Audit on a quarterly basis with the aim of ensuring the Group's risk exposure is properly mitigated
- 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

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. Glyn Jones was unable to attend two scheduled Audit Committee meeting due to other commitments.

- Monitored the Group's compliance with statutory and regulatory requirements and made recommendations within the scope of the Committee's terms of reference
- Reviewed the appropriateness of all accounting policies including revenue recognition and those in relation to significant areas pertinent to changes taking place in the business, including provisions for restructuring costs
- Assessed the external auditor's performance
- As part of the annual review, the Committee recommended to the Board revisions to its terms of reference
- Considered the ability of the Company and its principal subsidiaries to operate on a going concern basis
- Reviewed the draft Audit Committee report for inclusion in the Annual Report & Accounts for the year ending 31 December 2013

What will we be focusing on in 2014?

In addition to its regular monitoring, challenge and oversight responsibilities, the focus for the Committee in 2014 is expected to include the following:

- Considering the impact of ongoing regulatory changes on the assumptions and judgements used in our reserves and in our reporting
- Providing oversight to ensure that the control environment for financial reporting is not impacted by the migration of our underlying systems
- Ensuring Group Audit adopts industry best practice in line with recently published guidance
- Overseeing the enhancement in the process for setting reserve margins
- Considering the potential rotation of the auditor

Frequency of meetings

During 2013, the Committee met on seven occasions, six of which were scheduled meetings, and one was an ad hoc meeting. The members' attendance record is set out on the previous page.

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 scheduled meeting of the Board on the Committee's work.

Financial reporting control framework

RBS Group's shareholding in the Company fell to below 50% in March 2013. Prior to this, the Group had been operating a formal financial control framework including identification, cataloguing and testing of controls in line with requirements set out by SOX legislation. Following divestment, this no longer applied to the Group. However, as good governance practice, the Group has continued to adopt the embedded features of the existing SOX framework, albeit tailored to respond to the changes in the business control environment.

In formulating the approach for the new framework, the principles from the Committee of Sponsoring Organizations of the Treadway Commission framework have been followed. The approach aligns with our existing operational risk framework with assurance work undertaken across the business focusing on our key financial reporting controls. Reports are presented to the Committee every six months highlighting any deficiencies and mitigating action required.

Internal control

Group Audit carries out independent internal audit work.

The Group Head of Audit reports to the Chair of the Audit Committee and has functional reporting to the Chief Financial Officer.

Group Audit 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 64.

The key control issues that Group Audit reports to management and to the Committee are monitored on a quarterly basis with the aim of ensuring the related risk exposures have been properly mitigated.

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 and external actuarial review. Consultants appointed to provide validation of actuarial reviews are subject to approval by the Committee. During the year, an open tender process was conducted and the Committee approved the appointment of a professional services company to carry out the external actuarial review for the year ended 31 December 2013.

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.

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 and risk management 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.

Financial reporting

The review process undertaken by the Committee prior to the publication of the Group's financial statements focuses on the Group's 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.

In addition to the focus on matters relating to reserving, issues considered by the Committee in 2013 and the judgements that were made included:

- the overall presentation of the financial statements to ensure fairness and balance and, in particular, the presentation of adjusted performance, including the appropriateness of restructuring and other one-off costs;
- reports on the assumptions underlying the provisions made for redundancy and onerous leases;
- the assessments made for goodwill impairment and confirmed the carrying value remained supportable;
- the judgements made in respect of tax, in particular the carrying value of any deferred tax assets and liabilities recognised; and
- the carrying value of the investments held by the Group and the need for any impairment provisions.

External audit

The Committee plays a key role in managing the relationship with the Group's external auditor, Deloitte LLP. The external auditor provides some non-audit services, primarily in the provision of audit-related assurance services. 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 the Group's external auditor are closely monitored:

- the Committee formally approves a list of audit and non-audit services 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 Chair of the Committee approves non-audit services costing less than £100,000, while the Committee approves services costing £100,000 or more; and
- the Committee receives an annual report on all services provided during the year and their related costs.

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

The key issues and areas of focus during 2013

The external auditor provided updates to the Committee on the following key issues during 2013:

- reserve valuation;
- investment valuation;
- reinsurance asset valuation;
- revenue recognition;
- transformation projects; and
- planned migration of the Group's IT systems to the Capgemini platform.

Fees payable to the auditor

During the year ended 31 December 2013, Deloitte LLP's fees for audit services and other services supplied were £2.2 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 Committee approved fees of £0.1 million payable to Deloitte LLP for services not related to audit work, which accounted for 4.5% of total fees paid to the external auditor in the year.

A breakdown of fees paid to the auditor for the year ended 31 December 2013 is set out below:

Total fees for audit and other services	£2.2 million	
Audit fees	£2.1 million	95.5%
Non-audit fees	£0.1 million	4.5%

The non-audit fees of £0.1 million related to audit-related assurance services.

The Committee and Board remain 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 auditor is assessed every year, including its independence and objectivity and the effectiveness of the external audit process. The effectiveness review includes regular questioning of the external auditor during Committee meetings.

The Committee reviews the external audit plan 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, the external auditor, has been the Group's auditor since 2000. Prior to listing in 2012, the Group was audited as a division of RBS Group.

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 15 May 2014.

The new UK Corporate Governance Code requires FTSE 350 companies to put the audit services contract out to tender at least once every 10 years, to enable the Committee to compare the quality and effectiveness of the services provided by the incumbent auditor with those of other audit firms. Transitional arrangements provided by the Financial Reporting Council ("**FRC**") indicate the Company should tender the audit, at the latest, at the time of the next audit partner rotation. The latter is currently scheduled following the 2015 year end.

We may, however, put the audit out to tender at any time before this date. There are no contractual obligations restricting our choice of external auditor and no auditor liability agreement has been entered into. Equally, any recommendation to re-appoint Deloitte LLP as auditor of the Company is dependent on continued satisfactory performance.

Evaluation of the Committee

The annual evaluation of the Committee's effectiveness was initiated by the Chairman of the Board and undertaken by Edis-Bates Associates, as external facilitators. The evaluation concluded that the Committee continued to operate effectively, and the Committee will consider the results and recommended actions resulting from the evaluation in 2014. Further details of the effectiveness review can be found on page 63.

This report was reviewed and approved by the Board on 25 February 2014.

Andrew Palmer

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 recommends risk appetite and tolerance to the Board 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

	Scheduled meetings[1]	Ad hoc meetings[1,2]
Committee Chair		
Jane Hanson	6 of 6	3 of 3
Non-Executive Directors		
Andrew Palmer	6 of 6	3 of 3
Clare Thompson	6 of 6	3 of 3
Priscilla Vacassin	6 of 6	3 of 3

Other attendees include

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

Minimum number of meetings per annum

The Committee meets at least four times a year at appropriate times in the risk and regulatory reporting cycle.

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. The Committee met jointly with the Remuneration Committee on 30 September 2013.

What did the Committee say it would do in 2013?

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

What have we achieved?

- Reviewed and challenged the following, receiving reports as standing agenda items:
  - significant risks and any other specific matters regarding the Group's risks, received from the Chief Risk Officer and Risk and Compliance functions;
  - the High Level Controls and System of Governance document;
  - legal and regulatory issues; and
  - whistle-blowing issues, statistics and trends.
- Reviewed the comprehensive Individual Capital Adequacy Standards Plus ("**ICAS+**") submission including the draft in development Own Risk and Solvency Assessment ("**ORSA**")
- Reviewed, challenged and recommended to the Board the high-level risk appetite and the supporting statements
- Considered the results of the stress tests and scenario analysis completed in 2013 and the material risk assessment undertaken by the Risk function
- Received the annual report from the Money Laundering Reporting Officer
- Reviewed and challenged the new Conduct Risk Policy, agreed our Conduct Risk appetite statements and monitored Key Risk Indicators ("**KRIs**")
- Reviewed and recommended the new Compliance, Whistle-blowing and Customer Conduct policies to the Board for approval
- Approved the Risk function's target operating model, adjusted to align with the business transformation plan, and to differentiate clearly between the roles and responsibilities across the three lines of defence model
- Reviewed the Direct Line Group tax strategy for consistency with risk appetite
- Reviewed the governance framework of the Group and in particular the High Level Controls and System of Governance document, which was recommended to the Board and approved
- Reviewed and approved the Enterprise-wide Risk Management ("**ERM**") strategy and framework document
- Reviewed, in conjunction with the Remuneration Committee, the incentive arrangements in the customer facing areas
- As part of the annual review, the Committee recommended to the Board revisions to its terms of reference
- Reviewed the draft risk management report and the Board Risk Committee report for inclusion in the Annual Report & Accounts for the year ending 31 December 2013

What will we be focusing on in 2014?

In addition to its regular monitoring, challenge and oversight responsibilities, the focus for the Committee in 2014 is expected to include the following:

- Guiding the continued development of an embedded risk and control culture which reinforces adaptability, flexibility and improving efficiency, while overseeing alignment of culture to appropriate customer outcomes
- Challenging our level of preparedness for external changes and driving business improvement of processes and frameworks
- Overseeing preparations for changes in market, legal and regulatory environments, including emerging risks, the Group's approach to periodic payment orders and preparations for Solvency II
- Continuing the pro-active governance, oversight and challenge of risk and control across the Group
- In readiness for greater capability in a digital world, overseeing and monitoring processes currently being embedded in the business
- Reviewing and overseeing operational risk management in the context of significant change programmes
- Overseeing a review of the maturity and effectiveness of the Risk Management Committee

Evaluation of the Committee

The annual evaluation of the Committee's effectiveness was initiated by the Chairman of the Board and undertaken by Edis-Bates Associates, as external facilitators. The evaluation concluded that the Committee continued to operate effectively, and the Committee will consider the results and recommended actions resulting from the evaluation in 2014. Further details of the effectiveness review can be found on page 63.

This report was reviewed and approved by the Board on 25 February 2014.

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 Committee is to ensure that the 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 charitable donations and community involvement.

Membership and attendance

	Scheduled meetings[1]	Ad hoc meetings[1]
Committee Chair		
Jane Hanson	4 of 4	1 of 1
Committee members		
Paul Geddes	4 of 4	1 of 1
Clare Thompson	4 of 4	1 of 1
Tom Woolgrove	4 of 4	1 of 1

Other attendees include

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

Minimum number of meetings per annum

The Committee meets at least four times a year.

What did the Committee say it would do in 2013?

- Review the Group's overall Corporate Social Responsibility ("**CSR**") strategy, measures, policies and compliance
- Review performance and priorities against both internal targets and relevant external benchmarking indices
- Review the extent, effectiveness and transparency of external reporting
- Consider and recommend the Group's positioning on relevant emerging CSR issues
- Oversee the Group's compliance with its health and safety statutory and regulatory requirements and overseeing the embedding of a health and safety culture across the Group

Note:

1. Attendance is expressed as the number of meetings attended out of the number of meetings possible or applicable for the Director to attend.

What have we achieved?

- Scrutinised and challenged standing reports relating to key focus areas of the Committee as follows:
  - priorities and targets on key CSR matters;
  - health and safety, including consideration of updates on the 2013 plan, health & safety 'dashboards' detailing performance against plan and compliance with policies and procedures;
  - workplace policies and engagement; and
  - community engagement activities.
- Monitored progress by Human Resources and the employee network, Diversity Network Alliance, in achieving the key objectives of raising diversity awareness through training, and collecting management information
- Performed the annual review of relevant Direct Line Group policies and procedures and oversaw compliance with them
- Analysed and set the Health & Safety plan for 2014
- Determined the Group's position on emerging CSR issues
- Agreed the Group's approach to responsible investment and identified activities to support our CSR strategy
- Discussed and agreed the 2014 CSR strategy and sustainability targets
- As part of the annual review, the Committee recommended to the Board revisions to its terms of reference
- Reviewed the draft Corporate Social Responsibility report and the Corporate Social Responsibility Committee report for inclusion in the Annual Report & Accounts for the year ending 31 December 2013

What will we be focusing on in 2014?

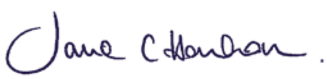
In addition to its regular monitoring, challenge and oversight responsibilities, the focus for the Committee in 2014 is expected to include the following:

- Sustaining and measuring the Group's CSR progress and impact, continuing to embed CSR into our business strategy and operations
- Engaging with external stakeholders, to shape our future CSR strategy and identifying emerging issues
- Reviewing and recommending the 2015 CSR strategy, plan and targets
- Reviewing the effectiveness of the Group's CSR communications
- Encouraging employee engagement in CSR and community programmes

Evaluation of the Committee

The annual evaluation of the Committee's effectiveness was initiated by the Chairman of the Board and undertaken by Edis-Bates Associates, as external facilitators. The evaluation concluded that the Committee continued to operate effectively, and the Committee will consider the results and recommended actions resulting from the evaluation in 2014. Further details of the effectiveness review can be found on page 63.

This report was reviewed and approved by the Board on 25 February 2014.



Jane Hanson, Chair of the Corporate Social Responsibility Committee

Investment Committee report

Glyn Jones, Chair of the Investment Committee

Role and focus

The role of the Investment Committee is to oversee the management and performance of the investment strategy of the Group.

Membership and attendance

	Scheduled meetings[1]	Ad hoc meetings[1]
Committee Chairs		
Andrew Palmer[2]	3 of 3	1 of 1
Glyn Jones[3,5]	3 of 3	–
Committee members		
Jane Hanson	3 of 3	1 of 1
Clare Thompson[4,5]	3 of 3	–

Other attendees include

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

Minimum number of meetings per annum

The Committee meets at least three times a year.

What did the Committee say it would do in 2013?

- Consider changes to the existing asset benchmark composition for the Group's investment portfolio with the aim of improving the expected risk-adjusted returns, taking into account the Group's investment risk appetite set by the Board
- Use the internal capital model to support asset strategy decisions by understanding and monitoring the capital and solvency implications
- Review the liquidity requirements of the business and consider the adequacy of liquidity available to meet such needs from the investment portfolio
- Review the merits of derivative and asset strategies proposed to mitigate risks associated with long-term liabilities
- Monitor the selection and implementation process for any new asset classes approved for the investment portfolio

What have we achieved?

- Reviewed a major asset and liability management study on UK Insurance Limited, particularly in the context of a low interest rate environment. The study used the internal capital model to examine the capital consequences of asset allocations proposed
- Recommended to the Board the inclusion of a new asset class in the U K Insurance Limited investment portfolio and oversaw the subsequent implementation of the asset class into the portfolio
- Determined an appropriate liquidity policy for the investment portfolio and how liquidity needs could continue to be met in a stressed scenario
- Agreed changes to the risk management framework underpinning investment activity, in line with risk appetite set by the Board on the recommendation of the Board Risk Committee
- Considered reports from the Director of Investment Management and Treasury covering, inter alia key market developments, financial performance from investment activity, performance of external fund managers and the custodian, and compliance with risk and exposure limits set
- Agreed oversight and support arrangements in respect of the international businesses regarding treasury and investment activities
- Reviewed the findings and recommendations from the internal audit of the Investment and Treasury function and monitored resolution of the actions arising
- Considered how investment activities should support the Company's corporate social responsibility agenda
- Examined the investment returns forecast for the 2014-2017 period
- As part of the annual review, the Committee recommended to the Board revisions to its terms of reference
- Reviewed members' training requirements for 2014
- Reviewed the draft Investment Committee report for inclusion in the Company's Annual Report & Accounts for the year ended 31 December 2013

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. Andrew Palmer stepped down as Chair of the Committee on 28 March 2013 and remained a member of the Committee.
3. Glyn Jones was appointed a member and Chair of the Committee on 28 March 2013.
4. Clare Thompson was appointed a member of the Committee on 28 March 2013.
5. Glyn Jones and Clare Thompson attended a meeting of the Committee on 14 February 2013 before being appointed members of the Committee.

What will we be focusing on in 2014?

In addition to its regular monitoring, challenge and oversight responsibilities, the focus for the Committee in 2014 is expected to include the following:

- Finalising the appropriate combination of assets and the use of derivatives, if deemed appropriate, to back the Group's long-term liabilities (PPOs) with the benefit of the November 2013 European agreement on Omnibus II (Solvency II)
- Within the Board's risk appetite, seeking to reduce further the excess liquidity above stressed requirements within the U K Insurance Limited portfolio and reinvesting this in assets offering an illiquidity premium and / or better risk adjusted returns
- Monitoring the pace of economic recovery and the tapering of quantitative easing and the resulting impact on interest rates, credit spreads and asset values and then reviewing the implications for the positioning of the Group's investment portfolio
- Receiving an asset and liability management study covering the investment portfolios of the International division

Evaluation of the Committee

The annual evaluation of the Committee's effectiveness was initiated by the Chairman of the Board and undertaken by Edis-Bates Associates, as external facilitators. The evaluation concluded that the Committee continued to operate effectively and the Committee will consider the results and recommended actions resulting from the evaluation in 2014. Further details of the effectiveness review can be found on page 63.

This report was reviewed and approved by the Board on 25 February 2014.

Glyn Jones, 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 and re-appointment of Directors. It also makes 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 and attendance

	Scheduled meeting	Ad hoc meeting[1]
Committee Chair		
Mike Biggs	1 of 1	1 of 1
Non-Executive Directors		
Glyn Jones	1 of 1	1 of 1
Andrew Palmer	1 of 1	1 of 1

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

The Committee meets 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.

Changes to the Board

Mark Catton resigned from the Board on 25 April 2013 when RBS Group reduced its shareholding in Direct Line Group below 50%, whereupon RBS Group's entitlement to nominate Directors under the Relationship Agreement with the Company reduced from two to one. Mr Catton rejoined the Board on 1 October 2013 when Bruce Van Saun resigned in order take up an appointment with RBS Group in America. As RBS Group are entitled to nominate a Director to the Board under the terms of their Relationship Agreement with the Company, it was not appropriate to engage an external search agency nor to use

Note:

1. Attendance is expressed as the number of meetings attended out of the number of meetings possible or applicable for the Director to attend.

open advertising to fill the vacancy on Mr Van Saun's resignation. Mr Catton will step down as a Director when RBS Group's holding in the Company falls below 20%.

Board Appointment and Reappointment Process

No new Directors were appointed during 2013. The Committee does, however, have a pre-established Board appointment process. It includes the use of independent external search consultants, an evaluation of the balance of skills, diversity, independence and knowledge on the Board and establishment of target criteria for the appointment of new Directors. Details of the latter are shown on page 61 of this Report.

In advance of the proposed re-election of Directors at the 2013 AGM, the Committee reviewed the independent status of Non-Executive Directors. It was concluded that Ms Hanson, Mr Jones, Mr Palmer, Ms Thompson and Ms Vacassin were independent within the meaning of the UK Corporate Governance Code. Mr Biggs was independent on his appointment as Chairman. Mr Van Saun and Mr Catton, being RBS Group nominated Directors, did not meet the independence criteria of the Code though both had demonstrated a sufficient level of Board challenge to be considered independent in character and by judgement. Accordingly, it was recommended to the Board and Shareholders that all serving Directors be re-appointed at the 2013 AGM.

Diversity

The Group seeks to hire the best candidates for all positions at all levels throughout the business, irrespective of gender, including candidates at Board level. With three female independent Non-Executive Directors, 33% of the current Board is female, which is a greater percentage than that recommended by the Davies' Report on Boardroom Diversity. However, both the Nomination Committee and Board recognise the benefits of gender diversity and will ensure that this is taken into account when considering any particular appointment. Accordingly, this is embedded in the Nomination Committee's terms of reference. Work on encouraging the promotion of women to senior and executive management roles within the business will continue.

Please refer to page 63 for the Group's approach to diversity, including gender diversity.

Terms of reference

As part of the annual review, the Committee recommended to the Board revisions to its terms of reference.

Evaluation of the Committee

The annual evaluation of the Committee's effectiveness was initiated by me as Chairman, and undertaken by Edis-Bates Associates as external facilitators. The evaluation concluded that the Committee has not since the IPO had to deal with the usual workload of such a committee, given the short period since the IPO. In addition, the only changes to the Board in 2013 were changes to the RBS Group-nominated Directors, which RBS Group was entitled to do pursuant to the Relationship Agreement between RBS Group and the Company. One of the actions arising from the Nomination Committee performance evaluation was the need for greater focus on succession planning, which has been incorporated in the Committee's forward agenda for 2014.

This report was reviewed and approved by the Board on 25 February 2014.

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 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[1,2]
Committee Chair		
Priscilla Vacassin	7 of 7	3 of 3
Non-Executive Directors		
Mike Biggs[3]	6 of 7	3 of 3
Andrew Palmer	7 of 7	3 of 3
Clare Thompson	7 of 7	3 of 3

Other attendees include

- Chief Executive Officer
- Human Resources Director
- General Counsel and Company Secretary
- Director of Performance and Reward
- FIT Remuneration Consultants LLP (independent adviser)

The Committee works closely with the Chairs of the Board Risk Committee and the Audit Committee.

Meeting frequency

The Committee meets 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. The Committee met jointly with the Board Risk Committee on 30 September 2013.
3. Mike Biggs was unable to attend a scheduled meeting of the Committee due to another commitment.

Governance

What did the Committee say it would do in 2013?

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

What have we achieved?

- After consultation with the Chief Risk Officer and the Board Risk Committee, approved the outcomes under the 2012 AIP and made awards under the Company's deferred share incentive arrangements
- Reviewed the overall remuneration policy to ensure it continues to support the Company's strategic objectives going forward
- Determined the share ownership guidelines and reviewed compliance against these by the Executive Directors and members of the Executive Committee
- Developed extensive payment gateways for the AIP which requires the Committee to be satisfied that it is appropriate to permit payment of a bonus or at a given level
- Reviewed and approved the overall 2013 salary budget for Direct Line Group, including proposed salaries for Executive Directors, members of the Executive Committee and other strategic leaders
- Agreed the high level principles and key terms of the incentive plan arrangements for 2013 and rolled out the BAYE scheme in the United Kingdom and Italy
- Approved the Direct Line Group's termination policy
- Reviewed the approach to malus and clawback
- Reviewed the implications for the 2013 Directors' remuneration report of changes in regulations introduced by the Department for Business, Innovation and Skills
- Obtained advice from the Board Risk Committee on risk weightings and implemented adjustments to be applied to performance objectives and remuneration arrangements
- Determined the implications for remuneration arising from the evolution of the Group's strategy through liaison with the Audit Committee and Finance function
- Oversaw the review of incentive arrangements in the customer facing areas of the business following the publication of FCA guidance in conjunction with the Board Risk Committee
- Reviewed the proposed approach to salary benchmarking for Executive Directors, the Executive Committee and other strategic leaders
- Considered the effectiveness of the performance of FIT Remuneration Consultants LLP during 2013 and agreed to re-appoint them as independent external advisers to the Committee for 2014
- As part of the annual review, the Committee recommended to the Board revisions to its terms of reference
- Reviewed the draft Remuneration Committee report and the Directors' remuneration report for inclusion in the Company's Annual Report & Accounts for the year ending 31 December 2013

What will we be focusing on in 2014?

In addition to its regular monitoring, challenge and oversight responsibilities, the focus for the Committee in 2014 is expected to include the following:

- Greater alignment between reward and shareholder value creation
- Differentiation between average and great performance
- Ensuring that short-term results are not driven at the expense of maximising shareholder value
- Ensuring that reward is predicated upon satisfied and well served customers
- Ensuring that there is an appropriate level of oversight and balancing risk and reward in all of our schemes

Evaluation of the Committee

The annual evaluation of the Committee's effectiveness was commissioned by the Chairman of the Board and undertaken by Edis-Bates Associates, as external facilitators. The evaluation concluded that the Committee continued to operate effectively, and the Committee will consider the results and recommended actions resulting from the evaluation in 2014. Further details of the effectiveness review can be found on page 63.

This report was reviewed and approved by the Board on 25 February 2014.

Priscilla Vacassin, Chair of the Remuneration Committee

Relations with shareholders

We consider that 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.

The Executive Directors frequently meet with investors. The Chairman, Senior Independent Director and Non-Executive Directors are available to attend meetings with major shareholders at the shareholders' request so that they have 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 kept aware of shareholder views by the Company's corporate brokers who regularly attend Board meetings for this purpose.

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

What did we do in 2013?

Roadshows

4 trips to the US targeting investors in New York, Boston, San Francisco and Chicago

1 trip to Canada

1 trip to Copenhagen

1 trip to Dublin

3 roadshows in London

2 visits to Edinburgh

Conferences	2013	Stock broker briefings
Morgan Stanley European Financials, London[1]	March	Royal Bank of Canada
Autonomous conference, London	May	Morgan Stanley and Goldman Sachs
Goldman Sachs European Financials, Brussels[1]	June	
	August	Nomura
JP Morgan small mid cap conference, London Keefe, Bruyette & Woods conference, London Bank of America Merrill Lynch conference, London[1]	September	Keefe, Bruyette & Woods and Numis
	November	Canaccord

Note:

1. The conferences where the Chief Executive Officer gave a brief presentation to all delegates

What are we focusing on in 2014?

We will continue to provide detailed disclosures on the Group's financial performance and strategic plans and host a number of events to foster engagement. The Group recognises the importance of maintaining an active dialogue with our shareholders, target investors and other important insurance sector investors. Planned activities for 2014 include:

- Presentations of our financial results
- Investor road shows in the UK, Europe, the United States 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 stockbrokers to convey key messages and performance and strategy

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, Nomination 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.

2013 & 2014 AGMs – key highlights

2013 AGM

Held on 6 June 2013 at The Auditorium, Allen & Overy LLP, One Bishops Square, London E1 6AD.

- Full Director attendance
- 1,250 million to 1,258 million votes cast for each resolution (83% of issued share capital)
- All Directors were elected or re-elected to the Board, receiving at least 99% of the votes cast in favour
- Remuneration report resolution passed, with 98.84% in favour
- Highest votes in favour – 99.75% to authorise political donations and expenditure
- Lowest votes in favour – 98.84% to approve the Remuneration report

2014 AGM

To be held on 15 May 2014 at The Auditorium, Allen & Overy LLP, One Bishops Square, London E1 6AD.

- All Directors are expected to stand for re-election to the Board
- Each Director has been formally evaluated by the Nomination Committee before standing for re-election
- The Board believes that each Director is effective and demonstrates commitment to his or her role
- There will be a vote on the Directors' remuneration policy.

Priscilla Vacassin, Chair of the Remuneration Committee

Dear shareholder

I welcome you to our second remuneration report. In an important year for Direct Line Insurance Group plc, our first full year as a listed company, the Remuneration Committee ("**Committee**") has sought to ensure that we continue to provide a reward proposition that supports the Group's business strategy and is fair to our employees and our shareholders alike in the context of our overall performance.

As a Group, we continue to make good progress against both our strategic priorities and financial targets and have delivered on our COR target in 2013, which has resulted in a RoTE in excess of our long-term target, and have delivered a Total Shareholder Return of 24% over the financial year. At the same time, we are conscious of the need to exercise restraint in executive pay given the current economic environment and our cost savings initiatives. These factors have been reflected in our remuneration decisions as set out in full in this remuneration report and highlighted below.

Linking remuneration to overall business objectives – looking back to what we did in 2013

We remain committed to ensuring that Executive Directors are appropriately incentivised to deliver superior long-term business performance and that they will receive their full remuneration opportunity only when material value has been created for shareholders.

To that extent, we have carefully considered the 2013 bonus outcome under the Annual Incentive Plan ("**AIP**") to ensure that payouts are appropriate and reflect a rounded assessment of performance. The initial AIP outcome is based on a balanced scorecard in line with our approach last year. In addition, recognising both the complexity of the business and that assessment of success, particularly in an insurance group, requires the application of broader judgement than a simple application of the audited results, the Committee considers it appropriate to look at the wider factors of Group performance and exercise its judgement to better reflect the overall position. For 2013, it exercised such judgement by applying a quality of earnings assessment of the financial elements and a gateway assessment for all AIP elements, as described in more detail in the annual remuneration section of this report. In addition, overriding judgement based on each executive's performance was taken into account. The Committee will continue to use such judgement in future years. In respect of 2013, this resulted in a lower payout than would have been the case under a more formulaic approach.

The resulting bonus award of 63% of the maximum bonus potential to Paul Geddes and 60% of the maximum bonus potential to John Reizenstein are therefore broadly at the on-target level of performance. We believe that this level of payout is appropriate and that it demonstrates that our remuneration policy effectively aligns pay with underlying performance.

The first awards under our 2012 Long-Term Incentive Plan ("**LTIP**") were made only following the IPO in October 2012 and are not due to vest until 2015. Awards vesting under legacy RBS plans are described in the annual remuneration section of the report.

Looking forward to 2014 – what we have decided

In the context of the new requirements for executive pay reporting in the UK, the Committee took the opportunity to review our approach to remuneration and the associated policies put in place at the time of the IPO to ensure that, after their first full year of operation, they continue to support our strategic objectives.

As part of this review, we have not proposed any major changes to the policy for 2014; however, we have reached specific decisions as to how this policy will apply in the future in order to enhance its effectiveness, fairness between executives and other stakeholders and transparency for our shareholders. The section of this remuneration report describing how we intend to implement our remuneration policy following approval at the 2014 AGM explains this further.

I would like to highlight the following areas:

- as in 2013, and in line with our commitment to exercise restraint in executive pay, there will be no increase to Executive Directors' salaries in 2014
- the approach to measuring performance under the AIP in 2014 will be similar to that followed in 2013 and the Committee will continue to apply judgement in assessing payouts. Additional financial and non-financial indicators will be considered which will include forward-looking metrics as opposed to purely historical ones
- we are not proposing any changes to the performance measures for 2014 awards under the 2012 LTIP and we will continue the practice of making LTIP awards twice a year at the same levels as during 2013, subject to stretching performance targets over each award's performance period

Our shareholder register has changed significantly in the year since IPO, following a further disposal of shares by RBS Group. As a consequence I, as the Chair of the Remuneration Committee, jointly with the Chairman of the Board contacted our major institutional shareholders, as well as the ABI and Institutional Shareholder Services, and we made ourselves available to discuss our remuneration policy.

Structure of remuneration report

We have made some changes to the order in which this year's remuneration report is presented, in line with the new regime for the reporting of executive pay in the UK.

Accordingly, over the following pages we have set out:

- our forward-looking Directors' remuneration policy which is subject to a binding shareholder vote at our 2014 AGM; and
- our annual remuneration report setting out the details of the implementation of our reward policy in 2013 and how the proposed remuneration policy will be implemented in 2014. This section of the report is subject to an advisory vote at our 2014 AGM.

In preparing the disclosures on our forward-looking policy, we have sought to balance the need to give our shareholders sufficient information to be able to evaluate it with the need to maintain sufficient operational flexibility over pay to allow us to respond to changing circumstances.

I hope that you will find this report informative and accessible and I welcome any feedback you may have.

Priscilla Vacassin, Chair of the Remuneration Committee

Questions and answers on our executive remuneration policy in the first full financial year of listing since the IPO[1]

Q Why do Executive Directors (and other senior executives) need to be paid bonuses on top of their salary and other benefits?

When we listed in October 2012, we set out our commitment to offer remuneration at the right cost, while ensuring that we provide Executive Directors with market-competitive rewards compared with relevant peer companies. Variable pay in the form of short and long-term incentives forms a significant proportion of total remuneration in the market in which we compete for executive talent and including this as part of our remuneration offering gives us the ability to attract the right calibre of executives without the need to increase fixed remuneration.

At the same time, in line with our value to 'aim higher' and strive to be the best in everything we do, we actively want to motivate Executive Directors and other senior executives, incentivise the delivery of strong performance and recognise and reward success at the individual and Group level. Our AIP is just one of many tools used throughout the business (and not just at senior executive level) to achieve these objectives.

Finally, having a high proportion of our total remuneration dependent on the achievement of stretching performance targets (through both the AIP and the LTIP) enables us to manage our costs appropriately by ensuring that the total expenditure on executive pay appropriately reflects performance at both the individual and Group level. The context of the external market environment is also taken into account. This would not be possible if our executive remuneration package comprised only fixed elements of pay.

Q How were 2013 bonuses determined for the Executive Directors?

We started by setting a range of measures and targets reflecting the Committee's assessment of what success would look like against the business plans set by the Board. Following the year-end, the Committee undertook a quantitative assessment of performance against the financial measures included within the AIP, and an assessment of performance against all other measures including each individual's personal objectives. This assessment simply determined the initial outcomes under the AIP; however, no payments were approved until after the Remuneration Committee carried out a quality of earnings assessment of the financial elements and a 'gateway assessment' for all AIP outcomes.

The gateway criteria used by the Committee included factors such as affordability, the Group's overall performance against the agreed risk profile, performance relative to peers, the occurrence of any regulatory breaches or reputational damage, whether the payment of any bonus may give rise to reputational damage and the wider economic environment. The Committee also considered whether there were any exceptional events or other factors that should be taken into account in assessing the bonus outcome.

Note:

1. This section and the Group remuneration policy on page 79 are not subject to the binding vote on remuneration policy.

The quality of earnings and gateway assessments resulted in the reduction of the initial bonus outcome for Executive Directors as explained on pages 94.

For both Executive Directors, 40% of the bonus awarded will be deferred in Company shares for a period of three years. This is in line with the approach followed for all our strategic leaders (around 60 of our most senior executives, including Executive Committee members, who are responsible for developing and executing Group strategy).

Q How can you justify paying bonuses to Executive Directors when at the same time you are going through cost reduction initiatives and making redundancies?

Making redundancies is a tough decision; however, we sometimes need to take steps like this, to make the business sustainable in the long run and remain competitive. Where possible, we are managing redundancy decisions through redeployment and support. Our aim is to treat respectfully and fairly all those affected.

In this context, the Committee aims to ensure that employees, including Executive Directors, are continuously engaged to deliver against our plan and are provided with fair pay for the job, which takes into account the context of pay in the wider market as well as their individual performance. It is also vital to ensure that we continue to pay competitively, at all levels.

As discussed elsewhere, the Committee has exercised its judgement in determining the final bonus levels to reduce the amount of AIP awards to the Executive Directors for 2013, to reflect its qualitative assessment of performance during the year.

Q Why are you paying bonuses to Executive Directors when gross written premium has reduced in 2013?

As explained elsewhere in the annual report, the reduction in gross written premiums reflects the impact of a competitive market, particularly in UK motor, and our decision to maintain a cautious underwriting approach by emphasising underwriting margins over volume.

Gross written premium is just one of the set of metrics that we consider when assessing our business performance. Overall, we believe that good progress has been made across a range of financial and non-financial metrics and these determined the final bonus for Executive Directors.

Q Why are the Executive Directors still receiving shares under RBS Group Long-Term Incentive Plans?

In line with other Group employees previously granted awards under RBS Employee Share Plans, Paul Geddes and John Reizenstein continue to hold awards granted under the RBS Group Long-Term Incentive Plans ("**RBS Group LTIP**") and the RBS Group Deferral Plan granted prior to the IPO.

It has been agreed with RBS that awards granted under the RBS Group LTIP in 2011 and 2012 will now be delivered in the form of Direct Line Insurance Group plc shares transferred by RBS Group, to the extent that the original performance conditions have been met. This ensures maximum alignment with the performance of Direct Line Group. Awards granted under the RBS Group Deferral Plan will continue to be delivered in RBS Group shares.

These awards were granted to the Executive Directors in respect of their work as executives of RBS Insurance, as the Group was previously known when it was wholly owned by RBS Group. The extent to which awards under the RBS Group LTIP vest is determined by the Remuneration Committee of RBS Group based on an assessment against the performance conditions shown on page 99 of this remuneration report. RBS Group deferred awards are not subject to any performance conditions, as they represent the deferral element of annual bonuses that have already been earned.

Q Do you comply with the provisions of the FCA's Remuneration Code?

As an insurance business, we are not subject to the provisions of the FCA's Remuneration Code. However, we seek to comply with the core requirements of the Code that we should establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management. Accordingly, for all of our strategic leaders including Executive Directors, significant elements of incentive-related pay are subject to deferral and potential malus and clawback as explained further within the remuneration report. In addition, the independence of our control functions is maintained by assessing their annual bonuses independently of the Group financial results.

Although not impacting Directors' pay, separately, following the publication of the FCA's guidance on risks to customers from financial incentives, we have reviewed our remuneration systems for customer-facing employees to ensure that they are fit-for-purpose and that the risk of mis-selling and other risks identified by the FCA are appropriately managed. The Remuneration Committee and the Board Risk Committee contributed to (and reviewed the outcome of) this assessment. This forms the basis of an ongoing joint review. Our initial assessment concluded that our existing plans were broadly compliant and that evolutionary changes, where necessary, will take effect from 2014.

Group remuneration policy for all employees

This section is not subject to the binding vote on remuneration policy

Performance related
- Reward reflects individual and business performance
- Outstanding individual performance is recognised and rewarded
- Group and individual performance will be reflected through variable pay
- Poor performance is identified with effective management remedies in place

Transparent and fair
- We aim to have a competitive total reward proposition
- We aim to be open about our salary and variable pay arrangements and how they work
- We aim to manage pay consistently for people doing the same role with equal opportunity for all
- Remuneration is benchmarked periodically to ensure continued competitiveness with the market

Manager ownership
- We empower managers to genuinely lead and foster a culture consistent with the Group's attitude to risk and values
- Individual performance is assessed both in terms of what is achieved and the way in which it is achieved
- Individual performance will be reflected in employees' reward through their salary and variable pay

Simple and robust
- The reward proposition is straightforward and simple for everyone to understand
- Reward structures are easy to administer
- The mix between fixed and variable pay is right for our business

Valued by our people
- Our people know what is expected of them. Performance is fairly rewarded against internal and external comparators
- We offer one pension arrangement for everyone
- We offer product discounts and build flexibility in our benefits offering
- Employees are able to choose a range of other benefits to suit their lifestyle and needs

Within this overall policy, the individual elements of remuneration for Executive Directors are shown below:

Base salary, pension & benefits

Annual Incentive Plan
- Cash
- Deferred shares (three years)
- Financial, customer and other strategic and personal objectives

Long-Term Incentive Plan
- Performance shares (three years)
- RoTE and relative Total Shareholder Return

All employee share plans

Introduction

The remuneration report has been prepared in accordance with the requirements of the Companies Act 2006 and The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (the "**Regulations**"). The Company also complies with the UK Corporate Governance Code in relation to remuneration.

Directors' remuneration policy

The following section contains the material required to be set out as the Directors' remuneration policy for the purposes of Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended). This policy will be put forward for shareholder approval at the 2014 AGM in accordance with section 439A of the Companies Act 2006 and, on approval, will take effect immediately following the 2014 AGM.

Context of policy

The Group's remuneration policy is to provide, in the context of the Group's business strategy, a compelling 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.

The remuneration policy guides the design and implementation of reward programmes in the Group that are market competitive and aligned to business objectives, both financial and non-financial.

Policy report (pages 80 to 88)

Policy table

The policy shown for Directors will apply immediately after approval at the 2014 AGM. Information in relation to the operation of the policy for 2014 is set out in the annual remuneration report section starting on page 89 of this report.

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 executives with the skill sets to achieve our key aims while managing costs	• Base salaries are reviewed annually and set in April of each year, although the Committee may undertake an out-of-cycle review if it determines that this is appropriate • Salaries are typically reviewed against: – level of skill, experience and scope of responsibilities, individual and business performance, economic climate and market conditions; – the median market pay in the context of insurance peers and companies of a similar size, particularly FTSE 31-100 companies being companies which are considered to be reflective of the size and complexity of the Group; and – general base salary movement across the Group. • The Committee does not strictly follow data but uses it as a reference point in considering, in its judgement, the appropriate level having regard to other relevant factors including corporate and individual performance and any changes in an individual's role and responsibilities • The principles for setting base salary are similar to those applied to other employees in the Group, although the specific benchmarking groups used to review external market relativities may differ across employee groups • Base salary is paid monthly
Annual Incentive Plan (the "**AIP**")	• To motivate executives and incentivise delivery of performance over a one-year operating cycle, focusing on the short to medium-term elements of our strategic aims	• For Executive Directors, at least 40% of the award is deferred into shares under the Deferred Annual Incentive Plan (the "**DAIP**") typically vesting three years after grant (with deferred awards also capable of being settled in cash). The remainder of the award is paid in cash following year-end • The percentage deferred and the terms of deferral will be kept under review by the Committee to ensure that levels are in line with regulatory requirements and best practice and may be changed in future years but will not, in the view of the Committee, be changed to be less onerous overall • Malus and clawback provisions apply to both the cash and deferred elements and are explained in more detail in the notes to the policy table
2012 Long-Term Incentive Plan (the "**LTIP**")	• To motivate and incentivise delivery of sustained business performance over the long term, aligning executives' interests with those of shareholders • To aid long-term retention of key executive talent	• Awards will typically be made in the form of nil-cost options or conditional share awards which vest to the extent performance conditions are satisfied over a period of at least three years. Under the Plan rules, awards may also be settled in cash • Vested options will remain exercisable for a period of seven years • Malus and clawback provisions apply to the LTIP and are explained in more detail in the notes to the policy table • Awards under the LTIP may be made at various times during the financial year. While the Committee reserves the right to do otherwise, practice has been to make awards twice in each financial year following the announcement of the Group's annual and half-year results

Maximum opportunity	Performance measures
• The Committee has determined that its policy will be to only set base salaries by reference to the factors set out in the previous column for the duration of this policy. In any event no increase will be made if it would take an Executive Director's salary above the median level of salaries for relevant roles in the FTSE 100 as determined using data available to the Committee at or shortly prior to when any increase is considered • Where salary increases are awarded, the Committee will have regard to the increase being awarded to employees within the Group more generally, as well as the other factors outlined in this table under 'Operation'	• Not applicable
• Maximum and target bonus levels for Executive Directors are set by reference to practice at other insurance and general market comparators • The maximum bonus level potential under the AIP is 175% of base salary per annum. The current maximum bonus level applying for each individual Executive Director is shown in the statement of implementation of policy in 2014 section of the annual remuneration report	• Performance over the financial year is assessed against performance measures which the Committee considers to be appropriate • These may be financial, non-financial (Group, divisional or business line) and individual. Each year, at least 50% of the bonus is based on financial measures. The remainder of the bonus will be based on a combination of non-financial and individual performance measures • Targets are set at the beginning of each financial year by the Committee • No more than 10% of the bonus is paid for threshold performance (30% for the individual performance element). No more than 60% of the maximum opportunity pays out for target performance. However, the Committee retains flexibility to amend the level of payout at different levels of performance for future bonus cycles based on its assessment of the level of stretch inherent in the targets that have been set and will disclose any such determinations appropriately • Before any payment can be made, the Committee will perform an additional gateway assessment to determine whether the amount of any bonus is appropriate in view of such facts or circumstances as the Committee considers relevant. This assessment may result in moderation (either positive or negative) of each AIP performance measure but subject to the individual maximum bonus levels • The AIP remains a discretionary arrangement and the Committee reserves discretion to adjust the out-turn (from zero to the cap) should it consider that to be appropriate. In particular, the Committee will operate this discretion as a gateway in respect of any risk concerns
• The Plan allows for awards over shares with an absolute maximum value of 200% of base salary per financial year (although awards of up to 300% of base salary are permitted in exceptional circumstances in relation to the recruitment or retention of an employee, as determined by the Remuneration Committee)	• The Committee will determine the performance condition for each award made under the LTIP, with performance measured over a single period of at least three years with no provision to retest • Performance is measured against targets set at the beginning of the performance period which may be set by reference to the time of grant or financial year • Awards vest based on performance against financial and / or share return measures, as set by the Committee, to be aligned with the long-term strategic objectives of the Group • For awards to be granted in 2014, vesting is determined based on two measures: RoTE and relative Total Shareholder Return ("**TSR**") performance against the FTSE 350 (excluding investment trusts). The Committee may apply different performance measures and targets in future years • 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 is an underpin relating to the Committee's view of the underlying financial performance of the Group • Fuller details of the performance conditions and targets for 2014 awards are set out in the statement of implementation of policy in 2014 section of the annual remuneration report • For both the TSR and RoTE elements, 20% of the award vests for threshold performance with 100% vesting for maximum performance. The Committee reserves the discretion to make changes to these levels which it considers non-material • The Committee reserves the right to lengthen (but not reduce) any performance period and / or to introduce a separate holding period

Element	Purpose and link to strategy	Operation
Pension	• To remain competitive within the market place • To encourage retirement planning and retain flexibility for individuals	• Pension contributions are paid only in respect of base salary • Executive Directors are eligible to participate in the 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
Benefits	• A comprehensive and flexible benefits package is offered, with the emphasis on individuals being able to choose the combination of cash and benefits that suits them	• Executive Directors receive a benefits package generally set by reference to market practice in companies of a similar size and complexity, particularly FTSE 31-100 companies. Benefits currently provided include a company car or car allowance, private medical insurance, life insurance, health screening and income protection • The Committee may periodically amend the benefits available to employees. The Executive Directors are eligible to receive such additional benefits on similar terms to other senior executives • In line with our approach to all employees, certain Group products are offered to Executive Directors at a discount • Executive Directors are also eligible to participate in any of the employee share plans operated by the Company, in line with HMRC guidelines (where relevant), on the same basis as for other eligible employees. Currently this includes the Share Incentive Plan, which was also used to provide an award of free shares to all employees (including Executive Directors) at the time of the IPO
Share ownership guidelines	• To further align the interests of Executive Directors with those of shareholders	• Executive Directors are expected to retain all of the ordinary shares vesting under any of the Company's share incentive plans, after any disposals for the payment of applicable taxes, until they have achieved the required level of shareholding

Notes to the policy table

Stating maximum amounts for each element of remuneration

Where the table refers to the maximum amounts that may be paid in respect of any element of the policy (as required under the Regulations) these will operate simply as caps and not be indicative of any aspiration.

Malus and clawback

Malus (being the forfeiture of unvested awards) and clawback (being the ability of the Company to claim repayment of paid amounts as a debt) provisions apply to the AIP (cash and deferred element) and LTIP if, in the opinion of the Committee, any of the following has occurred:

- There has been a material misstatement of the Company's financial results which has led to an overpayment
- The assessment of performance targets is based on an error or inaccurate or misleading information or assumptions
- Circumstances warranting summary dismissal in the relevant period
- A material failure of risk management or any other act or omission that has had a sufficiently significant impact on the reputation of the Company to justify such action

Amounts in respect of awards under both plans may be subject to clawback for up to three years post payment or vesting as appropriate.

Exercise of discretion

In line with market practice, the Committee retains discretion in relation to the operation and administration of the AIP, DAIP and LTIP. This discretion includes, but is not limited to:

- The timing of awards and payments
- The size of awards, within the overall limits disclosed in the policy table
- The determination of vesting
- The treatment of awards in the case of change of control or restructuring
- The treatment of leavers within the rules of the plan and the termination policy summary shown on page 86
- Adjustments needed in certain circumstances, (for example, a rights issue, corporate restructuring or special interim dividend)

The Committee also retains the discretion to amend the performance measures, weightings and targets after they have been set if events make it appropriate to do so. Any changes will be explained in future annual remuneration reports and, if appropriate, be the subject of consultation with the Company's major shareholders.

Adjustment to number of shares under deferred bonus and LTIP

The number of shares subject to deferred bonus and LTIP awards may be increased to reflect the value of dividends that would have been paid in respect of any dates falling between the grant of awards and the date of vesting of awards (the date of transfer of shares for awards made prior to 2014).

Maximum opportunity	Performance measures
• Pension contributions for both Executive Directors are set at 25% of base salary per annum	• Not performance related
• The costs of benefits provided may fluctuate from year to year even if the level of provision has remained unchanged • An annual limit of 10% of base salary per Executive Director has been set for the duration of this policy. The Committee will monitor the costs in practice and ensure that the overall costs do not increase by more than the Committee considers to be appropriate in all the circumstances • In addition, the limit for any employee share plans in which the Executive Directors participate will be in line with the caps permitted by HMRC from time to time • The Executive Directors may be entitled to retain fees received for any directorships held outside of the Group	• Not performance related
• 200% of salary for the Chief Executive Officer and 150% for the Chief Financial Officer • The Committee reserves the discretion to amend these levels in future years	• Not applicable

The terms of incentive plan awards may be adjusted in the event of a variation of the Company's share capital, demerger or a similar event that materially affects the price of the shares or otherwise in accordance with the plan rules.

Remuneration payments agreed prior to appointment to the Board

The Committee reserves the right to make any remuneration payments and payments for loss of office (including, where relevant, exercising any discretions available to it in connection with such payments) notwithstanding that they are not in line with the policy set out above where the terms of the payment were agreed (i) before the policy came into effect or (ii) at a time when the relevant individual was not a Director of the Company and, in the opinion of the Committee, the payment was not in consideration for the individual becoming a Director of the Company. For these purposes 'payments' include pension arrangements, the Committee satisfying awards of variable remuneration and, in relation to an award over shares, the terms of the payment are 'agreed' at the time the award is granted.

RBS legacy arrangements

Both Executive Directors continue to hold unvested awards previously granted to them under the RBS Group LTIP 2011 and 2012 which are subject to performance conditions to be assessed by the RBS Group Remuneration Committee. These awards were granted to Paul Geddes and John Reizenstein at a time when they were divisional directors of RBS Group and will now be satisfied by the transfer of Company shares from RBS Group on vesting. The performance conditions for these awards 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.

In addition, both Executive Directors continue to hold awards originally awarded under the RBS Group Deferral Plan and these will continue to be delivered in RBS Group shares. These awards are not subject to any performance conditions on vesting.

Selection of performance measures

Annual Incentive Plan

The AIP performance measures have been selected by the Committee to incentivise Executive Directors to achieve financial targets for the year as well as specific strategic and personal objectives. These measures are aligned with the key performance indicators that we use as a business to monitor performance against our strategic priorities, as shown on pages 20 and 21 of the Annual Report & Accounts.

The relevant targets are set at or following the start of each year to ensure that Executive Directors are appropriately focused on the key objectives for the next 12 months.

Long-Term Incentive Plan

The ultimate goal of our strategy is to provide long-term sustainable returns for our shareholders.

For 2014, awards under the LTIP will therefore continue to be subject to performance against both RoTE and relative TSR targets, which are important KPIs for the business. The Committee believes that this combination provides a balanced approach to the measurement of Group performance over the longer term by using both a stated financial KPI that incentivises individuals to keep growing the business in an efficient way and a measure based on relative shareholder return. This combination of measures achieves an appropriate balance of absolute and relative returns.

Differences in remuneration policy from broader employee population

When determining Executive Directors' remuneration, the Committee takes into account pay throughout the Group to ensure that the arrangements in place remain appropriate.

The Group has one consistent reward policy for all levels of employees, as outlined on page 79. Therefore, the same reward principles guide reward decisions for all Group employees, including Executive Directors, although remuneration packages differ to take into account appropriate factors in different areas of the business:

- **AIP** – approximately 5,000 employees participate in the AIP and the corporate performance measures for all employees are consistent with those used for Executive Directors although the weighting attributable to those factors may differ. The Group's strategic leaders also receive part of their bonus in Company shares deferred for a period of three years
- **LTIP** – our strategic leaders participate in the LTIP currently based on the same performance conditions as those for Executive Directors, although the Committee reserves the discretion to vary the performance conditions for awards made to employees below the Board for future awards
- **All employee share plans** – the Committee considers it is important for all employees to have the opportunity to become shareholders in the Company. The HMRC-approved Buy-As-You-Earn plan in the UK and an International plan mirroring the UK plan for Italy were both launched during 2013. The International plan is being further rolled out to employees in Germany and the Committee expects this process to be completed in 2014. At year end, approximately 1,900 employees throughout the Group had signed up to these schemes

Remuneration policy for Non-Executive Directors

Element	Chairman and Non-Executive Directors' fees
Purpose and link to strategy	To enable the Company to recruit and retain Non-Executive Directors of the highest calibre, at the appropriate cost
Approach to setting fees and cap	• Non-Executive Directors are paid a basic annual fee plus reasonable travel expenses. Additional fees may be paid to Non-Executive Directors who chair a Board Committee, sit on a Board Committee and for the Senior Independent Director. The level of fees for 2014 is shown in the annual remuneration section • Fee levels for Non-Executive Directors are reviewed and may be increased at appropriate intervals by the Board, with affected individual Directors absenting themselves from deliberations • In setting the level of fees, the Company takes into account the expected time commitment of the role and fees at other companies of a similar size, sector and / or complexity to the Group • The fees paid to the Chairman are inclusive of all Board and Committee membership fees and are determined by the Remuneration Committee • Subject to a Non-Executive Director aggregate fee cap in the Articles of Association (currently £2,000,000 per annum), the Company reserves the right to change how the elements and weightings within the overall fees are paid and to pay a proportion of the fees in shares within this limit
Other items	• The Non-Executive Directors are not entitled to receive any compensation for loss of office, other than fees for their notice period. They do not participate in the Group's bonus, employee share plan or pension arrangements and do not receive any benefits

Recruitment remuneration policy

The recruitment remuneration policy aims to give the Committee sufficient flexibility to secure the appointment and promotion of high-calibre executives to strengthen the management team and secure the skill sets to deliver the Group's strategic aims.

Principles for recruitment remuneration	• In terms of the principles for setting a package for a new Executive Director, the starting point for the Committee will be to look to the policy for Executive Directors as set out in the policy table and structure a package in accordance with that policy. Consistent with the Regulations, the caps contained within the policy table for fixed pay do not apply to new recruits, although the Committee would not envisage exceeding these caps in practice • 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 (including a major change in role), the Committee may agree that the Company will meet certain relocation expenses, legal and other fees involved in negotiating any recruitment or pay expatriate benefits in line with the Group's international assignment policy, as appropriate
Buy-out awards	• Where it is necessary to make a recruitment-related pay award to an external candidate, the Company will not pay more than is necessary, in the view of the Committee, and will in all cases seek, in the first instance, to deliver any such awards under the terms of the existing incentive pay structure • All such awards for external appointments, whether under the AIP, LTIP or otherwise, to compensate for awards forfeited on leaving their previous employer will be capped at the commercial value of the amount forfeited and will take account of the nature, time-horizons and performance requirements of those awards. In particular, the Committee's starting point will be to ensure that any awards being forfeited which remain subject to outstanding performance requirements (other than where substantially complete) are bought-out with replacement requirements and any awards with service requirements are bought out with similar terms. However, exceptionally the Committee may relax those obligations where it considers it to be in the interests of shareholders and those factors are, in the view of the Committee, equally reflected in some other way, for example through a significant discount to the face value of the awards forfeited. It will only include guaranteed or non pro-rated amounts under the AIP where the Committee considers that it is necessary to secure the recruitment

The elements of any package for a new recruit, including the maximum level of variable pay, but excluding buy-outs, and the approach taken by the Committee in relation to setting each element of the package will be consistent with the Executive Directors' remuneration policy described in this report, as modified by the above statement of principles where appropriate. The Committee reserves the right to avail itself of the current Listing Rule 9.4.2 if needed in order to facilitate, in exceptional circumstances, the recruitment of an Executive Director. Awards granted under this provision will only be used for buy-out awards.

Any commitments made before promotion to the Board (except when made in connection with the appointment to the Board) can continue to be honoured under the policy even if they are not consistent with the policy prevailing when the commitment is fulfilled.

In exceptional circumstances, the initial notice period may be longer than the Company's 12-month policy up to a maximum of 24 months. However, this will reduce by one month for every month served, until it has reduced to 12 months in line with the Company's policy position.

The remuneration policy for the Chairman and Non-Executive Directors as set out earlier in this report will apply in relation to any recruitments to those positions.

Service contracts

Subject to the discretion noted above for new recruits, it is the Company's policy to set notice periods for Executive Directors of no more than 12 months (both by the Director or Company). The Executive Directors' service agreements summary is as follows:

Director	Effective date of contract	Notice period (by Director or Company)	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.

There are no further obligations which could give rise to a remuneration or loss of office payment other than those set in the remuneration policy table and termination policy summary.

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. A Director is deemed a "good leaver" if the following circumstances are met:

- Annual Incentive Plan and Long-Term Incentive Plan – death, injury, ill-health, redundancy, retirement, the sale of the individual's employing company or business out of the Group, or in such other circumstances as the Committee determines
- Deferred Annual Incentive Plan – for any reason other than summary dismissal or resignation unless, in the case of resignation only, the Committee determines otherwise

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 AIP and LTIP 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 taking into account the performance of the departing executive and the circumstances of leaving.

Incentives	If a leaver is a 'bad leaver', for example leaving through resignation or summary dismissal	If a leaver is deemed to be a 'good leaver'	Other events, for example, change in control or winding up of Company
Annual Incentive Plan	No awards made	Bonus paid at the normal time and on a time pro-rata basis, unless the Committee determines otherwise.	Bonus determined on such basis as the Committee considers appropriate and paid on a time pro-rata basis, unless the Committee determines otherwise.
Deferred Annual Incentive Plan	All awards will lapse	Deferred shares typically vest on the normal vesting date, although the Committee reserves discretion to accelerate vesting. In the case of the participant's death or other exceptional circumstances, awards may vest immediately.	Awards will vest in full. In the event of a demerger or similar event, the Committee may determine that awards vest on the same basis.
Long-Term Incentive Plan	All awards will lapse	Awards will vest on the normal vesting date subject to performance and, unless the Committee determines otherwise, time pro rating. In exceptional circumstances, as determind by the Committee, for example in the case of the participant's death, awards may vest on cessation.	Awards will vest subject to the application of the performance conditions and, unless the Committee determines otherwise, time pro rating. In the event of a demerger or similar event, the Committee may determine that awards vest on the same basis.

Following RBS Group's shareholding in the Company reducing to less than 50% of the Ordinary Shares in the Company, the Company can in its discretion terminate each Executive Director's service agreement with immediate effect by making a payment in lieu of notice. Service agreements for Executive Directors provide that Paul Geddes and John Reizenstein are not eligible to receive any enhanced redundancy terms which may be offered by the Group from time to time. Their rights to a statutory redundancy payment are not affected.

Depending on the circumstances of departure, an Executive Director may have additional claims under relevant employment protection laws and the Company may contribute to any legal fees involved in agreeing a termination. It may also agree to incur certain other expenses such as the provision of outplacement services. Any such fees would be disclosed as part of the detail of any termination arrangements.

Non-Executive Director letters of appointment
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. Mark Catton, being the Director nominated by the RBS Group, will step down as Director when RBS Group owns less than 20% of Direct Line Group.

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 required to submit themselves for re-election at each AGM.

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, which do not apply in the case of a Director not being re-elected by shareholders or retiring from office under the articles of association. Other than fees for this notice period, the Chairman and Non-Executive Directors are not entitled to any compensation on exit.

External directorships
The Company 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 generally limited to accepting one external directorship.

Currently, the Executive Directors do not hold any external directorships.

Consideration of employment conditions elsewhere in the Group
As explained elsewhere in the Directors' remuneration report, the Committee 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 in determining the Directors' remuneration policy and the remuneration payable to Directors. Through the Chief Executive Officer, Paul Geddes, and other senior management the Committee may receive input provided by employee groups within the Group, such as the Employee Representative Body ("**ERB**"), as required.

In accordance with prevailing commercial practice, the Committee did not consult with employees in preparing the Directors' remuneration policy.

Consideration of shareholders' views
The Committee takes into account the approval levels of remuneration related matters at the AGM in determining that the current Directors' remuneration policy remains appropriate.

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 policy for the Company.

The Committee will also seek to build an active and productive dialogue with investors on developments in the remuneration aspects of corporate governance generally and any changes to the Company's executive pay arrangements in particular. During the year, the Chair of the Committee and the Chairman of the Board jointly wrote to major shareholders and made themselves available to discuss remuneration policy.

The Committee is satisfied that no element of the Directors' remuneration policy conflicts with the Group's approach to environmental, social or corporate governance matters.

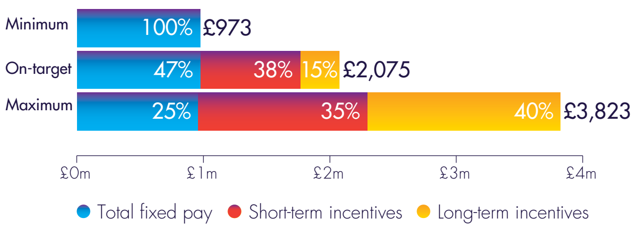
Performance scenarios

The Directors' remuneration policy has been designed to ensure that a significant proportion of total remuneration is delivered in the form of variable pay and is therefore dependent on performance against our strategic objectives.

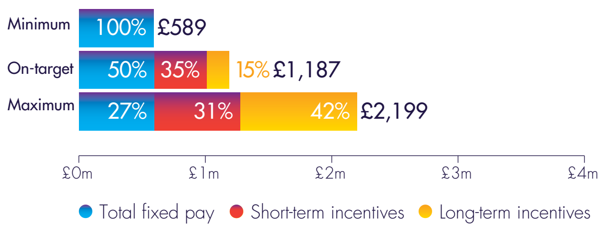
The Committee has considered the level of remuneration that may be paid under different performance scenarios to ensure that it would be appropriate in each situation in the context of the performance delivered and the value created for shareholders.

The following charts show the potential remuneration that may be earned by Executive Directors under three assumed performance scenarios as follows:

CEO – Paul Geddes
(£'000)



CFO – John Reizenstein
(£'000)



The elements of remuneration included in each scenario are as follows.

Minimum	Consists of fixed remuneration only (that is, base salary, benefits and pension): • Base salary is the salary to be paid in 2014 • Benefits measured as benefits paid in 2013 as set out in the single figure table on page 93 • Pension measured as the defined contribution or cash allowance in lieu of Company contributions, as a percentage of salary (25% of 2014 salary for both Executive Directors)
On-target	Based on what the Director would receive if performance was on-target (excluding share price appreciation and dividends): • Fixed remuneration as above • AIP – consists of the on-target bonus of 60% of maximum bonus opportunity • LTIP – consists of the threshold level of vesting (20% vesting)
Maximum	Based on the maximum remuneration receivable (excluding share price appreciation and dividends): • Fixed remuneration as above • AIP – consists of the maximum bonus (175% of base salary for Paul Geddes, 150% for John Reizenstein) • LTIP – consists of the face value of awards (200% of salary)

Annual remuneration report section A: unaudited information

Remuneration Committee governance

The members of the Remuneration Committee during 2013 (which remained unchanged during the year) are shown below. Each member's attendance at meetings is set out in the Corporate Governance section on page 73.

Committee Chair
Priscilla Vacassin
Non-Executive Directors
Mike Biggs
Andrew Palmer
Clare Thompson

Advisers to the Committee

The Committee regularly 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 strategic leaders. 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 General Counsel and Company Secretary advises the Committee on corporate governance guidelines and provides secretarial assistance to the Committee. The Committee works closely with the Chairs of the Board Risk Committee and the Audit Committee.

In addition, the Committee has appointed FIT Remuneration Consultants LLP ("**FIT**"), signatories to the Remuneration Consultants Group's Code of Conduct, as its independent adviser. This appointment was made by the Committee in preparation for the IPO and following consideration of the firm's experience in this sector. FIT was reappointed by the Committee during the year following a review of its performance.

FIT provided advice during the year on market practice, corporate governance, incentive plan design and other matters under consideration by the Committee. FIT does not provide any other services to the Company, and accordingly the Committee is satisfied that the advice provided by FIT is objective and independent.

FIT's total fees for the provision of remuneration-related advice in 2013 were £197,793 exclusive of VAT. FIT's fees were charged on the basis of the firm's standard terms of business for advice provided.

Allen & Overy LLP, one of the Group's legal advisers, has also provided legal advice in relation to the Group's executive remuneration arrangements, and has provided the Group with other legal services.

Distribution statement

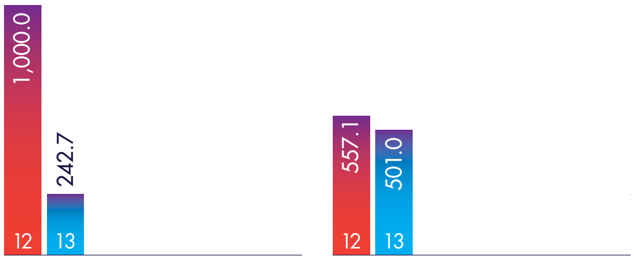
The following chart shows the overall expenditure on pay across all Group employees compared against the total value of dividends paid to shareholders for both 2012 and 2013.

Dividend (£m)

£242.7m

Overall expenditure on pay (£m)

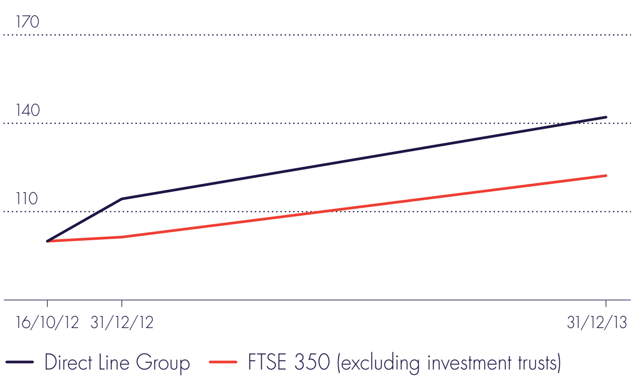
£501.0m



Note:
The £1,000 million dividend paid out in 2012 was to RBS Group and made prior to the IPO. There were no share buy-backs since the IPO other than shares purchased by the Employee Benefits Trust to satisfy the awards of shares under the Company's share plans. Consistent with expected practice elsewhere, the overall expenditure on pay has been taken from note 10 to the income statement and has not, therefore, been calculated in a manner consistent with the single figure contained in this report.

Historical performance of Total Shareholder Return

The following graph shows the Company's TSR since trading of the Company's shares began on the London Stock Exchange in October 2012 against the FTSE 350 Index (excluding investment trusts) over the same period. The FTSE 350 Index (excluding investment trusts) has been selected as it is a broad index, of which the Company is a constituent, and is also the same group of companies used for the purposes of measuring relative TSR under the LTIP.



The following table shows historical levels of the Chief Executive Officer's pay for 2012 and 2013 and vesting of annual and long-term incentive pay awards as a percentage of the maximum available opportunity.

Paul Geddes – Chief Executive Officer	Single figure of total remuneration £'000	Annual bonus payout (% of maximum)[1]	Long term incentive vesting (% of maximum)[2]
2013	2,430	63%	55%
2012[3]	1,908	65%	30%

Notes:

1. The relevant percentages were calculated by reference to the salary paid over the financial year.
2. Based on vesting under the 2010 and expected vesting under the 2011 RBS legacy long-term incentive awards in respect of 2012 and 2013.
3. The 2012 figures represent the whole of 2012 and not simply the period from IPO.

Percentage change in pay of Chief Executive Officer 2012 to 2013

The table below shows the percentage change in the total annual remuneration of the Chief Executive Officer against all UK employees. The remuneration elements included in the calculation are salary, taxable benefits, and annual bonus outcomes. The Committee considers that it is appropriate to compare against all UK employees but to exclude those based outside the UK to ensure that the comparison against the Chief Executive Officer's total annual remuneration can be made on a consistent basis.

	Change 2012 to 2013 (%)			
	Salary	Benefits[1]	Bonus (including deferred amount)	Total annual remuneration
Chief Executive Officer	13%	-51%	10%	9%
All UK employees	6%	-63%	17%	4%

Note:

1. The reduction in the value of benefits between 2012 and 2013 reflects the change in benefit arrangements with the corresponding increase in base pay to ensure total fixed pay was comparable both before and after separation from RBS Group.

Paul Geddes' salary and benefits for 2012 reflect a period as an employee of RBS Group, prior to his appointment as a Director of the Company on 1 September 2012, when his salary and benefits were set at current levels in advance of the Company's IPO. Paul Geddes' salary and benefits package remain unchanged since then and will not be increased in 2014.

Voting outcomes from AGM 2013

The table below shows the percentage of shareholders voting for, voting against and the percentage of votes withheld in relation to the resolution to approve the 2012 Directors' remuneration report put to the 2013 AGM.

	For		Against		Number of votes withheld (abstentions)	Percentage votes withheld (abstentions)
	Number	Percentage	Number	Percentage		
Approval of Directors' remuneration report	1,226,921,305	98.8%	14,419,804	1.2%	16,879,549	1.3%

Note:

The percentages of votes for and against are expressed as a percentage of votes cast, excluding abstentions. The percentage of votes withheld is expressed as a percentage of total votes cast, including abstentions.

Statement of implementation of policy in 2014

Executive Directors' salaries in 2014

The current base salaries paid to the Executive Directors were set prior to the IPO. The Committee has considered the current level of salaries in the context of the need to apply restraint in executive pay whilst recognising the need to retain key executive talent in the context of a highly competitive market. It concluded that there will be no increase to Executive Directors' salaries in 2014.

Director	Position	2014 base salary £'000	2013 base salary £'000	Percentage change in base salary 2013-2014
Paul Geddes	Chief Executive Officer	760	760	0%
John Reizenstein	Chief Financial Officer	460	460	0%

Annual Incentive Plan 2014

The maximum annual incentive awards which may be payable to Executive Directors in respect of 2014 are shown below and have remain unchanged from the maximum awards payable under the AIP in respect of the financial year ended 31 December 2013.

Director	Position	Maximum annual incentive award for 2014 (% base salary)	Percentage deferred under the Deferred Annual Incentive Plan
Paul Geddes	Chief Executive Officer	175%	40%
John Reizenstein	Chief Financial Officer	150%	40%

During 2013, the Committee considered the relative importance of the performance measures and whether the Board's strategic priorities going forward were fully reflected in the AIP. This assessment resulted in the introduction of lead strategic indicators for 2014, which will include both financial and non-financial measures which indicate the overall strategic progress of the business. Furthermore, to further emphasise the gateway factors, the Committee concluded that while it would set a target for each measure (which is commercially confidential at the outset but which may be disclosed on a retrospective basis), it would not set threshold and stretch targets, leaving such assessment to judgement.

Through 2013, the Committee worked alongside the Board Risk Committee to ensure that risk management is central to all pay decisions and, for 2014, will more explicitly use risk as a gateway to moderate all aspects of the AIP. The Committee therefore decided to remove the specific risk measure, as it felt that attributing 10% to such aspect devalued the criticality of this metric. It also took the opportunity to improve the alignment to strategic objectives and removed the COR element which was felt to be largely duplicative with profit.

	Measures	2014 weighting	2013 weighting
Financial	Adjusted on-going operating profit	40%	35%
	Other financial measures not reflected in the definition of profit, primarily movements in historic reserves, the performance of run-off businesses and management of tax and restructuring costs (which replaces COR for 2013)	10%	10%
	Cost targets	10%	10%
Risk	Risk management within risk appetite	As gateway	10%
Strategic	A mix of financial and non-financial lead indicators including market share, retention, quote to conversion ratio, scored loss ratio, progress with technology and strategic projects and others	10%	n/a
	Based on a balance of customer metrics (for 2014, this will include Net Promoter Score)	10%	10%
Personal objectives	No more than five defined objectives	20%	25%

Given the competitive nature of the insurance sector, while the performance measures for annual bonus are disclosed, the detailed targets are considered commercially sensitive and likely to remain so and are accordingly not disclosed. The level of achievement against each measure in respect of the financial year ended 31 December 2013 is shown in the audited section of the annual remuneration report. The Committee will aim to provide a consistent level of disclosure in future years.

All AIP outcomes will be determined following the Committee's determination of a payment gateway, which requires the Committee to be satisfied that it is appropriate to permit the award of a bonus, at all or at a given level. The gateway necessarily involves an element of subjective judgement of performance and may result in moderation, either positive or negative, of each AIP performance measure. The gateway criteria for AIP for 2014 are set out overleaf.

Gateway criteria for 2014 AIP outcomes

- Affordability
- Risk management within risk appetite
- The relative performance of the Group to that of its peers
- The wider economic environment
- Exceptional events, such as abnormal weather
- The occurrence of any regulatory breaches and / or reputational damage to the Group
- Committee satisfaction that payment of the bonus does not give rise to major reputational concerns
- Such other factors as the Committee may consider to be relevant

In addition to the gateway criteria, the Committee may use its discretion to take into account additional factors such as customer conduct and experience, the quality of financial results, the view of the "direction of travel" in all metrics and a wider consideration of reputation, risk and audit.

Performance conditions for LTIP awards to be made in 2014

LTIP awards to be granted in 2014 will continue to be subject to the achievement of the following performance conditions:

- 60% to be based on RoTE over a three-year performance period (2014, 2015 and 2016); and
- 40% to be based on relative TSR performance against the constituents of the FTSE 350 (excluding investment trusts) over a three-year performance period starting on the date of grant. The starting TSR and closing TSR will both be averaged over a three-month period.

For these purposes, the Group's standard definition for RoTE is used (see definition on page 178) 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

For both the TSR and RoTE elements, 20% of the award vests for threshold performance with 100% vesting for maximum performance. There is a straight-line interpolation between these points for the TSR measure (on a ranked basis). For the RoTE element, 40% vests for 15% RoTE, otherwise, similar to TSR, a straight-line interpolation occurs from threshold to target and then from target to maximum performance.

In addition, the LTIP awards will vest only 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 date of grant until vesting. In making these considerations, the Committee will take into account whether there have been any material risk failings.

Pension and benefits

A pension contribution of 25% of base salary will continue to be paid to both Executive Directors in 2014 as shown in the table below:

Director	Position	Pension contribution (% base salary)
Paul Geddes	Chief Executive Officer	25%
John Reizenstein	Chief Financial Officer	25%

Benefits will continue to comprise the provision of a company car or car allowance, private medical insurance, life assurance, income protection and health screening. The Executive Directors are also eligible to receive certain Group products at a discount, in line with the approach for all employees.

Non-Executive Director fees

The current fees for the Chairman and Non-Executive Directors were set in 2012 and have not been changed to date.

Position	2013 Fees £'000
Board Chairman fee	400
Basic Non-Executive Director fee	70
Additional fees	
Senior Independent Director fee	30
Chair of Audit, Risk and Remuneration Committees	30
Chair of CSR Committee	10
Member of Board Committee (Audit, Risk or Remuneration)	10
Member of Board Committee (CSR or Nomination)	5

No additional fees are paid for membership or chairmanship of the Investment Committee.

Annual remuneration report section B: audited information

Single figure table

£'000		Salary[1]	Annual bonus[2]	Long-term incentives[3,4]	Benefits[1,5]	All Employee share plans[6]	Pension contributions and cash allowance in lieu of pension[1]	Participation in RBS Group defined benefit plan[7]	Total
Paul Geddes	**2013**	**760**	**835**	**622**	**23**	**0**	**190**	**–**	**2,430**
	2012	671	760	205	47	0	190	35	1,908
John Reizenstein	**2013**	**460**	**415**	**135**	**14**	**1**	**115**	**n/a**	**1,140**
	2012	407	345	n/a	26	0	115	n/a	893

Notes:

1. Base salary, benefits, pension contributions and cash allowance in lieu of pension during the financial year ending 31 December 2012 include part of the year as an employee of RBS Group and part of the year as an employee of Direct Line Group.
2. Includes amounts earned for performance during the year but deferred under the Deferred Annual Incentive Plan as shown on page 94.
3. Long-term incentives in 2012 and 2013 for Paul Geddes and in 2013 for John Reizenstein represent the vesting of the RBS Group Long-Term Incentive Plan awards granted in 2010 and 2011 respectively, with vesting amounts assessed by the RBS Group Remuneration Committee. For 2011 RBS Group LTIP awards vesting by reference to 2013 performance, the vesting outcome is calculated at 54.75% for Paul Geddes giving 274,514 Company shares and at 58% for John Reizenstein, giving 59,713 Company shares. These expected vesting outcomes are then accordingly multiplied by the average Company share price from 1 October 2013 to 31 December 2013 of £2.2658.
4. Details of the performance measures and targets applicable to the vesting of RBS legacy LTIP awards are shown on pages 98 to 99.
5. Benefits include a company car or allowance, private medical and income protection insurance. In 2012 the Executive Directors were participants in benefits provided by RBS Group prior to being appointed Directors of the Company on 1 September 2012. The benefits figure reported for 2012 has been updated from the figure presented for the 2012 accounts to reflect changes in the reporting rules.
6. Includes the value of matching shares under the Share Incentive Plan. For 2012, this also includes the free share awards made to each Director (valued at £289 for each Director). All figures in the table are rounded to the nearest thousand.
7. Paul Geddes was a participant in an RBS Group defined benefits scheme until 1 September 2012, when he became a member of Direct Line Group's defined contribution scheme. He has kept his accrued pension in the RBS Group defined benefits scheme but received no benefit in the year as he is a deferred member only and no additional accruals were made to the scheme in respect of his participation.

Confirmation has been received by each Executive Director that they have not received any other items in the nature of remuneration, other than those already disclosed in the single figure table.

2013 AIP

Outcomes against the specific performance metrics during the year both before and after the exercise of judgement by the Committee were as follows:

	Group performance metrics					Personal objectives	
Measure	Profit	Combined operating ratio	Cost reduction target	Risk management within risk appetite	Customer experience	Paul Geddes	John Reizenstein
2013 weighting	35%	10%	10%	10%	10%	25%	
Unadjusted assessment	◕	●	●	◑	◔	◑	◑
Adjusted assessment	◑	◑	●	◑	○		

Where the icons above represent performance broadly as follows:
○ = below threshold, ◔ = threshold to 90% of on-target, ◑ = 90% to 110% of on-target, ◕ = above 110% of on-target, ● = maximum

In considering outcomes against the specific measures, the Committee applied judgement in relation to the quality of earnings assessment of the financial elements, gateway considerations as described elsewhere in this report and its overriding judgement in assessing the actual payment for each Executive Director and, where appropriate, outcomes were moderated accordingly. The Committee intends to operate a similar approach in future years and will explain the use of its judgement accordingly.

Overall, the Committee felt that a broadly on-target level of performance was warranted for the financial elements, with the exception of the cost reduction target where all of the stretch objectives were met. In respect of the customer experience metric, despite a strong performance on customer conduct, with improvements in many measures, the Committee considered that the Group had not met its own stretching objectives to develop and differentiate customer propositions, and this remains a priority in 2014. The Committee therefore reduced this element to below threshold to recognise this.

Consequently, the annual incentive awards payable to the Executive Directors in respect of the financial year ended 31 December 2013 are shown in the table below:

Director	Position	Maximum annual incentive award (% of base salary)	Actual annual incentive award for 2013 (% of base salary)	Actual annual incentive award for 2013 (including cash and deferred element) £'000
Paul Geddes	Chief Executive Officer	175%	110%	835
John Reizenstein	Chief Financial Officer	150%	90%	415

Deferred Annual Incentive Plan

The table below details the deferred share awards to be granted to Paul Geddes and John Reizenstein in respect of the 2013 financial year. These awards are not subject to any conditions other than continuous employment.

Unlike the bonus in respect of 2012, when Paul Geddes's bonus was 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 part of 2012, the deferral terms for the bonus outcome in respect of 2013 will be the same for both Executive Directors.

Director	Total AIP award for 2013 £'000	Percentage deferred	Amount deferred £'000	Vesting date
Paul Geddes	835	40%	334	March 2017
John Reizenstein	415	40%	166	March 2017

Non-Executive Directors

Remuneration for the Non-Executive Directors for the year ended 31 December 2013 is shown in the table below. The only remuneration paid to the Non-Executive Directors in 2012 and 2013 was in the form of fees.

Director	Fees[1] £'000	Total 2013 £'000	Total 2012 £'000
Mike Biggs	400	400	270
Mark Catton[2]	–	–	–
Glyn Jones	115	115	27
Jane Hanson	120	120	80
Andrew Palmer	125	125	82
Clare Thompson	105	105	31
Priscilla Vacassin	110	110	29
Bruce Van Saun[2]	–	–	–-

Notes:

1. Non-Executive Directors are not eligible to participate in any of the Group's bonus or share incentive schemes or join any Group pension scheme.
2. Mark Catton, a Director nominated by the RBS Group, resigned as a Director of the Company on 26 April 2013, following the reduction in the shareholding of RBS Group to less than 50% on 13 March 2013, and was reappointed as a Director on 1 October 2013 following the resignation of Bruce Van Saun. RBS Group is entitled, under its Relationship Agreement with the Company, to nominate one Non-Executive Director to the Board while its shareholding in the Company remains 20% or more. During their appointment as Non-Executive Directors, Bruce Van Saun and Mark Catton were RBS Group employees with any fees they may receive payable to RBS Group.

Shareholdings

The Executive Directors are subject to share ownership guidelines and are expected to retain all of the Ordinary Shares that they obtain from any of the Company's share incentive plans, after any disposals necessary for the payment of personal taxes on the acquisition of such Ordinary Shares, until they have achieved the required level of shareholding. 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.

The extent to which Executive Directors have achieved the guideline requirements by 31 December 2013 can be summarised as follows:

Position	Share ownership guideline (% of salary)	Value of shares held at 31 December 2013 (% of salary)
Chief Executive Officer	200%	32%
Chief Financial Officer	150%	33%

The total share interests of each Executive Director under share plans are shown in the table below:

		Share plan interests at 31 December 2013			Beneficial share interests	
Director	Position	Share plan awards subject to performance conditions[1]	Share plan awards not subject to performance conditions[2]	Share plan interests vested but unexercised[3]	Shares held at 31 December 2013[4,5]	Shares held at 31 December 2012
Paul Geddes	Chief Executive Officer	2,416,123	113,256	75,409	58,768	57,142
John Reizenstein[6]	Chief Financial Officer	958,796	68,859	–	60,904	57,142

Notes:

1. Includes legacy RBS LTIPs granted in 2011 and 2012. As described in the notes to the single figure table, 54.75% and 58% of Direct Line Group shares in respect of 2011 awards granted to Paul Geddes and John Reizenstein respectively are expected to vest in March 2014 following an assessment of performance by the RBS Group Remuneration Committee.
2. Includes matching and free shares held under the Share Incentive Plan (as disclosed on page 98) and deferred shares under the DAIP. RBS Group deferred awards are not included as these are to be settled in RBS Group shares.
3. 40% of the shares awarded to Paul Geddes under the DAIP in March 2013 vested during the financial year, consistent with the policy applying at RBS Group.
4. As at the date of this report the number of shares beneficially held by Paul Geddes and John Reizenstein had increased to 59,247 and 61,910 respectively.
5. Includes holdings of connected persons, as defined in sections 252-255 of the Companies Act.
6. Beneficial share interest includes participant shares held under the Share Incentive Plan.

The beneficial interests of the Non-Executive Directors in the Company's shares as at 31 December 2012 and 31 December 2013 are shown in the table below:

Director	Shares held at 31 December 2013[1,2]	Shares held at 31 December 2012
Mike Biggs	–	–
Mark Catton	–	–
Jane Hanson	28,571	28,571
Glyn Jones	60,395	57,142
Andrew Palmer	11,428	11,428
Clare Thompson	30,197	28,571
Priscilla Vacassin	30,197	28,571
Bruce Van Saun[3]	–	–

Notes:

1. As at the date of this report, the number of shares held by Directors was as follows: Glyn Jones – 61,353; Clare Thompson – 30,676; and Priscilla Vacassin – 30,676. There were no other changes between the year end and the date of this report.
2. Includes holdings of connected persons, as defined in sections 252-255 of the Companies Act.
3. Bruce Van Saun resigned as a Director on 1 October 2013. His shareholding for 2013 is shown as of that date.

Direct Line Group share awards

Direct Line Group Deferred Annual Incentive Plan

The table below details the first awards made to Paul Geddes and John Reizenstein under the Direct Line Group Deferred Annual Incentive Plan relating to the bonus in respect of 2012, the monetary value of which was disclosed in full in last year's Remuneration Report.

Director	Awards granted during the year	Grant date	Share price at grant date £	Face value of award £	Vesting date	Awards held at 31 December 2013
Paul Geddes	188,522[1]	28 March 2013	2.0157	380,004	1 June 2013 – 1 March 2016[2]	188,522
John Reizenstein	68,462[1]	28 March 2013	2.0157	137,999	28 March 2016	68,462

Notes:

1. The awards in respect of the financial year ending 31 December 2012 were granted on 28 March 2013 as nil-cost options.
2. The terms on which Paul Geddes' 2012 bonus outcome was deferred meant that 60% of the outcome was deferred, with deferral split broadly evenly between deferral into deferred cash and deferred shares, with phased vestings of the deferred amounts over the three year deferral period. As shown on page 96, 75,409 of the awards granted on 28 March 2013 vested during the year.

Direct Line Group Long Term Incentive Plan

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

Director	Awards at 1 January 2013	Awards granted during the year	Grant date	3 day-average share price for grant of award £	Face value of award	Vesting date	Percentage of scheme interests that would be receivable if the minimum performance was achieved	Awards held at 31 December 2013
Paul Geddes	388,250[2]	377,040	28 March 2013	2.0157	£760,000	28 March 2016	20%	
		352,439	28 August 2013	2.1564	£759,999	28 August 2016	20%	1,117,729
John Reizenstein	234,993[2]	228,208	28 March 2013	2.0157	£459,999	28 March 2016	20%	
		213,318	28 August 2013	2.1564	£459,999	28 August 2016	20%	676,519

Notes:

1. The Company's share price on 31 December 2013 was £2.496 and the range of prices in the year was £1.982 to £2.496.
2. These awards take the form of nil cost options over the Company's shares and are subject to performance conditions to be assessed by the Committee, which are the same as those for awards to be made in 2014 as described on page 92. Awards accrue dividend entitlements until the date of transfer of shares.
3. These figures do not include those RBS Group LTIP awards held by the Executive Directors which are included in the table on page 98.

The Company's policy is to make awards twice a year following the announcement of the Group's full and half-year results. The value of each grant of awards is set at 50% of the normal annual policy level, so that the total face value of awards to each Executive Director during the year equates to 200% of base salary, measured using an average share price prior to the date of grant.

Direct Line Group 2012 Share Incentive Plan

From 18 February 2013, all employees including Executive Directors can invest from £10 up to £125 per month from their pre-tax pay into the BAYE Share Incentive Plan (the "**SIP**") and receive one matching share for every two shares purchased. The limit of £125 per month may be reviewed as legislation evolves to take account of any changes, where appropriate.

The table below details the number of shares held by John Reizenstein under the SIP. Paul Geddes does not participate in the plan.

Director	Matching shares granted during the year	Matching shares cancelled during the year	Value of matching shares granted[1] £	Balance of matching shares at 31 December 2013
John Reizenstein	254	–	561	254

Note:
1. The accumulated market value of matching shares at the time of each award. Purchase of the matching shares takes place within 30 days of the BAYE contributions being deducted from salary.

In addition, at the time of the IPO, and under the same terms as other employees, Executive Directors were offered the opportunity to subscribe for 143 free Company shares which will vest in November 2015, three years from grant. Both Executive Directors subscribed for this offer and the value of £289 for each Director is included in the single figure table.

Dilution

The Company 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 Company's share plans. Legacy RBS Group awards to be satisfied in Company shares will be satisfied by RBS Group rather than the Company and RBS Group has placed shares in trust to facilitate this.

Legacy RBS Group awards

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. These awards have been included as they were granted to the Executive Directors in respect of their work as directors of RBS Insurance, as the Group was previously known.

RBS Group Long-Term Incentive awards

Awards originally granted under the RBS Group Long-Term Incentive Plans ("**RBS Group LTIP**") in 2011 and 2012 will be delivered in Company 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 Company shares. No awards were granted, vested or lapsed during the year although the potential value of the 2011 LTIP has been included in the single figure of remuneration as described on page 93.

Director and scheme	Awards held at 1 January 2013 (Direct Line Group shares)	Awards held at 31 December 2013	Grant date	Market price at grant date (RBS Group shares) £	Vesting date
Paul Geddes					
RBS Group LTIP 2011	501,394	501,394	7 March 2011	4.45	7 March 2014
RBS Group LTIP 2012	797,000	797,000	9 March 2012	2.80	9 March 2015
John Reizenstein					
RBS Group LTIP 2011	102,953	102,953	7 March 2011	4.45	7 March 2014
RBS Group LTIP 2012	179,324	179,324	7 March 2012	2.80	7 March 2015

Notes:
1. The Direct Line Group share price at 31 December 2013 was £2.496 and the range of prices in the year was £1.982 to £2.496.
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 Company 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 Group share offer price (£1.75). This conversion equated to 1.487 Company shares for every RBS Group share under grant. Both Executive Directors took up this offer.

These awards 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.

The table below details the awards held by Paul Geddes made under the RBS Group LTIP in 2010 which vested in RBS Group shares during 2013.

Director and scheme	Awards held at 1 January 2013 (RBS Group shares)	Awards vested during the year (RBS Group shares)	Awards lapsed during the year (RBS Group shares)	Awards held as at 31 December 2013	Grant date	Vesting date
Paul Geddes						
RBS Group LTIP 2010	229,779	69,509	160,270	–	14 May 2010	24 April 2013

Note:

1. The market price of RBS Group shares at vesting was £2.9477. These awards were subject to performance conditions assessed by the RBS Group Remuneration Committee at the time of vesting, 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. No awards were granted or lapsed during the year.

Director and scheme	Awards held at 1 January 2013 (RBS Group shares)	Awards Vested during the year (RBS Group shares)	Awards held as at 31 December 2013 (RBS Group shares)	Grant date	Vesting dates
Paul Geddes					
2011	35,961	17,980[1]	17,981	7 March 2011	7 March 2012 – 7 March 2014
2012	96,464	32,154[1]	64,310	9 March 2012	9 March 2012 – 9 March 2015
John Reizenstein					
2011	4,794	2,397[1]	2,397	7 March 2011	7 March 2012 – 7 March 2014
2012	13,219	4,406[1]	8,813	7 March 2012	7 March 2012 – 7 March 2015

Note:

1. Vested on 7 March 2013 when the RBS Group share price was £3.036.

This report was reviewed and approved by the Board on 25 February 2014.

Priscilla Vacassin, Chair of the Remuneration Committee

The Directors present their report for the financial year ended 31 December 2013.

Strategic report

The Company has chosen, in accordance with section 414c(ll) of the Companies Act 2006, and as noted in this Directors' report, to include certain additional matters in its Strategic report that would otherwise be required to be disclosed in this Directors' report.

Disclosure and Transparency Rule 4.1.5(2) requires this Annual Report & Accounts to include a management report. The information that fulfils this requirement can be found in the Strategic report on pages 2 to 49.

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 consolidated financial statements.

The forward-looking statements disclaimer is set out on page 179.

Corporate governance statement

The information that fulfils the requirements of the corporate governance statement for the purposes of Disclosure and Transparency Rule 7.2 can be found in this Directors' report and in the corporate governance report on pages 56 to 75, which is incorporated into this Directors' report by reference.

Post-balance sheet events and likely future developments

Details of events after the statement of financial position date are contained in note 40 to the consolidated financial statements and form part of this report.

Dividends

The Board is recommending a final dividend of 8.4 pence per share to shareholders, which, subject to shareholder approval, will be paid on 20 May 2014 to all holders of Ordinary Shares on the Register of members at close of business on 14 March 2014.

In addition, the Company paid a special interim dividend of 4.0 pence per share in December and the Board is now declaring a second special interim dividend of 4.0 pence per share. Both these special interim dividends relate to items in 2013 that were not expected at the start of the year. The second special interim dividend will be paid on 20 May 2014 to all holders of Ordinary Shares on the Register of members at close of business on 14 March 2014.

Directors

Details of the Company's rules on the appointment and term of appointment of Directors are given on pages 61 to 62.

Remuneration of Directors

The Remuneration report starting on page 76 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 55.

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 is 1,500,000,000 Ordinary Shares of 10 pence each.

During the AGM held on 6 June 2013, the Directors were authorised 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 2014 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, 28.5% 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 2013 are given in notes 27 and 33 of the consolidated financial statements which form part of this report.

The Company held no Treasury Shares during the year or at the date of this 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.

Details of Directors' remuneration, service contracts, employment contracts and interests in the shares of the Company are set out in the Directors' remuneration report on pages 76 to 99.

Relationship Agreement with RBS Group

Under the terms of a Relationship Agreement between the Company and RBS Group, RBS Group has the right to nominate Directors to the Board of the Company; whilst RBS Group held over 50% of the shares of the Company RBS Group was entitled to nominate two Directors and such Directors were Bruce Van Saun and Mark Catton.

Following the reduction of RBS Group's shareholding below 50% on 13 March 2013, RBS Group became entitled to nominate one rather than two Directors and Mark Catton accordingly resigned on 26 April 2013. On the resignation of Bruce Van Saun on 1 October 2013 on account of his work for RBS Group moving to the United States, Mark Catton re-joined the Board as RBS Group's nominated Director in place of Bruce Van Saun.

Under the terms of the agreement, after ceding control of the Company, RBS Group may only nominate one Director until such time as its shareholding reduces below 20%.

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.

Significant agreements

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 allow 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 to the satisfaction of any performance conditions, and normally with an additional time based pro-rata reduction where performance conditions apply

Substantial shareholdings

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

Shareholder	31 December 2013	25 February 2014[1]
The Royal Bank of Scotland Group plc[2]	28.50%	28.50%

Notes:
1. The interests of RBS Group indicated above are held directly.
2. Information provided to the Company pursuant to the Disclosure and Transparency Rules is publicly available via the regulatory information services and on the Company's website.

Employee consultation

The Group's statement on our employees is set out in the Strategic report on page 46. In summary, we encourage open, honest and transparent communication and dialogue with employees.

We have well-established Employee Representative Bodies ("**ERBs**") that comprise elected representatives of employees across our business. ERBs help shape initiatives by helping us share and discuss proposals and initiatives which affect our future and advise the Executive Committee regarding employee matters.

These bodies are consulted as part of future change programmes, and in particular about collective redundancies and TUPE transfers. They complement our existing communication processes and represent their constituents' interests.

On 26 June 2013, the Company announced proposals to improve its operational efficiency as part of its business transformation plan.

These proposals resulted in approximately 3,200 roles being put at risk. The Group ensured meaningful consultation took place with elected representatives regarding ways to avoid, reduce or mitigate the impact of proposed reductions in the number of roles.

Employees can also raise issues and ideas through "BEST Quest" – an intranet based communication tool which facilitates on-line information sharing. We will be phasing this out and replacing it with Yammer; a business social networking tool which will help reinforce some of our core values such as 'working together' 'say it like it is' and 'bring all of yourself to work' and reduce the impact of geographic and organisational barriers to communication.

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 and sexual orientation. These commitments extend to recruitment and selection, training, career development, flexible working arrangements, promotion and performance appraisal.

Numerical data relating to the gender diversity of the Board, senior executives and the employees may be found on page 47.

Employees with disabilities

As an organisation we are committed to ensuring that diversity is promoted across all areas of our business. At recruitment we make adjustments to facilitate applications and the selection process and provide guidance and where necessary additional training for interviewers.

Our Diversity Network Alliance has a 'strand' which focuses on matters important to our employees with a disability and to identify areas that we can improve upon. To facilitate continued employment we make reasonable adjustments to the working environment/equipment, the role or role requirements and ensure that the same opportunities are available to all.

Political contributions

The Group made no political donations during the year (2012: nil).

Governmental regulation

To comply with European Union ("**EU**") 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 and RBS Group ceded control of Direct Line Group on 13 March 2013 and reduced its shareholding further to 28.5% on 27 September 2013.

Greenhouse gas emissions

The Group has followed the 2013 UK Government environmental reporting guidance for greenhouse gas ("**GHG**") emissions, used the UK Government's greenhouse gas conversion factors and adopted the financial-control approach. GHG emissions are classified as either direct or indirect, and are divided into Scope 1 and Scope 2 emissions.

Direct GHG emissions are those from sources that are owned or controlled by the Group. Indirect GHG emissions are those that are a consequence of the activities of the Group, but that occur at sources owned or controlled by another organisation. The Group has considered the six main GHGs, reported in CO_2e tonnes equivalent and have set 2013 as the base year. The Group has included emissions from all of its overseas subsidiaries. It has not included emissions associated with its investment portfolio.

- Scope 1 – direct emissions including fuels used in office buildings, accident repair centres and owned vehicles
- Scope 2 – indirect emissions resulting from the generation of electricity purchased for office buildings and accident repair centres

The Group's total GHG emissions for 2013 were 30,624 tonnes (see table below). This primarily comprised of emissions from purchased electricity and natural gas, diesel fuel and refrigerant gas used.

In addition to total emissions, the Group also monitors emissions per £ million of net earned premium. In 2013, this was 8.7 tonnes per £ million of net earned premium. This is a measure of how efficiently insurance products are provided and allows comparison between insurance companies.

The GHG emissions data has been externally verified by Ecometrica. The verification statements can be found on the Group's website (www.directlinegroup.com).

Further information on the Group's approach to energy and the environment can be found in the corporate social responsibility report on page 44.

Greenhouse gas emissions – total Group

For the year ended 31 December 2013	CO_2e tonnes
Scope 1 direct	8,424
Scope 2 indirect	22,200
Total gross emissions	**30,624**
Emissions per £ million of net earned premium	8.7

Financial instruments

The Group's companies use financial instruments to manage certain types of risk, including those relating to foreign currency exchange, cash flow, liquidity and interest rates. Details of the objectives and management of these instruments are contained in the Risk management and Capital management sections on pages 22 to 27 and 42. 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 including the management of 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 finance review on pages 34 to 43 describes the Group's capital management strategy, which covers how it measures its 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 3.2 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; and
- 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.

Auditor

Deloitte LLP has expressed its willingness to continue in office as external auditor. A resolution to reappoint the firm will be proposed at the forthcoming AGM.

Directors' responsibility 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 EU and Article 4 of the International Accounting Standard ("**IAS**") Regulation and have also chosen to prepare the Parent Company financial statements under IFRSs as adopted by the EU. 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, IAS 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 is 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.

Each of the Directors, whose names and functions are listed on pages 52 to 53 confirm, that to the best of their knowledge:

- the financial statements, prepared in accordance with IFRS, 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
- the Strategic report (given on pages 2 to 49) 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.

Statement of the Directors in respect of the Annual Report & Accounts

The Directors confirm that they consider that the Annual Report & Accounts, taken as a whole, are fair, balanced and understandable and provide the information necessary for shareholders to assess the Group's performance, business model and strategy.

In arriving at this conclusion, the Board was supported by a number of processes which included:

- the Annual Report & Accounts were drafted by management with overall governance and co-ordination provided by a steering group comprised of a team of cross-functional senior management to ensure consistency across sections;
- a verification process was undertaken to ensure that the content was factually accurate;
- drafts of the Annual Report & Accounts were reviewed by members of the Executive Committee;
- an advanced draft was reviewed by the Company's Disclosure Committee and legal advisers; and
- the substantially final draft was reviewed by the Audit Committee prior to consideration by the Board.

This Directors' report was reviewed and approved by the Board on 25 February 2014.

By order of the Board

Paul Geddes, Chief Executive Officer 25 February 2014	John Reizenstein, Chief Financial Officer 25 February 2014

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Opinion on the financial statements of Direct Line Insurance Group plc

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 December 2013 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards ("**IFRSs**") as adopted by the European Union;
- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; 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.

The financial statements comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated and Parent Company balance sheets, the consolidated and Parent Company cash flow statements, the consolidated and Parent Company statements of changes in equity and the related notes 1 to 40 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 IFRSs as adopted by the European Union and, as regards the Parent Company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Separate opinion in relation to IFRSs as issued by the IASB

As explained in note 1 to the consolidated financial statements, in addition to complying with its legal obligation to apply IFRSs as adopted by the European Union, the Group 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.

Going concern

As required by the Listing Rules we have reviewed the Directors' statement on page 102 that the Group is a going concern. We confirm that:

- we have concluded that the Directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate; and
- we have not identified any material uncertainties that may cast significant doubt on the Group's ability to continue as a going concern.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's ability to continue as a going concern.

Our assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team.

Risk	How the scope of our audit responded to the risk
The methodology and assumptions used in setting insurance reserves The determination of the value of the insurance reserves requires significant judgment in the selection of key assumptions and methodology. Management makes significant judgement in respect of the trends in bodily injury claims frequency and severity, the propensity for large claims to settle as PPOs, the Ogden discount rate consultation and other regulatory developments.	We have tested the design and implementation and operating effectiveness of the key controls over the end to end reserving process engaging our internal actuarial specialists where appropriate. In addition we have: • tested the completeness and accuracy of the underlying data used; • considered the suitability of the methodology used in setting insurance reserves; and • challenged management's key assumptions and judgements against industry benchmarks. Our work included assessing whether the reserving methodology has been applied consistently across periods. We have also performed work to understand the sensitivity of insurance reserves to changes in key assumptions and methodology.
The valuation of investments including complex financial instruments and their accounting treatment in accordance with IAS 39 and IFRS 13 The valuation of financial investments held at fair value utilises a range of inputs. Many of the inputs required can be obtained from readily available, liquid market prices and rates. Where observable market data is not available, for example, when determining the valuation of investment property, estimates must be developed based on the most appropriate source data and are subject to significant judgement.	We have performed audit procedures over the valuation and accounting of investments held by the Group. We have tested the design and implementation and operating effectiveness of the key controls over the investment valuation process. On a sample basis we have tested their valuation at the year end. We also performed a review of sources and systems used by the Group for valuation and compared valuations to those obtained from more than one independent source or recalculated them. We also engaged our valuation specialists where appropriate and checked that the disclosure requirements of IAS 39 and IFRS 13 were appropriately addressed. We have also tested the Group's compliance with the accounting rules for complex financial instruments.

Risk	How the scope of our audit responded to the risk
Transformation projects There is a risk that the business transformation programmes undertaken by the Group could negatively impact the internal financial reporting control environment, in particular in areas of the business where there has been significant headcount reduction or new processes and procedures. There is a risk that there may no longer be an appropriate level of review and adequate segregation of duties.	We have tested the design and implementation and operating effectiveness of key business processes that have been subject to change. We have tested to determine whether appropriate segregation of duties exists within the Group's system of internal controls. For example, the procedures included an assessment of the wider implementation of the new claims system.
Reinsurance asset valuation The valuation of the reinsurance asset in respect of the ceded part of the insurance reserves requires significant judgement to reflect the counterparty risk exposure to long-term assets arising from PPOs.	We have tested the design and implementation and operating effectiveness of the key controls over the reinsurance asset valuation process. We have challenged management's key assumptions over counterparty risk and the calculation methodology, including a comparison of the underlying credit ratings for key reinsurance counterparties to independent sources. We have also considered the consistency of the approach with the prior year.
Revenue recognition International Standard on Auditing 240 (UK and Ireland) state this risk must always be treated as significant. We focus on the completeness of the revenue recorded in the financial statements and the flow of premium information from the underwriting systems to the financial reporting ledger.	We have tested the design and implementation and operating effectiveness of the key controls over revenue recognition, focusing on the flow of information from the underwriting systems to the financial reporting ledger. In addition, we performed substantive analytical testing procedures on the gross and unearned premium balances.

The Audit Committee's consideration of these risks is set out on page 67.

Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures. Our opinion on the financial statements is not modified with respect to any of the risks described above, and we do not express an opinion on these individual matters.

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

We determined materiality for the Group to be £40 million, which is below 10% of normalised pre-tax profit, and below 1.5% of equity. Pre-tax profit was normalised by taking the average pre-tax profit from ongoing operations, which excludes the impact of discontinued activities and the transformation costs, for current year and the previous two years to exclude the effect of year-on-year volatility from our determination.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £800,000, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

The scope of our group audit was determined by obtaining an understanding of the Group and its environment, including Group-wide controls, and assessing the risks of material misstatement at the Group level. Based on that assessment, we focused our group audit scope on the audit work at three primary operating locations the UK, Italy and Germany.

Four entities at these locations were subject to a full audit, a further two were subject to an audit of specified account balances where the extent of our testing was based on our assessment of the risks of material misstatement and of the materiality of the Group's operations at those locations. These six entities represent the principal business units and account for 98% of the Group's net assets, 99% of the Group's revenue and 95% of the Group's profit before tax. They were also selected to provide an appropriate basis for undertaking audit work to address the risks of material misstatement identified above. Our audit work at the three locations was executed at levels of materiality applicable to each individual entity which were lower than Group materiality.

At the Parent Company level we also tested the consolidation process and carried out analytical procedures to confirm our conclusion that there were no significant risks of material misstatement of the aggregated financial information of the remaining components not subject to audit or audit of specified account balances.

The group audit team followed a programme of planned visits that has been designed so that the Senior Statutory Auditor visits each of the locations where the group audit scope was focused at least once a year.

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 Strategic report and 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

Adequacy of explanations received and accounting records

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the Parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the Parent Company financial statements are not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Directors' remuneration

Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of Directors' remuneration have not been made or the part of the Directors' remuneration report to be audited is not in agreement with the accounting records and returns. We have nothing to report arising from these matters.

Corporate governance statement

Under the Listing Rules we are also required to review the part of the corporate governance statement relating to the Company's compliance with nine provisions of the UK Corporate Governance Code. We have nothing to report arising from our review.

Our duty to read other information in the Annual Report

Under International Standards on Auditing (UK and Ireland), we are required to report to you if, in our opinion, information in the Annual Report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit; or
- otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the Directors' statement that they consider the Annual Report is fair, balanced and understandable and whether the Annual Report appropriately discloses those matters that we communicated to the Audit Committee which we consider should have been disclosed. We confirm that we have not identified any such inconsistencies or misleading statements.

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. We also comply with International Standard on Quality Control 1 (UK and Ireland). Our audit methodology and tools aim to ensure that our quality control procedures are effective, understood and applied. Our quality controls and systems include our dedicated professional standards review team, strategically focused second partner reviews and independent partner reviews.

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.

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 Parent 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 and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

David Rush (Senior Statutory Auditor)
for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
London, United Kingdom
25 February 2014

Consolidated income statement

For the year ended 31 December 2013

	Notes	2013 £m	2012 £m
Gross earned premium	5	**3,896.3**	4,048.5
Reinsurance premium ceded	5	**(373.0)**	(326.5)
Net earned premium	5	**3,523.3**	3,722.0
Investment return	6	**221.1**	281.8
Instalment income		**117.8**	125.4
Other operating income	7	**62.4**	73.3
Total income		**3,924.6**	4,202.5
Insurance claims	8	**(2,334.8)**	(2,875.3)
Insurance claims recoverable from reinsurers	8	**180.5**	451.0
Net insurance claims	8	**(2,154.3)**	(2,424.3)
Commission expenses	9	**(392.4)**	(452.9)
Operating expenses	10	**(928.3)**	(1,047.5)
Total expenses		**(1,320.7)**	(1,500.4)
Operating profit		**449.6**	277.8
Finance costs	11	**(37.7)**	(28.7)
Gain on disposal of subsidiary	19	**12.0**	–
Profit before tax		**423.9**	249.1
Tax charge	12	**(111.1)**	(64.8)
Profit for the year attributable to owners of the Company		**312.8**	184.3

	Notes	2013	2012
Earnings per share:			
Basic (pence)	15	**20.9**	12.3
Diluted (pence)	15	**20.8**	12.3

The attached notes on pages 113 to 167 form an integral part of these consolidated financial statements.

Consolidated statement of comprehensive income

For the year ended 31 December 2013

	Notes	2013 £m	2012 £m
Profit for the year		**312.8**	184.3
Other comprehensive (loss) / income			
Items that will not be reclassified subsequently to profit or loss:			
Actuarial loss on defined benefit pension scheme	32	**(6.9)**	(3.4)
Tax relating to items not reclassified		**1.5**	0.6
		(5.4)	(2.8)
Items that may be reclassified subsequently to profit or loss:			
Exchange differences on translation of foreign operations		**(4.9)**	(2.4)
Fair value (loss) / gain on available-for-sale investments	28	**(108.2)**	109.9
Less: realised net gains on available-for-sale investments included in income statement	28	**(25.7)**	(89.5)
Tax relating to items that may be reclassified		**33.9**	1.3
		(104.9)	19.3
Other comprehensive (loss) / income for the year net of tax		**(110.3)**	16.5
Total comprehensive income for the year attributable to owners of the Company		**202.5**	200.8

The attached notes on pages 113 to 167 form an integral part of these consolidated financial statements.

Consolidated balance sheet

As at 31 December 2013

	Notes	2013 £m	2012 £m
Assets			
Goodwill and other intangible assets	16	**500.1**	421.5
Property, plant and equipment	17	**102.3**	92.4
Investment property	18	**223.4**	128.9
Reinsurance assets	20	**1,011.0**	1,102.0
Deferred tax assets	13	**19.3**	22.5
Current tax assets	12	**1.3**	5.5
Deferred acquisition costs	21	**321.5**	327.6
Insurance and other receivables	22	**1,122.0**	1,164.0
Prepayments, accrued income and other assets		**95.7**	82.6
Derivative financial instruments	23	**40.7**	37.5
Retirement benefit asset	32	**–**	2.5
Financial investments	24	**7,441.2**	7,801.5
Cash and cash equivalents	25	**908.3**	1,508.4
Assets held for sale	26	**1.0**	1.0
Total assets		**11,787.8**	12,697.9
Equity		**2,790.0**	2,831.6
Liabilities			
Subordinated liabilities	29	**486.6**	787.5
Insurance liabilities	30	**5,757.4**	6,398.5
Unearned premium reserve	30	**1,818.7**	1,872.9
Retirement benefit obligations	32	**2.0**	–
Borrowings	25	**55.1**	90.9
Derivative financial instruments	23	**19.3**	6.5
Trade and other payables including insurance payables	34	**818.3**	654.6
Deferred tax liabilities	13	**19.3**	20.9
Current tax liabilities	12	**21.1**	34.5
Total liabilities		**8,997.8**	9,866.3
Total equity and liabilities		**11,787.8**	12,697.9

The attached notes on pages 113 to 167 form an integral part of these consolidated financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 25 February 2014. They were signed on its behalf by:

John Reizenstein
Chief Financial Officer

Consolidated statement of changes in equity

For the year ended 31 December 2013

	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 2012	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 / (loss)	–	–	–	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)
Shares acquired by employee trusts	–	(5.0)	–	–	–	–	–	(5.0)
Credit to equity for equity-settled share-based payments	–	–	–	–	–	–	0.3	0.3
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
Profit for the year	**–**	**–**	**–**	**–**	**–**	**–**	**312.8**	**312.8**
Other comprehensive loss	**–**	**–**	**–**	**(100.0)**	**–**	**(4.9)**	**(5.4)**	**(110.3)**
Dividends	**–**	**–**	**–**	**–**	**–**	**–**	**(242.7)**	**(242.7)**
Transfer to non-distributable reserve	**–**	**–**	**–**	**–**	**29.6**	**–**	**(29.6)**	**–**
Shares acquired by employee trusts	**–**	**(5.7)**	**–**	**–**	**–**	**–**	**–**	**(5.7)**
Credit to equity for equity-settled share-based payments	**–**	**–**	**–**	**–**	**–**	**–**	**4.1**	**4.1**
Shares distributed by employee trusts	**–**	**0.5**	**–**	**–**	**–**	**–**	**(0.5)**	**–**
Deferred tax on share-based payments	**–**	**–**	**–**	**–**	**–**	**–**	**0.2**	**0.2**
Balance at 31 December 2013	**150.0**	**(10.2)**	**1,450.0**	**58.8**	**92.8**	**0.1**	**1,048.5**	**2,790.0**

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 2012	258.5
Transfer to subordinated liabilities	(258.5)
Balance at 31 December 2012 and 31 December 2013	**–**

The attached notes on pages 113 to 167 form an integral part of these consolidated financial statements.

Financial statements

Consolidated cash flow statement
For the year ended 31 December 2013

	Notes	2013 £m	2012 £m
Net cash used by operating activities before investment of insurance assets	35	**(307.0)**	(966.0)
Cash generated from investment of insurance assets	35	**433.0**	2,004.8
Net cash generated from operating activities		**126.0**	1,038.8
Cash flows from investing activities			
Purchases of property, plant and equipment	17	**(39.1)**	(63.7)
Purchases of intangible assets	16	**(115.5)**	(96.6)
Net cash flows from disposal of subsidiary	19	**18.8**	–
Cash flows from net investment hedges		**(9.5)**	6.1
Net cash used by investing activities		**(145.3)**	(154.2)
Cash flows from financing activities			
Dividends paid	14	**(242.7)**	(1,000.0)
Repayment of borrowings and subordinated liabilities		**(258.5)**	(246.4)
Proceeds on issue of subordinated liabilities		**–**	493.0
Finance costs		**(37.8)**	(16.1)
Purchase of employee trust shares		**(5.7)**	(5.0)
Net cash used by financing activities		**(544.7)**	(774.5)
Net (decrease) / increase in cash and cash equivalents		**(564.0)**	110.1
Cash and cash equivalents at the beginning of the year	25	**1,417.5**	1,309.6
Effect of foreign exchange rate changes		**(0.3)**	(2.2)
Cash and cash equivalents at the end of the year	25	**853.2**	1,417.5

The attached notes on pages 113 to 167 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 ("**AFS**") 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 former 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 2011. 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.

As part of the divestment from RBS Group, the treatment of 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 related expenses are now incurred directly by the Group and reflected in expenses in the income statement; other services are still provided by RBS Group under transitional services agreements and the related expenses are charged to the Group. In order to aid comparability, the Group's accounting policy was changed on 1 January 2011 so that all expenses were 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 was 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 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, with an equal and opposite credit in the statement of changes in equity.

Adoption of new and revised standards

The following new or revised standards have been adopted in the year and have not had a material impact on the Group's financial statements:

IFRS 10 'Consolidated Financial Statements' replaced SIC 12 'Consolidation – Special Purpose Entities' and the consolidation elements of IAS 27 'Consolidated and Separate Financial Statements'. 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;

IAS 27 'Separate Financial Statements' was amended to delete all other aspects of the previous standard other than those dealing with separate financial statements;

IFRS 12 'Disclosure of Interests in Other Entities' covers disclosures for entities reporting under IFRS 10 and IFRS 11, replacing the requirements in IAS 28 and IAS 27. Entities are required to disclose information that helps users of financial statements evaluate the nature, risks and financial effects associated with an entity's interests in subsidiaries, associates and joint arrangements and unconsolidated structured entities;

IFRS 13 'Fair Value Measurement' sets out a single IFRS framework for defining and measuring fair value and requiring disclosures about fair value measurements;

IAS 1 'Presentation of Items of Other Comprehensive Income' requires 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;

IFRS 7 'Financial Instruments: Disclosure – Offsetting Financial Assets and Financial Liabilities' was amended to allow users to consider the impact of netting arrangements as permitted by IAS 32 (paragraph 42) on the financial statements; and

IAS 19 'Employee Benefits' was revised and requires 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 bond rate; and all past service costs to be recognised immediately when a scheme is curtailed or amended.

1. Accounting policies continued

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 2013 and 31 December 2012. Control exists when the Group is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the 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 31 December 2013 and 31 December 2012 to items considered material to the consolidated financial statements.

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.

1.2 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 that arise on hedges of net investments in foreign operations, which were reported in other comprehensive income.

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 AFS non-monetary financial assets, 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 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 cover 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.

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 long-term assurance contracts that the Group wrote included whole-life and term assurance contracts that were expected to remain in force for an extended period of time. The contracts insured events associated with human life (for example, death or the occurrence of a critical illness). These were recognised as revenue when they became payable by the contract holder. Premiums were 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 AFS, estimates are based on the straight-line method, which 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 income comprises fees in respect of referral income received when a customer or a non-fault policyholder (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 repair 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 claims 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.

1. Accounting policies continued

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 counterparty 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.

1.7 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 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	3 years
Computer equipment	Up to 5 years
Other equipment, including property adaptation costs	2 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 ("**CGU**") 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 CGU, discounted at a rate that reflects market interest rates, adjusted for risks specific to the asset or CGU 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 adjusted for the specific characteristics of each property. 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, AFS, designated at fair value through profit or loss, or loans and receivables. The Group only has AFS financial assets and loans and receivables.

AFS
Financial assets that are not classified as loans and receivables are classified as AFS. Financial assets can be designated as AFS on initial recognition. AFS 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 AFS 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 AFS 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 and 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 reasonably be 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 AFS. 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.

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 AFS 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 have adversely affected the amount or timing of future cash flows from the asset.

AFS
When a decline in the fair value of a financial asset classified as AFS 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 AFS equity instruments are not reversed through profit or loss, but those on AFS 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 AFS other investment funds were recognised in equity.

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.

1. Accounting policies continued

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 charged to the income statement and the bad debt provision is released 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 enters into a number of hedge relationships for cash flow and fair value hedges. Previously the Group entered into hedge relationships for net investments.

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 were recognised directly in equity, where they remain until disposal or partial disposal of the associated subsidiaries. Any ineffective portion was recognised in the income statement. Non-derivative financial liabilities as well as derivatives may have been 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, 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.

The Group makes provision for all insurance industry levies, such as the Financial Services Compensation Scheme and Motor Insurance Bureau.

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 future economic benefit. In respect of leasehold properties, a provision is recognised when the Group has a detailed formal plan to vacate the leasehold property, or significantly reduce its level of occupancy, the plan has been communicated to those affected and the future property costs under the lease exceed future economic benefits.

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.

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.

The Group's defined benefit pension scheme, as described in note 32, 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 net interest on net pension liability or asset, is charged or credited 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 under 'Items that will not be reclassified subsequently to profit or loss'.

1.19 Taxation

The tax charge or credit represents the sum of the tax currently payable or receivable and deferred tax.

The current tax charge 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 assets and liabilities are calculated at the tax rates expected to apply when the assets are realised or liabilities are settled 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 to 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 plans under which it awards Company shares and share options to its employees. Such awards are generally subject to vesting 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.

The cancellation of an award through failure to meet non-vesting conditions triggers an immediate expense for any unrecognised element of the cost of an award.

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 for the benefit of the employee trusts is deducted from equity.

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. Accounting policies continued

1.23 Accounting developments

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.

IFRS 9 'Financial Instruments' is a new standard that is intended to replace IAS 39 'Financial instruments: Recognition and Measurement' in its entirety. The replacement project consists of three planned phases and will impact the measurement and disclosures of financial instruments.

The first phase will change the basis and treatment of the classification and measurement of financial assets and financial liabilities.

The second phase is the impairment methodology and a revised exposure draft in March 2013 has proposed a more forward-thinking impairment model that reflects expected credit losses as opposed to the incurred loss model in IAS 39.

The final phase will cover hedge accounting for both general hedge accounting and macro hedge accounting.

There is currently no mandatory effective date for IFRS 9.

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 113 to 120. 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 claims handling provision. Outstanding claims provisions net of related reinsurance recoveries and liability adequacy provision at 31 December 2013 amounted to £4,840.1 million (2012: £5,377.6 million).

Claims reserves are assessed separately for large and attritional claims typically using normal actuarial methods of projection. Key judgements in this assessment include the selection of specific methods as well as assumptions for claims frequency and severity through the review of historical claims and emerging trends. The corresponding reinsurance recoveries are also calculated on an equivalent basis as discussed in note 1.6.

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. 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 MoJ 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 was 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. The latest consultation closed in June 2013 and the results are pending.

The Group holds provisions for a reduction in the Ogden discount rate at 31 December 2013 to 1.5% (2012: 1.5%). Details of sensitivity analysis to the assumed Ogden discount rate are shown in 3.3.1.

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 table below analyses the outstanding PPO claims provisions on a discounted and an undiscounted basis at 31 December 2013 and 31 December 2012. These represent the total cost of PPOs rather than any costs in excess of purely Ogden-based settlement.

At 31 December	**Discounted 2013 £m**	**Undiscounted 2013 £m**	Discounted 2012 £m	Undiscounted 2012 £m
Gross claims				
Approved PPO claims provisions	**367.7**	**1,099.9**	300.5	918.3
Anticipated PPOs	**631.2**	**1,935.7**	962.9	2,778.6
Total	**998.9**	**3,035.6**	1,263.4	3,696.9
Reinsurance				
Approved PPO claims provisions	**(204.9)**	**(656.3)**	(175.5)	(573.3)
Anticipated PPOs	**(165.9)**	**(707.9)**	(270.0)	(1,074.4)
Total	**(370.8)**	**(1,364.2)**	(445.5)	(1,647.7)
Net of reinsurance				
Approved PPO claims provisions	**162.8**	**443.6**	125.0	345.0
Anticipated PPOs	**465.3**	**1,227.8**	692.9	1,704.2
Total	**628.1**	**1,671.4**	817.9	2,049.2

The provision for PPOs have been categorised as either claims which have already settled as PPOs (approved PPO claims provisions) and those expected to settle as PPOs in the future (anticipated PPOs). Anticipated PPOs consists of both existing large loss case reserves including allowances for development as well as claims yet to be reported to the Group. 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.

In the majority of cases, the inflation index agreed in the settlement is the Annual Survey of Hours and Earnings inflation published by the Office for National Statistics, for which the long-term rate is assumed to be 4.0% (2012: 4.0%). The rate of interest used for the calculation of present values is 4.0% (2012: 4.0%), which results in a real discount rate of 0.0% (2012: 0.0%).

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

AFS

The Group determines that AFS 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 AFS debt securities are impaired based on the following criteria:

- price performance of a particular AFS debt security, or group of AFS 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 AFS financial assets at 31 December 2013 amounted to £nil (2012: £nil).

Had all the declines in AFS asset values met the criteria above at 31 December 2013, the Group would suffer a further £40.4 million loss (2012: £21.5 million loss), being the transfer of the total AFS 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. Critical accounting estimates and judgements continued

2.3 Fair value

Financial assets classified as AFS debt securities are recognised in the financial statements at fair value. The fair value of all AFS debt securities was determined using observable market input and at 31 December 2013 amounted to £7,005.5 million (2012: £7,156.5 million).

Freehold and long leasehold properties that are classified as investment properties are recognised in the financial statements at fair value. The fair value at 31 December 2013 amounted to £223.4 million (2012: £128.9 million) was determined using a valuation model that includes inputs that are unobservable.

Estimation of the fair value of assets and liabilities

In estimating the fair value of financial assets and investment properties the methods and assumptions used by the Group incorporate:

Financial assets and liabilities

For fixed maturity securities, fair values are generally based upon quoted market prices. Where market prices are not readily available, fair values are estimated using values obtained from quoted market prices of comparable securities.

Investment property

Investment property is recorded at fair value, measured by independent valuers who hold a recognised and relevant professional qualifications. The valuation model is driven predominantly by unobservable inputs, as although in part the valuations are compared with recent market transactions for similar properties, they are adjusted for the specific characteristics of each property.

For disclosure purposes, fair value measurements are classified as Level 1, 2 or 3 based on the degree to which fair value is observable:

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.

Level 2 financial assets are 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.

Level 3 fair value measurements used for investment properties are those derived from a valuation technique that include inputs for the asset that are unobservable.

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 2013 amounted to £321.5 million (2012: £327.6 million). During 2013, the Group reviewed these 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 2013 was £211.0 million (2012: £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. 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 CGUs or groups of CGUs expected to benefit from the combination. Goodwill impairment testing involves the comparison of the carrying value of a CGU or group of CGUs with its recoverable amount. The recoverable amount is the higher of the CGU's fair value and its value in use. Value in use is the present value of expected future cash flows from the CGU or group of CGUs. Fair value is the amount obtainable from the sale of the CGU in an arm's length transaction between knowledgeable, willing parties.

Impairment testing inherently involves a number of judgemental areas: the preparation of the five-year strategic plan and the extrapolation of cash flow forecasts beyond the normal requirements of management reporting; the assessment of the discount rate appropriate to the business; estimation of the fair value of CGUs; and the valuation of the separable assets of each business whose goodwill is being reviewed. Details of a sensitivity analysis on the recoverable amount in excess of carrying value are shown in note 16.

2.6 Property, plant and equipment

The Group does not revalue property, plant and equipment. However it takes appropriate steps to consider whether the aggregate value of property, plant and equipment exceeds the balance sheet carrying value of such items.

The Group is satisfied that the aggregate value of property, plant and equipment are not less than their carrying value.

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 of the Strategic report on page 22.

3.2 Risk and capital management modelling

The Board has ultimate responsibility for ensuring that the Group has sufficient funds to meet its liabilities as they fall due. The Group carries out detailed 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. The assessment is submitted to the PRA as the ICA in respect of its UK regulated entities. The ICA quantifies the insurance, market, counterparty, liquidity, operational and Group risk that the UK regulated entities are undertaking.

The Board is closely involved in the ICA process and reviews and approves its assumptions and results.

3.3 Principal risks from insurance activities and use of financial instruments

The Risk management section of the Strategic Report sets out all the risks assessed by the Group as principal risks. Detailed below is the Group's risk exposure arising from its insurance activities and use of financial instruments specifically in respect of insurance risk, market risk and counterparty risk.

3.3.1 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 motor, residential property, roadside 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.

Prior to July 2011, the Group underwrote long-term insurance falling within the business classes of life and annuity and permanent health. From 6 July 2011 the Group ceased accepting new business. The products provided included mortgage life cover, fixed term 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 extended for a period ranging from five years up to 52 years. On 28 November 2013, the Life business was sold and liability was transferred away from the Group.

For creditor insurance, contracts are 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.

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.

3. Risk management continued

Reserving risk is controlled through a range of processes:

- regular periodic reviews of the claims, premium and 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.

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 under review by the MoJ. 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.

As referred to on page 25, 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 claims 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 and above could have an additional financial impact on the Group.

	Increase / (decrease) in income statement		Increase / (decrease) in total equity at 31 December	
	2013 £m	2012 £m	**2013 £m**	2012 £m
PPOs[1]				
Impact of an increase in the discount rate used in the calculation of present values of 100 basis points ("**bps**")	**81.7**	104.7	**80.5**	104.7
Impact of a decrease in the discount rate used in the calculation of present values of 100bps	**(118.5)**	(150.4)	**(116.8)**	(150.4)
Ogden				
Impact of an increase in the Ogden discount rate by 100bps	**169.7**	156.6	**169.7**	156.6
Impact of a decrease in the Ogden discount rate by 100bps	**(238.2)**	(219.8)	**(238.2)**	(219.8)

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 4.0%. 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 include the impact of reinsurance, but exclude the impact of taxation.

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 major weather and other catastrophic events, known as the 'Surge Demand Plan'. A surge is the collective name given to an incident which significantly increases 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.

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 insurance risk to reinsurers but, in return, assumes back counterparty 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 counterparty risk are subject to an approval process whereby reinsurance is only purchased from reinsurers that hold a credit rating of at least A- at the time cover is purchased. The Group's leading counterparty exposures represent the accumulated counterparty risk for all Group underwriting entities and are reviewed on a monthly basis. 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.

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 loss. The retained deductible is £150 million at 31 December 2013 (2012: £125 million). 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.

3.3.2 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 by the Investment Committee. The Investment Committee determines policy and controls, covering such areas as safety, liquidity and performance. The Investment Committee meets 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.

3. Risk management continued

The investment management objectives are:

- to maintain the safety of the portfolio's principal both in economic terms and from a capital, accounting and reporting perspective;
- to maintain sufficient liquidity to provide cash requirements for operations, including in the event of a catastrophe; and
- to maximise the portfolio's total return within the constraints of the other objectives and the limits defined by the investment guidelines and capital allocation.

3.3.2.1 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;
- 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 having considered strategy, risk appetite and capital resources.

The Group monitors its market risk exposure on a monthly basis and has established an aggregate exposure limit consistent with its risk objective to maintain capital adequacy. Interdependencies across risk types have also been considered within the aggregate exposure limit. The allocation of the Group's investments across asset classes has been approved at the Investment Committee.

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 99.5% 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. The market risk policy explicitly prohibits the use of derivatives for speculative or gearing purposes, however the Group is able to, and does, use derivatives for hedging its currency risk and interest rate risk exposures.

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 30-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 London Interbank Offered Rate ("**LIBOR**") floating rate.

The Group also invests in floating rate notes, whose investment income is influenced by the movement of the short-term interest rate. A 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, 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.

Spread risk

Spread risk represents the risk of adverse fluctuation of the value of assets due to changes in the level of spreads. The level of spread is the difference between the risk free rate and actual rate paid on the asset, with larger spreads being associated with higher risk assets. The Group is exposed to spread risk through its investments in investment grade bonds and securitised credit.

Foreign currency risk

The exposure to currency risk is generated by the Group's investments in US Dollar corporate bonds, US Dollar securitised credit and its investment in subsidiaries.

At 31 December 2013, the Group maintained exposure to US Dollar securities through its investments in US Dollar corporate bonds and US Dollar securitised credits. The foreign currency exposure of these investments is hedged by foreign currency forward contracts, maintaining a minimal unhedged (direct) currency exposure on these portfolios, as well as a low basis currency risk on the hedging.

The Group is also exposed to currency risk through its investments in subsidiaries in Italy and Germany (that is, investments in equity). In September 2013, the Group changed its currency hedging strategy on these investments to accept the long-term foreign exchange fluctuation impact on its investment in subsidiaries.

Property risk

Property risk results from adverse price fluctuations on real estate investments. At 31 December 2013, the value of these investments in property was £223.4 million (2012: £128.9 million). The property investments are located in the UK and are subject to the asset admissibility rules as defined by the PRA.

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	
	2013 £m	2012 £m	**2013 £m**	2012 £m
Spread				
Impact of an increase in AFS debt securities of 100bps movement in spreads[1]	**–**	–	**(187.8)**	(155.3)
Interest rate				
Impact on AFS debt securities of an increase in interest rate of 100bps[1,2]	**18.0**	12.9	**(170.5)**	(168.6)
Investment property				
Impact of a decrease in property markets of 15%	**(33.5)**	(19.3)	**(33.5)**	(19.3)

Notes:

1. The income statement impact 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 impacted by a change in prevailing market rates, as the accounting treatment for AFS debt securities means that only the coupon received is processed through the income 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 subordinated debt is excluded from the sensitivity analysis.
4. The selection of these sensitivities should not be interpreted as a prediction.
5. 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.
6. The sensitivities set out above exclude the impact of taxation.

3. Risk management continued

The tables below analyse the maturity of the Group's derivative assets and liabilities.

At 31 December 2013	Notional amounts £m	Maturity and fair value Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative assets					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	**1,315.8**	23.8	–	–	**23.8**
Interest rate swaps	**370.1**	(1.0)	1.7	8.9	**9.6**
Interest rate futures	**561.3**	7.3	–	–	**7.3**
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	**–**	–	–	–	**–**
Total	**2,247.2**	**30.1**	**1.7**	**8.9**	**40.7**

At 31 December 2013	Notional amounts £m	Maturity and fair value Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £m
Derivative liabilities					
At fair value through the income statement:					
Foreign exchange contracts (forwards)	**–**	–	–	–	**–**
Interest rate swaps	**739.9**	(1.1)	0.4	18.5	**17.8**
Interest rate futures	**–**	–	–	–	**–**
Designated as hedging instruments:					
Foreign exchange contracts (forwards)	**9.6**	0.8	0.7	–	**1.5**
Total	**749.5**	**(0.3)**	**1.1**	**18.5**	**19.3**

At 31 December 2012	Notional amounts £m	Maturity and fair value Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £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	Maturity and fair value Less than 1 year £m	1 – 5 years £m	Over 5 years £m	Total £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

The Group has a number of open interest rate and foreign exchange derivative positions. Collateral management arrangements are in place for significant counterparty exposures. At 31 December 2013, £4.9 million (2012: £4.6 million) in cash and a £20.0 million (2012: £nil) UK Gilt have been pledged by the Group to cover out of the money derivative positions. £18.0 million (2012: £0.8 million) in cash and £nil (2012: £1.1 million) US Treasury bonds have been pledged to the Group to cover in the money derivative positions.

The terms and conditions of collateral pledged for both assets and liabilities are market standard. When securities are pledged they are required to be readily convertible to cash, and as such there has been no policy established for the disposal of assets not readily convertible into cash.

3.3.2.2 Counterparty risk

Counterparty risk arises from the potential that losses are incurred from the failure of counterparties to meet their credit obligations, due to either their failure and / or their inability to pay or their unwillingness to pay amounts due.

Counterparty risk is primarily managed through the Credit Risk and Investment Forum. The main responsibility of this forum is to ensure that all material aspects of counterparty risk within the Group are identified, monitored and measured.

The main sources of counterparty 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 – counterparty 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 counterparty risk in terms of both quantum and longevity.

The tables below analyse the carrying value of financial and insurance assets that bear counterparty risk between those assets that have not been impaired, by age in relation to due date, and those that have been impaired.

At 31 December 2013	Neither past due nor impaired £m	Past due 1 – 90 days £m	Past due more than 90 days £m	Assets that have been impaired £m	Carrying value in the balance sheet £m
AFS debt securities	**7,001.2**	–	–	4.3	**7,005.5**
Deposits with credit institutions	**1,036.5**	–	–	–	**1,036.5**
Reinsurance assets	**1,011.0**	–	–	–	**1,011.0**
Derivative assets	**40.7**	–	–	–	**40.7**
Cash at bank and in hand	**307.5**	–	–	–	**307.5**
Insurance and other receivables	**1,075.8**	42.8	3.4	–	**1,122.0**
Total	**10,472.7**	**42.8**	**3.4**	**4.3**	**10,523.2**

At 31 December 2012	Neither past due nor impaired £m	Past due 1 – 90 days £m	Past due more than 90 days £m	Assets that have been impaired £m	Carrying value in the balance sheet £m
AFS 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 receivables	1,109.8	50.3	3.9	–	1,164.0
Total	11,550.6	50.3	3.9	8.6	11,613.4

There were no material financial assets that would have been past due or considered for impairment had the contractual terms not been renegotiated.

Within the analysis of AFS debt securities above are bank debt securities at 31 December 2013 of £1,625.2 million (2012: £1,510.8 million), that can be further analysed as: secured £135.9 million (2012: £211.1 million); unsecured £1,297.4 million (2012: £1,153.4 million); and subordinated £191.9 million (2012: £146.3 million).

3. Risk management continued

The tables below analyse the credit quality of AFS debt securities that are neither past due nor impaired.

At 31 December 2013	AAA £m	AA+ to AA- £m	A+ to A- £m	BBB+ to BBB- £m	BB+ and below £m	Total £m
Corporate	321.3	695.6	2,722.7	1,134.2	–	**4,873.8**
Supranational	317.3	48.4	–	–	–	**365.7**
Local government	75.7	44.0	14.8	–	–	**134.5**
Sovereign	4.3	1,369.0	–	26.2	–	**1,399.5**
Securitised credit[1]	193.4	22.1	8.4	–	3.8	**227.7**
Total	**912.0**	**2,179.1**	**2,745.9**	**1,160.4**	**3.8**	**7,001.2**

At 31 December 2012	AAA £m	AA+ to AA- £m	A+ to A- £m	BBB+ to BBB- £m	BB+ and below £m	Total £m
Corporate	497.6	748.4	2,534.3	680.8	5.9	4,467.0
Supranational	447.0	74.8	–	–	–	521.8
Local government	127.8	110.5	15.6	17.2	–	271.1
Sovereign	1,831.2	11.6	–	–	–	1,842.8
Securitised credit[1]	24.8	–	16.7	–	3.7	45.2
Total	2,928.4	945.3	2,566.6	698.0	9.6	7,147.9

Note:

1. Securitised credit is all in the form of prime mortgage backed securities, collateralised loan obligations, securitised student loans and commercial mortgage backed securities.

The tables below analyse the credit quality of financial and insurance assets that are neither past due nor impaired (excluding AFS debt securities analysed above). The table includes reinsurance exposure, after provision. Note 3.3.1 details the Group's approach to reinsurance counterparty risk management.

At 31 December 2013	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB+ to BBB- £m	BB+ and below £m	Not rated £m	Total £m
Deposits with credit institutions	545.8	60.0	430.7	–	–	–	**1,036.5**
Reinsurance assets	0.3	710.9	289.0	0.7	–	10.1	**1,011.0**
Derivative assets	–	5.7	35.0	–	–	–	**40.7**
Cash at bank and in hand	–	0.2	255.4	51.7	–	0.2	**307.5**
Insurance and other receivables[1]	–	9.2	25.7	2.4	–	1,038.5	**1,075.8**
Total	**546.1**	**786.0**	**1,035.8**	**54.8**	**-**	**1,048.8**	**3,471.5**

At 31 December 2012	AAA £m	AA+ to AA– £m	A+ to A– £m	BBB+ to BBB- £m	BB+ and below £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 receivables[1]	–	10.7	88.7	1.0	1.3	1,008.1	1,109.8
Total	1,256.7	906.1	1,205.9	9.8	5.6	1,018.6	4,402.7

Note:

1. Other loans and receivables due from policyholders, agents, brokers and intermediaries generally do not have a credit rating.

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 and is detailed within the liquidity risk policy and supporting minimum standards. 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 analyses AFS debt securities by maturity.

At 31 December	**2013 £m**	2012 £m
Within 1 year	**1,018.4**	760.1
1 – 3 years	**1,953.0**	3,088.5
3 – 5 years	**1,920.9**	2,026.5
5 – 10 years	**1,794.9**	1,152.3
Over 10 years	**318.3**	129.1
Total	**7,005.5**	7,156.5

In addition to the above, the Group held cash and cash equivalents at 31 December 2013 of £908.3 million (2012: £1,508.4 million) to cover short-term liabilities arising from insurance contracts.

The tables below analyse insurance and financial liabilities by remaining duration, in proportion to the cash flows expected to arise during that period, for each category.

At 31 December 2013	Total £m	Within 1 year £m	1 – 3 years £m	3 – 5 years £m	5 – 10 years £m	Over 10 years £m
Subordinated liabilities	**486.6**	8.2	–	–	478.4	–
Insurance liabilities	**5,757.4**	1,817.3	1,469.9	687.1	630.9	1,152.2
Borrowings	**55.1**	55.1	–	–	–	–
Trade and other payables including insurance payables	**818.3**	794.3	6.4	1.9	6.4	9.3
Total	**7,117.4**	**2,674.9**	**1,476.3**	**689.0**	**1,115.7**	**1,161.5**

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

The above tables exclude unearned premium reserves as there are no liquidity risks inherent in them.

3. Risk management continued

Concentration risk

Concentration risk on investments 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 AFS debt securities by geographical area.

At 31 December 2013	Corporate £m	Supranational £m	Local government £m	Sovereign £m	Securitised credit £m	Total £m
Australia	249.8	–	–	–	–	**249.8**
Belgium	48.7	–	–	4.4	–	**53.1**
Brazil	2.9	–	–	1.4	–	**4.3**
Canada	59.2	–	52.2	–	–	**111.4**
China	1.7	–	–	–	–	**1.7**
Czech Republic	6.3	–	–	–	–	**6.3**
Denmark	38.2	–	–	–	–	**38.2**
Finland	13.3	–	–	–	–	**13.3**
France	364.9	–	8.1	1.8	8.4	**383.2**
Germany	407.3	–	24.3	–	33.5	**465.1**
Hong Kong	8.5	–	–	–	–	**8.5**
Ireland	0.3	–	–	–	3.8	**4.1**
Italy	49.3	–	–	20.4	–	**69.7**
Japan	44.5	–	–	–	–	**44.5**
Mexico	10.8	–	–	3.0	–	**13.8**
Netherlands	227.3	–	–	4.3	–	**231.6**
New Zealand	24.0	–	–	–	–	**24.0**
Norway	36.4	–	24.9	–	–	**61.3**
Russia	5.3	–	–	–	–	**5.3**
Singapore	24.4	–	–	–	–	**24.4**
South Africa	–	–	–	1.4	–	**1.4**
South Korea	7.1	–	–	–	–	**7.1**
Spain	31.2	–	–	–	–	**31.2**
Sweden	150.0	–	19.1	–	–	**169.1**
Switzerland	118.5	–	–	–	–	**118.5**
UAE	6.6	–	–	–	–	**6.6**
UK	1,671.4	–	–	1,362.8	35.1	**3,069.3**
USA	1,270.2	–	5.9	–	146.9	**1,423.0**
Multilateral / supranational	–	365.7	–	–	–	**365.7**
Total	**4,878.1**	**365.7**	**134.5**	**1,399.5**	**227.7**	**7,005.5**

The table below analyses the distribution of AFS debt securities by geographical area.

At 31 December 2012	Corporate £m	Supranational £m	Local government £m	Sovereign £m	Securitised credit £m	Total £m
Australia	239.0	–	–	–	–	239.0
Austria	–	–	–	2.9	–	2.9
Belgium	16.0	–	–	7.1	–	23.1
Brazil	0.4	–	–	–	–	0.4
Canada	69.4	–	134.6	–	–	204.0
Cayman Islands	7.5	–	–	–	–	7.5
Czech Republic	6.4	–	–	–	–	6.4
Denmark	32.5	–	–	–	–	32.5
Finland	13.3	–	–	–	–	13.3
France	291.7	–	–	4.5	8.4	304.6
Germany	359.6	–	–	–	33.1	392.7
Hong Kong	3.3	–	–	–	–	3.3
Ireland	13.9	–	–	–	3.7	17.6
Israel	4.4	–	–	–	–	4.4
Italy	36.4	–	–	–	–	36.4
Japan	65.7	–	–	–	–	65.7
Mexico	5.8	–	17.2	–	–	23.0
Netherlands	119.0	–	–	4.3	–	123.3
New Zealand	40.3	–	–	–	–	40.3
Norway	22.4	–	82.2	–	–	104.6
Singapore	25.5	–	–	–	–	25.5
South Korea	7.4	–	–	–	–	7.4
Spain	16.3	–	–	–	–	16.3
Sweden	200.7	–	31.0	–	–	231.7
Switzerland	108.5	–	–	–	–	108.5
UAE	12.2	–	–	–	–	12.2
UK	1,772.6	–	–	1,824.0	–	3,596.6
USA	985.4	–	6.1	–	–	991.5
Multilateral / supranational	–	521.8	–	–	–	521.8
Total	4,475.6	521.8	271.1	1,842.8	45.2	7,156.5

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3. Risk management continued

The table below analyses the distribution of AFS debt securities by industry sector classifications.

	2013		2012	
At 31 December	£m	%	£m	%
Basic materials	**196.5**	**3%**	199.7	3%
Communications	**394.1**	**6%**	333.7	5%
Consumer, cyclical	**192.9**	**3%**	137.2	2%
Consumer, non-cyclical	**451.0**	**6%**	475.7	6%
Diversified	**82.3**	**1%**	120.9	2%
Energy	**249.9**	**4%**	273.8	4%
Financial	**2,163.3**	**31%**	1,798.3	25%
Industrial	**274.9**	**4%**	265.1	4%
Mortgage and other asset backed securities	**227.7**	**3%**	45.2	0%
Sovereign, supranational and local government	**1,899.7**	**27%**	2,635.7	37%
Technology	**51.5**	**1%**	59.9	1%
Transport	**18.0**	**0%**	18.1	0%
Utilities	**803.7**	**11%**	793.2	11%
Total	**7,005.5**	**100%**	7,156.5	100%

3.4 Capital adequacy

The Group defines its capital requirement in accordance with the regulations prescribed by the PRA, other regulatory bodies and the credit rating agencies. Capital is managed in accordance with the Group's capital management minimum standard, the objectives of which are 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 capital requirement, the maintenance of a prudent excess capital over its regulatory capital requirements and its rating agency capital. The Group also seeks to hold capital coverage in the range of 125% to 150% of its risk-based capital requirement which is consistent with an 'A' range credit rating.

The UK regulated insurance entities of the Group carry out an assessment of the adequacy of their overall financial resources in accordance with the PRA's ICA methodology. The Group also monitors its financial resources with reference to the requirements of the IGD. The UK capital requirement is calculated based on an internal risk based capital model which is calibrated, as required by the PRA, to a 99.5% confidence interval over a one-year time horizon. The risk-based capital model also supports decision making in the business.

The capital for European entities is maintained in accordance with the local regulatory solvency requirements. The Group manages its subsidiaries on an ongoing basis to ensure that capital resources exceed regulatory minima in accordance with its risk appetite.

The Group has an IGD surplus at 31 December 2013 of approximately £1.8 billion (2012: £1.8 billion).

The Group's capital requirements and solvency position are produced and presented to the Board on a regular basis.

4. Segmental analysis

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 together with associated legal expenses 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 (conducted by Direct Line Life Insurance Company Limited which was sold on 28 November 2013) 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 sold through our bank partnership channel. 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 Direct Line for Business – and through its partnership with RBS and NatWest.

International

This segment consists primarily of personal motor car insurance cover sold in Italy and Germany using a multi-channel strategy through the Direct Line brand and through partnerships and PCWs.

Certain income and 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 income and charges are categorised as either run-off, described below, or restructuring and other one-off costs.

Run-off

The segment consists of two principal lines, policies previously written through the personal lines broker channel and Tesco business. These residual businesses are now in run-off.

No inter-segment transactions occurred in the year ended 31 December 2013 (2012: £nil). If any transaction were to occur, transfer prices between operating segments would be 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 in the year ended 31 December 2013:

	Motor £m	Home £m	Rescue and other personal lines[1] £m	Commercial £m	International £m	Total ongoing £m	Run-off[1] £m	Total £m
Gross written premium	1,421.1	943.1	383.4	474.5	604.5	**3,826.6**	7.9	**3,834.5**
Gross earned premium	1,498.4	958.9	383.1	468.7	579.3	**3,888.4**	7.9	**3,896.3**
Reinsurance premium ceded	(53.6)	(50.0)	(17.3)	(34.1)	(212.8)	**(367.8)**	(5.2)	**(373.0)**
Net earned premium	1,444.8	908.9	365.8	434.6	366.5	**3,520.6**	2.7	**3,523.3**
Investment return	122.8	24.1	8.2	29.6	23.4	**208.1**	13.0	**221.1**
Instalment income	78.3	25.2	1.3	6.2	6.8	**117.8**	–	**117.8**
Other operating income	48.5	0.7	9.1	3.3	0.8	**62.4**	–	**62.4**
Total income	1,694.4	958.9	384.4	473.7	397.5	**3,908.9**	15.7	**3,924.6**
Insurance claims	(978.3)	(476.7)	(240.0)	(274.8)	(453.0)	**(2,422.8)**	88.0	**(2,334.8)**
Insurance claims recoverable from reinsurers	38.1	(13.7)	20.2	4.2	169.6	**218.4**	(37.9)	**180.5**
Net insurance claims	(940.2)	(490.4)	(219.8)	(270.6)	(283.4)	**(2,204.4)**	50.1	**(2,154.3)**
Commission expenses	(36.3)	(177.9)	(27.3)	(92.2)	(57.9)	**(391.6)**	(0.8)	**(392.4)**
Operating expenses	(370.2)	(184.4)	(90.8)	(101.4)	(39.6)	**(786.4)**	(1.4)	**(787.8)**
Total expenses	(406.5)	(362.3)	(118.1)	(193.6)	(97.5)	**(1,178.0)**	(2.2)	**(1,180.2)**
Operating profit before restructuring and other one-off costs	**347.7**	**106.2**	**46.5**	**9.5**	**16.6**	**526.5**	**63.6**	**590.1**
Restructuring and other one-off costs[2]								**(140.5)**
Operating profit								**449.6**
Finance costs								**(37.7)**
Gain on disposal of subsidiary								**12.0**
Profit before tax								**423.9**
Underwriting profit / (loss)	**98.1**	**56.2**	**27.9**	**(29.6)**	**(14.4)**	**138.2**		
Loss ratio	65.1%	53.9%	60.1%	62.3%	77.3%	**62.6%**		
Commission ratio	2.5%	19.6%	7.5%	21.2%	15.8%	**11.2%**		
Expense ratio	25.6%	20.3%	24.8%	23.3%	10.8%	**22.3%**		
Combined operating ratio	**93.2%**	**93.8%**	**92.4%**	**106.8%**	**103.9%**	**96.1%**		

Notes:

1. The Group's revenue and results for the year ended 2013 relating to the Life business which was disposed of on 28 November 2013 was recorded in two segments: Rescue and other personal lines (net earned premium: £11.8 million, net insurance claims: £1.8 million and operating profit: £6.4 million) and Run-off (net earned premium: £2.8 million, net insurance claims: £0.7 million and operating profit: £1.2 million).
2. Restructuring costs are costs which have been incurred in respect of business activities which have a material effect on the nature and focus of the Group's operations. One off costs are costs which are non-recurring in nature.

The table below is an analysis of the Group's revenue and results by reportable segment in the year ended 31 December 2012:

	Motor £m	Home £m	Rescue and other personal lines[1] £m	Commercial £m	International £m	Total ongoing £m	Run-off[1] £m	Total £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 income	88.4	25.9	1.2	3.5	6.4	125.4	–	125.4
Other operating income	59.7	0.6	9.5	2.4	0.7	72.9	0.4	73.3
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)	(858.0)
Total expenses	(439.0)	(363.4)	(121.7)	(181.8)	(86.4)	(1,192.3)	(118.6)	(1,310.9)
Operating profit before restructuring and other one-off costs	261.8	93.3	84.4	2.2	19.5	461.2	6.1	467.3
Restructuring and other one-off costs[2]								(189.5)
Operating profit								277.8
Finance costs								(28.7)
Profit before tax								249.1
Underwriting (loss) / profit	(26.3)	32.7	66.2	(33.1)	(11.3)	28.2		
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%		

Notes:

1. The Group's revenue and results for the year ended 2012 relating to the Life business which was disposed of on 28 November 2013 was recorded in two segments: Rescue and other personal lines (net earned premium: £18.1 million, net insurance claims: £1.6 million and operating profit: £8.1 million) and Run-off (net earned premium: £3.8 million, net insurance claims: £0.5 million and operating profit: £1.3 million).
2. Restructuring costs are costs which have been incurred in respect of business activities which have a material effect on the nature and focus of the Group's operations. One off costs are costs which are non-recurring in nature.

The tables below analyse the Group's assets and liabilities by reportable segment.

At 31 December 2013	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	International £m	Run-off £m	Total £m
Goodwill	126.4	45.8	28.7	10.1	–	–	**211.0**
Other segment assets	6,553.0	846.9	164.8	1,447.4	1,298.8	1,265.9	**11,576.8**
Segment liabilities	(4,982.5)	(643.9)	(125.3)	(1,100.5)	(1,068.7)	(1,076.9)	**(8,997.8)**
Reportable segment net assets	**1,696.9**	**248.8**	**68.2**	**357.0**	**230.1**	**189.0**	**2,790.0**

At 31 December 2012	Motor £m	Home £m	Rescue and other personal lines £m	Commercial £m	International £m	Run-off £m	Total £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

All operations are in the UK except for International which operates in Italy and Germany. The reportable segment net assets do not represent the Group's view of the capital requirements for its operating segments.

5. Net earned premium

	2013 £m	2012 £m
Gross earned premium:		
Gross written premium	**3,834.5**	4,001.4
Movement in unearned premium reserve	**61.8**	47.1
	3,896.3	4,048.5
Reinsurance premium ceded:		
Premium payable	**(368.0)**	(365.4)
Movement in reinsurance unearned premium reserve	**(5.0)**	38.9
	(373.0)	(326.5)
Total	**3,523.3**	3,722.0

6. Investment return

	2013 £m	2012 £m
Investment income:		
Interest income on AFS debt securities	**169.9**	172.5
Other investment funds income	**–**	3.1
Cash and cash equivalent interest income	**7.3**	19.3
Rental income from investment property	**11.4**	4.4
	188.6	199.3
Net realised gains:		
AFS debt securities	**25.7**	66.3
Other investment funds	**–**	23.2
Derivatives	**21.5**	17.8
	47.2	107.3
Net unrealised (losses) /gains:		
Derivatives	**(22.2)**	(20.0)
Investment property (note 18)	**7.5**	(4.8)
	(14.7)	(24.8)
Total	**221.1**	281.8

The table below analyses the realised and unrealised derivatives included in investment return.

	2013		2012	
	Realised £m	Unrealised £m	Realised £m	Unrealised £m
Derivative gains / (losses)				
Foreign exchange forward contracts	**21.2**	**12.0**	24.3	11.7
Associated foreign exchange risk	**2.0**	**(33.3)**	(2.9)	(32.6)
Net gains / (losses) on foreign exchange forward contracts	**23.2**	**(21.3)**	21.4	(20.9)
Interest rate derivatives	**(0.8)**	**19.6**	(3.8)	(2.1)
Associated interest rate risk	**(0.9)**	**(20.5)**	0.2	3.0
Net (losses) / gains on interest rate derivatives	**(1.7)**	**(0.9)**	(3.6)	0.9
Total	**21.5**	**(22.2)**	17.8	(20.0)

7. Other operating income

	2013 £m	2012 £m
Solicitors' referral fee income[1]	**6.9**	21.2
Vehicle replacement referral income	**15.7**	17.5
Revenue from vehicle recovery and repair services	**31.8**	25.9
Fee income from insurance intermediary services	**1.7**	1.9
Other income	**6.3**	6.8
Total	**62.4**	73.3

Note:

1. Following changes to LASPO the payment of referral fees in personal injury cases were prohibited with effect from 1 April 2013.

8. Net insurance claims

	2013		
	Gross £m	**Reinsurance £m**	**Net £m**
Current accident year claims paid	**1,306.2**	**(90.5)**	**1,215.7**
Prior accident years claims paid	**1,566.6**	**(75.8)**	**1,490.8**
Movement in insurance liabilities	**(538.0)**	**(14.2)**	**(552.2)**
Total	**2,334.8**	**(180.5)**	**2,154.3**

	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 insurance liabilities	(96.8)	(324.1)	(420.9)
Total	2,875.3	(451.0)	2,424.3

Claims handling expenses for the year ended 31 December 2013 of £246.8 million (2012: £290.3 million) have been included in the claims figures above.

A decrease in the liability adequacy provision for the year ended 31 December 2013 of £4.3 million (2012: £0.7 million increase) has been included in the movement in claims provision.

9. Commission expenses

	2013 £m	2012 £m
Commission expenses	**333.3**	316.5
Expenses incurred under profit participations	**59.1**	136.4
Total[1]	**392.4**	452.9

Note:

1. Includes commission expenses for the Run-off segment for the year ended 31 December 2013 of £0.8 million (2012: £115.4 million).

10. Operating expenses

	2013 £m	2012 £m
Staff costs	**395.3**	416.7
Marketing	**184.2**	203.1
Management fees	**–**	145.5
Depreciation	**21.0**	13.1
Amortisation and impairment of other intangible assets	**37.2**	40.7
Other operating expenses	**290.6**	228.4
Total	**928.3**	1,047.5

Staff costs attributable to claims handling activities are allocated to the cost of insurance claims.

Management fees were in respect of expenses recharged from RBS Group up until 30 June 2012. Management fees were charged on an arm's length basis. From 1 July 2012 the equivalent costs have been incurred directly by the Group and included in staff costs and other operating expenses.

The table below analyses restructuring and other one-off costs included in operating expenses.

	2013 £m	2012 £m
Staff costs[1]	**57.9**	103.9
Management fees	**–**	16.3
Other operating expenses	**82.6**	69.3
Total	**140.5**	189.5

Note:
1. Staff costs include redundancy costs for the year ended 31 December 2013 of £40.9 million (2012: £34.6 million).

The table below analyses the average monthly number of persons employed by the Group.

	2013	2012
Operations	**12,187**	13,662
Support	**1,773**	1,880
Total	**13,960**	15,542

Their aggregate remuneration comprised:

	2013 £m	2012 £m
Wages and salaries	**421.3**	444.5
Social security costs	**49.8**	50.0
Pension costs[1]	**25.8**	62.3
Share-based payments	**4.1**	0.3
Total	**501.0**	557.1

Note:
1. 2012 includes a one-off retirement benefit contribution of £31.3 million in respect of separation from RBS Group (see note 32).

The table below analyses Auditor's remuneration.

	2013 £m	2012 £m
Fees payable for the audit of:		
The Company's annual accounts – Deloitte LLP	**0.4**	0.2
The Company's subsidiaries – Deloitte LLP	**1.6**	1.3
The Company's subsidiaries – Mazars S.p.A	**0.1**	0.1
Total audit fees	**2.1**	1.6
Fees payable to Deloitte LLP for non-audit services:		
Audit-related assurance services	**0.1**	0.3
Taxation advisory services	**–**	0.1
Corporate finance services[1]	**–**	4.1
Total non-audit services	**0.1**	4.5
Total	**2.2**	6.1

Note:

1. Fees incurred for corporate finance services in the year ended 31 December 2012 relate to the divestment of the Group from RBS Group.

Aggregate Directors' emoluments

The table below analyses the total amount of Directors' remuneration in accordance with Schedule 5 to the Accounting Regulations.

	2013 £m	2012 £m
Salaries, fees, bonuses and benefits in kind	**3.2**	2.5
Gains on exercise of share options	**0.5**	0.2
Defined contribution pension scheme contributions	**0.1**	–
Total	**3.8**	2.7

Further information about the remuneration of individual Directors is provided in the Directors' remuneration report.

At 31 December 2013, one Director (2012: one) had retirement benefits accruing under the defined contribution pension scheme in respect of qualifying service.

During the year ended 31 December 2013, two Directors exercised share options (2012: one Director exercised share options) in relation to RBS Group LTIP and incentive deferral plans.

11. Finance costs

	2013 £m	2012 £m
Interest expense on subordinated dated notes[1]	**37.7**	26.7
Other interest expense	**–**	2.0
Total	**37.7**	28.7

Note:

1. As described in note 29, on 27 April 2012 the Group issued subordinated dated notes with a nominal value of £500 million at a fixed rate of 9.25%. On the same date, the Group also entered into a 10-year hedge to exchange the fixed rate of interest on the subordinated dated notes for a floating rate of three-month LIBOR plus a spread of 706 bps which increased to 707 bps with effect from 29 July 2013.

12. Tax charge

	2013 £m	2012 £m
Current taxation:		
Charge for the year	**102.5**	61.7
Under / (over) provision in respect of prior year	**1.8**	(1.0)
	104.3	60.7
Deferred taxation (note 13):		
Charge for the year	**1.6**	13.9
Under / (over) provision in respect of prior year	**5.2**	(9.8)
	6.8	4.1
Current taxation	**104.3**	60.7
Deferred taxation (note 13)	**6.8**	4.1
Tax charge for the year	**111.1**	64.8

The following table analyses the difference between the actual income tax charge and the expected income tax charge computed by applying the standard rate of UK corporation tax of 23.25% (2012: 24.5%).

	2013 £m	2012 £m
Profit before tax	**423.9**	249.1
Expected tax charge	**98.6**	61.0
Effects of:		
Higher tax rates on overseas earnings	**0.7**	3.0
Realised gains on disposal of subsidiary	**(2.8)**	–
Re-measurement of deferred tax asset	**3.7**	–
Disallowable expenses	**4.7**	9.6
Non-taxable items	**(0.5)**	(0.7)
Effect of change in UK taxation rate	**(0.3)**	2.7
Under / (over) provision in respect of prior year	**7.0**	(10.8)
Tax charge for the year	**111.1**	64.8
Effective income tax rate	**26.2%**	26.0%

Note:

1. The UK Government enacted a reduction in the UK corporation tax rate from 24% to 23% effective from 1 April 2013 in the Finance Act 2012 and in the Finance Act 2013 enacted further reductions to 21% effective from 1 April 2014 and 20% effective from 1 April 2015. As a consequence the closing deferred tax assets and liabilities have been recognised at the tax rates expected to apply when the assets or liabilities are settled. The impact of these changes on the tax charge for the year is set out in the table above.

.	2013 £m	2012 £m
Per balance sheet:		
Current tax assets	**1.3**	5.5
Current tax liabilities	**(21.1)**	(34.5)

13. Deferred tax

The table below analyses the major deferred tax assets and liabilities recognised by the Group and movements thereon.

	Provisions and other temporary differences[2] £m	Retirement benefit obligations £m	Depreciation in excess of capital allowances £m	Non-distributable reserve £m	Investment properties[1] £m	Share based payments £m	Total £m
At 1 January 2012	22.5	(0.6)	0.9	(8.0)	–	–	14.8
Credit / (charge) to income statement	5.2	(0.6)	(0.5)	(7.4)	–	(0.8)	(4.1)
(Charge) / credit to other comprehensive income	(6.1)	0.6	–	–	–	–	(5.5)
Other movements	(3.6)	–	–	–	–	–	(3.6)
At 31 December 2012	18.0	(0.6)	0.4	(15.4)	–	(0.8)	1.6
(Charge) / credit to income statement	**(4.5)**	**(0.5)**	**0.7**	**(3.5)**	**(1.5)**	**2.5**	**(6.8)**
Credit to other comprehensive income	**2.4**	**1.5**	**–**	**–**	**–**	**–**	**3.9**
Credit direct to equity	**–**	**–**	**–**	**–**	**–**	**0.2**	**0.2**
Other movements	**1.4**	**–**	**(0.7)**	**0.4**	**–**	**–**	**1.1**
At 31 December 2013	**17.3**	**0.4**	**0.4**	**(18.5)**	**(1.5)**	**1.9**	**–**

Notes:

1. A deferred tax asset of £1.2 million at 31 December 2012 was not recognised in respect of capital losses arising on the revaluation of investment property.
2. A deferred tax asset of £3.7 million at 31 December 2013 has not been recognised in respect of provisions and other timing differences in Italy.

	2013 £m	2012 £m
Per balance sheet:		
Deferred tax assets	**19.3**	22.5
Deferred tax liabilities	**(19.3)**	(20.9)
	–	1.6

14. Dividends

	2013 £m	2012 £m
Amounts recognised as distributions to equity holders in the period:		
Final dividend for the year ended 31 December 2012 of 8.0p (2011: nil) per share	**120.0**	–
Interim dividend for the year ended 31 December 2013 of 4.2p (2012: 66.6p) per share	**62.8**	1,000.0
First special interim dividend for the year ended 31 December 2013 of 4.0p (2012: nil) per share	**59.9**	–
	242.7	1,000.0
Second special interim dividend for the year ended 31 December 2013 of 4.0p (2012: nil) per share	**60.0**	–
Proposed final dividend for the year ended 31 December 2013 of 8.4p (2012: 8.0p) per share	**126.0**	120.0

The proposed final dividend is subject to approval by shareholders at the Annual General Meeting on 15 May 2014 and has not been included as a liability in these financial statements.

The trustees of the employee share trusts, waived their entitlement to dividends on shares, which are not held for the benefit of employees' (except for free share awards) which reduced the total dividend paid by £0.3 million (2012: £nil).

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.

	2013 £m	2012 £m
Earnings attributable to owners of the Company	**312.8**	184.3
Weighted average number of Ordinary Shares in issue (millions)	**1,495.4**	1,499.4
Basic earnings per share (pence)	**20.9**	12.3

Diluted

Diluted earnings per share is calculated by dividing the earnings attributable to the owners of the Company by 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.

	2013 £m	2012 £m
Earnings attributable to owners of the Company	**312.8**	184.3
Weighted average number of Ordinary Shares in issue (millions)	**1,495.4**	1,499.4
Effect of dilutive potential of share options and contingently issuable shares (millions)	**5.8**	0.6
Weighted average number of Ordinary Shares for diluted earnings per share (millions)	**1,501.2**	1,500.0
Diluted earnings per share (pence)	**20.8**	12.3

Net asset value and tangible net asset value per share

Net asset value per share is calculated as total shareholders' equity 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 2013 of 5,204,771 (2012: 2,848,991).

Tangible net asset value per share is calculated as total shareholders' equity less goodwill and other intangible assets divided by the number of Ordinary Shares in issue at the end of the period.

The table below analyses net asset and tangible net asset value per share.

At 31 December	2013 £m	2012 £m
Net assets	**2,790.0**	2,831.6
Goodwill and other intangible assets	**(500.1)**	(421.5)
Tangible net assets	**2,289.9**	2,410.1
Number of Ordinary Shares in issue (millions)	**1,500.0**	1,500.0
Shares held by employee share trusts (millions)	**(5.2)**	(2.8)
Closing number of Ordinary Shares in issue (millions)	**1,494.8**	1,497.2
Net asset value per share (pence)	**186.6**	189.1
Tangible net asset value per share (pence)	**153.2**	161.0

Return on equity

The table below details the calculation of return on equity.

	2013 £m	2012 £m
Profit for the year	**312.8**	184.3
Opening shareholders' equity	**2,831.6**	3,612.8
Closing shareholders' equity	**2,790.0**	2,831.6
Average shareholders' equity	**2,810.8**	3,222.2
Return on equity	**11.1%**	5.7%

16. Goodwill and other intangible assets

	Goodwill £m	Other intangible assets £m	Total £m
Cost			
At 1 January 2012	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 losses	–	(21.2)	(21.2)
At 31 December 2012	344.6	329.4	674.0
Effect of foreign currency exchange adjustment	**–**	**0.8**	**0.8**
Additions	**–**	**115.5**	**115.5**
Disposal of subsidiary	**(1.8)**	**–**	**(1.8)**
At 31 December 2013	**342.8**	**445.7**	**788.5**
Accumulated amortisation and impairment			
At 1 January 2012	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 losses	–	(10.5)	(10.5)
At 31 December 2012	133.6	118.9	252.5
Charge for the year	**–**	**37.2**	**37.2**
Effect of foreign currency exchange adjustment	**–**	**0.5**	**0.5**
Disposal of subsidiary	**(1.8)**	**–**	**(1.8)**
At 31 December 2013	**131.8**	**156.6**	**288.4**
Carrying amount			
At 31 December 2013	**211.0**	**289.1**	**500.1**
At 31 December 2012	211.0	210.5	421.5

Goodwill arose on the acquisition of U K Insurance Limited (£141.0 million) and Churchill Insurance Company Limited (£70.0 million), which is allocated across Motor, Home, Rescue and other personal lines and Commercial.

The Group's goodwill is reviewed annually at 30 September for impairment by comparing the recoverable amount of each CGU to which goodwill has been allocated with its carrying value and updated at each reporting date in the event of indicators of impairment.

16. Goodwill and other intangible assets continued

The table below analyses the goodwill of the Group by CGU.

	2013 £m	2012 £m
Motor	**126.4**	126.4
Home	**45.8**	45.8
Rescue and other personal lines	**28.7**	28.7
Commercial	**10.1**	10.1
Total	**211.0**	211.0

There have been no impairments in goodwill in the year ended 31 December 2013 (2012:nil).

The recoverable amount is the higher of the CGU 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.

The recoverable amounts of all CGUs at 30 September were based on the value in use test, using the Group's five-year strategic plan. The long-term growth rates have been based on GDP rates adjusted for inflation. The risk discount rates incorporate observable market long-term government bond yields and average industry betas adjusted for an appropriate risk premium based on independent analysis.

The table below details the recoverable amounts in excess of carrying value for the CGUs where goodwill is held.

CGU	Assumptions			Sensitivity: Impact in recoverable amount of a:		
	Terminal Growth Rate %	Pre-tax discount rate %	Recoverable amount in excess of carrying value £m	1% decrease in terminal growth rate £m	1% increase in pre-tax discount rate £m	1% decrease in forecast pre-tax profit[1] £m
Motor	3.0	11.9	714.3	(176.7)	(246.2)	(24.3)
Home	3.0	11.9	1,339.9	(119.9)	(165.4)	(15.5)
Rescue and other personal lines	3.0	11.9	493.4	(48.6)	(67.0)	(6.2)
Commercial	3.0	11.9	74.0	(32.7)	(45.3)	(4.3)

Note:

1. Reflects a 1% decrease to the profit for each year of the five-year forecast.

17. Property, plant and equipment

	Freehold land and buildings £m	Other equipment £m	Total £m
Cost			
At 1 January 2012	4.0	85.1	89.1
Additions	0.4	63.3	63.7
Disposals	–	(9.2)	(9.2)
Effect of foreign currency exchange adjustment	–	(1.2)	(1.2)
At 31 December 2012	4.4	138.0	142.4
Additions	**10.9**	**28.2**	**39.1**
Disposals	**–**	**(6.3)**	**(6.3)**
Disposal of subsidiary	**–**	**(0.2)**	**(0.2)**
Effect of foreign currency exchange adjustment	**–**	**0.3**	**0.3**
At 31 December 2013	**15.3**	**160.0**	**175.3**
Accumulated depreciation and impairment			
At 1 January 2012	0.8	41.4	42.2
Depreciation charge for the year	0.1	13.0	13.1
Disposals	–	(4.4)	(4.4)
Effect of foreign currency exchange adjustment	–	(0.9)	(0.9)
At 31 December 2012	0.9	49.1	50.0
Depreciation charge for the year	**0.2**	**20.8**	**21.0**
Disposals	**–**	**(3.4)**	**(3.4)**
Impairment losses	**–**	**5.5**	**5.5**
Disposal of subsidiary	**–**	**(0.2)**	**(0.2)**
Effect of foreign currency exchange adjustment	**–**	**0.1**	**0.1**
At 31 December 2013	**1.1**	**71.9**	**73.0**
Carrying amount			
At 31 December 2013	**14.2**	**88.1**	**102.3**
At 31 December 2012	3.5	88.9	92.4

18. Investment property

	2013 £m	2012 £m
At 1 January	**128.9**	69.5
Additions	**87.0**	133.7
Disposals	**–**	(69.5)
Increase / (decrease) in fair value during the year	**7.5**	(4.8)
At 31 December	**223.4**	128.9

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 investment properties are measured at fair value which was arrived at on the basis of a valuation carried out at the balance sheet date by independent valuers.

The valuation conforms to international valuation standards. The fair value was determined using a methodology based on recent market transactions for similar properties, which have been adjusted for the specific characteristics of each property within the portfolio. This approach to valuation is consistent with the methodology used in the year ended 31 December 2012. There has been no change to the valuation technique during the year. All investment properties are classified as level 3 under the fair value reporting hierarchy as described in note 2.3. Fair value equates to carrying value.

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 ended 31 December 2012 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 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 sold 100% of the share capital of Direct Line Life Insurance Company Limited on 28 November 2013. The fair value of the identifiable assets sold was £159.4 million (including cash and cash equivalents of £20.5 million) and the fair value of identifiable liabilities was £132.1 million. The total cash consideration received was £39.3 million generating a profit on disposal of £12.0 million. The Life business generated a gross earned premium of £35.9 million up to the point of sale (full year 2012: £46.6 million), a net earned premium of £14.6 million (full year 2012 £21.9 million) and operating profit of £7.6 million (full year 2012: £9.4 million).

The Group did not dispose of any other subsidiaries in the year ended 31 December 2013 (2012: no subsidiary disposals).

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.

20. Reinsurance assets

	2013 £m	2012 £m
Reinsurers' share of general insurance liabilities (including unearned premium reserve)	**1,064.2**	1,068.0
Impairment provision	**(53.2)**	(60.7)
	1,011.0	1,007.3
Reinsurers' share of life insurance liabilities	**–**	94.7
Total	**1,011.0**	1,102.0

Movements in reinsurance asset impairment provision

	2013 £m	2012 £m
At 1 January	**(60.7)**	(53.9)
Additional provision	**(3.5)**	(7.6)
Utilisation of provision	**2.0**	–
Release to income statement	**9.0**	0.8
At 31 December	**(53.2)**	(60.7)

21. Deferred acquisition costs

	2013 £m	2012 £m
At 1 January	**327.6**	310.5
Net (decrease) / increase in the year	**(7.3)**	18.5
Effect of foreign currency exchange adjustment	**1.2**	(1.4)
At 31 December	**321.5**	327.6

22. Insurance and other receivables

	2013 £m	2012 £m
Receivables arising from insurance and reinsurance contracts:		
Due from policyholders	**927.9**	965.3
Impairment of policyholder receivables	**(7.6)**	(9.7)
Due from agents, brokers and intermediaries	**53.4**	106.6
Impairment of agent, broker and intermediary receivables	**(0.5)**	(0.3)
Due from reinsurers	**19.3**	34.8
Other loans and receivables:		
Accrued interest	**1.2**	2.0
Receivables from related parties	**0.9**	5.1
Other debtors[1]	**127.4**	60.2
Total	**1,122.0**	1,164.0

Note:

1. Includes £42.1 million in respect of a deposit for the purchase of owner occupied property (2012: £nil).

23. Derivative financial instruments

	2013 £m	2012 £m
Derivative assets		
At fair value through the income statement	**40.7**	37.5
Total[1]	**40.7**	37.5
Derivative liabilities		
At fair value through the income statement	**17.8**	4.1
Designated as hedging instruments	**1.5**	2.4
Total[1]	**19.3**	6.5

Note:

1. Derivative financial instruments as shown above are all classified as level 2 under the fair value hierarchy as described in note 2.3. These are measured at fair value, which equates to carrying value.

24. Financial investments

	2013 £m	2012 £m
AFS debt securities		
Corporate	**4,878.1**	4,475.6
Supranational	**365.7**	521.8
Local government	**134.5**	271.1
Sovereign	**1,399.5**	1,842.8
Securitised credit	**227.7**	45.2
Total	**7,005.5**	7,156.5
AFS debt securities		
Fixed interest rate	**6,468.4**	6,854.2
Floating interest rate	**537.1**	302.3
Total	**7,005.5**	7,156.5
Loans and receivables		
Deposits with credit institutions with maturities in excess of three months	**435.7**	645.0
Total	**7,441.2**	7,801.5

24. Financial investments continued

The following table analyses financial instruments held at fair value, which equates to their carrying value, by level of the fair value hierarchy.

	2013 £m	2012 £m
Level 1[1]	**1,393.7**	1,839.9
Level 2[1]	**5,611.8**	5,316.6
Total	**7,005.5**	7,156.5

Notes:

1. Please refer to note 2.3 for details of the fair value hierarchy.
2. The Group held no level 3 securities at 31 December 2013 (2012: £nil).

25. Cash and cash equivalents

	2013 £m	2012 £m
Cash at bank and in hand	**307.5**	201.7
Short-term deposits with credit institutions[1]	**600.8**	1,306.7
Total	**908.3**	1,508.4

Note:

1. Short-term deposits included £nil (2012: £492.5 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 2013 was 0.41% (2012: 0.35%) and average maturity was 14 days (2012: 11 days).

The following table details cash and bank overdrafts for the purposes of the cash flow statement.

	2013 £m	2012 £m
Cash and cash equivalents	**908.3**	1,508.4
Bank overdrafts	**(55.1)**	(90.9)
Total	**853.2**	1,417.5

26. Assets held for sale

	2013 £m	2012 £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 2013, the property is being actively marketed, with no impairment losses recognised in the year ended 31 December 2013 (2012: £nil).

27. Share capital

	2013 Number million	2012 Number million
Issued and fully paid: equity shares		
Ordinary Shares of 10 pence each	**1,500.0**	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 then 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 Group satisfies share-based payments under the Group's share plans primarily through shares purchased in the market and held by employee share trusts.

At 31 December 2013, 5,204,771 Ordinary Shares (2012: 2,848,991) were owned by the employee share trusts with a cost of £10.2 million (2012: £5.0 million), with an undertaking to satisfy the awards of shares in the Company under the Group's share plans.

These shares were purchased by the employee share trusts and are carried at cost. At 31 December 2013, they had an aggregate nominal value of £0.5 million (2012: £0.3 million) and a market value of £13.0 million (2012: £6.2 million).

28. Other reserves

Movements in the revaluation reserve for AFS investments

	Other investment funds £m	AFS Debt securities £m	Total £m
At 1 January 2012	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)
Realised gains – tax	5.7	16.2	21.9
At 31 December 2012	–	158.8	158.8
Revaluation during the year – gross	**–**	**(108.2)**	**(108.2)**
Revaluation during the year – tax	**–**	**27.7**	**27.7**
Realised gains – gross	**–**	**(23.9)**	**(23.9)**
Realised gains – tax	**–**	**5.8**	**5.8**
Realised gain on disposal of subsidiary – gross	**–**	**(1.8)**	**(1.8)**
Realised gain on disposal of subsidiary – tax	**–**	**0.4**	**0.4**
At 31 December 2013	**–**	**58.8**	**58.8**

Movements in the non-distributable reserve

	2013 £m	2012 £m
At 1 January	**63.2**	30.3
Transfer from retained earnings	**29.6**	32.9
At 31 December	**92.8**	63.2

The non-distributable reserve relates to a UK statutory claims equalisation reserve that is calculated in accordance with the rules of the PRA.

29. Subordinated liabilities

	2013 £m	2012 £m
Subordinated dated notes	**486.6**	529.0
Undated subordinated loans	**–**	258.5
Total	**486.6**	787.5

The subordinated dated notes were issued on 27 April 2012 at a fixed rate of 9.25%. On the same date, the Group also 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 bps.

During 2013, a credit value adjustment was made to the interest rate hedge to reflect the market value of counterparty credit risk resulting from the majority divestment from RBS Group. This has resulted in an increase in the floating rate to three-month LIBOR plus a spread of 707 bps with effect from 29 July 2013.

29. Subordinated liabilities continued

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 as at 31 December 2013 is £625.4 million (2012: £597.6 million).

The undated subordinated loans were fully repaid on 8 January 2013.

30. Insurance liabilities, unearned premium reserve and reinsurance assets

	2013 £m	2012 £m
Insurance liabilities		
Life insurance (note 31)	–	107.2
General insurance	**5,757.4**	6,291.3
Total	**5,757.4**	6,398.5
Gross general insurance (including unearned premium reserve)		
Claims reported	**3,636.4**	3,969.3
Claims incurred but not reported	**1,992.7**	2,153.9
Claims handling provision	**128.3**	163.8
Liability adequacy provision	–	4.3
Total	**5,757.4**	6,291.3
Unearned premium reserve	**1,818.7**	1,872.9
Total	**7,576.1**	8,164.2
Reinsurers' share of general insurance (including reinsurance unearned premium reserve)		
Claims reported	**(467.5)**	(397.8)
Claims incurred but not reported	**(449.8)**	(511.6)
Total	**(917.3)**	(909.4)
Unearned premium reserve	**(93.7)**	(97.9)
Total	**(1,011.0)**	(1,007.3)
Net general insurance (including unearned premium reserve)		
Claims reported	**3,168.9**	3,571.5
Claims incurred but not reported	**1,542.9**	1,642.3
Claims handling provision	**128.3**	163.8
Liability adequacy provision	–	4.3
Total	**4,840.1**	5,381.9
Unearned premium reserve	**1,725.0**	1,775.0
Total	**6,565.1**	7,156.9

Gross general insurance liabilities

Accident year	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	**Total £m**
Estimate of ultimate claims costs:											
At end of accident year	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	2,652.5	36,987.0
One year later	(187.2)	(175.8)	(266.1)	(62.0)	23.2	120.0	(98.1)	(80.3)	(168.7)	–	(895.0)
Two years later	(89.8)	(141.7)	(42.0)	(1.1)	43.9	(42.5)	(115.3)	(99.5)	–	–	(488.0)
Three years later	(61.3)	(57.9)	(17.6)	49.4	(38.3)	(24.2)	(55.1)	–	–	–	(205.0)
Four years later	(41.9)	(59.5)	10.1	(7.0)	(22.0)	(101.8)	–	–	–	–	(222.1)
Five years later	(15.2)	15.3	(21.6)	(17.8)	(57.9)	–	–	–	–	–	(97.2)
Six years later	70.5	7.8	(9.1)	(26.3)	–	–	–	–	–	–	42.9
Seven years later	12.8	5.4	(13.4)	–	–	–	–	–	–	–	4.8
Eight years later	22.0	(34.4)	–	–	–	–	–	–	–	–	(12.4)
Nine years later	(29.1)	–	–	–	–	–	–	–	–	–	(29.1)
Current estimate of cumulative claims	3,359.9	3,566.7	3,731.9	4,325.7	3,827.0	4,099.5	3,993.4	2,900.7	2,628.6	2,652.5	35,085.9
Cumulative payments to date	(3,186.6)	(3,447.6)	(3,520.0)	(4,022.7)	(3,528.3)	(3,564.7)	(3,326.3)	(2,201.3)	(1,842.7)	(1,119.6)	(29,759.8)
Liability recognised in balance sheet	**173.3**	**119.1**	**211.9**	**303.0**	**298.7**	**534.8**	**667.1**	**699.4**	**785.9**	**1,532.9**	**5,326.1**
2003 and prior											**303.0**
Claims handling provision											**128.3**
Total gross liability											**5,757.4**

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30. Insurance liabilities, unearned premium reserve and reinsurance assets continued

Net general insurance liabilities

Accident year	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	**Total £m**
Estimate of ultimate claims costs:											
At end of accident year	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	2,401.5	35,793.8
One year later	(169.2)	(159.3)	(249.7)	(81.7)	24.1	70.0	(109.7)	(119.3)	(157.8)	–	(952.6)
Two years later	(94.1)	(159.4)	(52.7)	(23.3)	8.2	(23.0)	(136.4)	(88.1)	–	–	(568.8)
Three years later	(68.3)	(62.0)	(28.2)	17.7	(24.5)	(64.2)	(48.5)	–	–	–	(278.0)
Four years later	(53.3)	(61.6)	9.9	(10.4)	(51.2)	(67.5)	–	–	–	–	(234.1)
Five years later	(13.5)	7.2	(43.5)	(22.4)	(51.2)	–	–	–	–	–	(123.4)
Six years later	60.7	(0.4)	(21.0)	(21.2)	–	–	–	–	–	–	18.1
Seven years later	(4.1)	(12.2)	(14.2)	–	–	–	–	–	–	–	(30.5)
Eight years later	(5.4)	(27.1)	–	–	–	–	–	–	–	–	(32.5)
Nine years later	(18.2)	–	–	–	–	–	–	–	–	–	(18.2)
Current estimate of cumulative claims	3,120.7	3,394.8	3,631.4	4,200.0	3,721.4	4,028.3	3,924.7	2,738.7	2,412.3	2,401.5	33,573.8
Cumulative payments to date	(3,029.2)	(3,317.3)	(3,468.0)	(3,957.6)	(3,490.8)	(3,531.0)	(3,310.0)	(2,110.4)	(1,748.1)	(1,046.4)	(29,008.8)
Liability recognised in balance sheet	**91.5**	**77.5**	**163.4**	**242.4**	**230.6**	**497.3**	**614.7**	**628.3**	**664.2**	**1,355.1**	**4,565.0**
2003 and prior											**146.8**
Claims handling provision											**128.3**
Total net liability											**4,840.1**

Movements in general insurance liabilities and reinsurance assets

	Gross £m	Reinsurance £m	Net £m
Claims reported	4,036.9	(318.1)	3,718.8
Incurred but not reported	2,217.5	(281.8)	1,935.7
Claims handling provision	153.2	–	153.2
Liability adequacy provision	3.6	–	3.6
At 1 January 2012	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)
Effect of foreign currency exchange adjustment	(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
Claims reported	3,969.3	(397.8)	3,571.5
Incurred but not reported	2,153.9	(511.6)	1,642.3
Claims handling provision	163.8	–	163.8
Liability adequacy provision	4.3	–	4.3
At 31 December 2012	6,291.3	(909.4)	5,381.9
Cash paid for claims settled in the year	**(2,852.1)**	**149.1**	**(2,703.0)**
Increase / (decrease) in liabilities:			
Arising from current-year claims	**2,894.2**	**(250.9)**	**2,643.3**
Arising from prior-year claims	**(583.9)**	**96.7**	**(487.2)**
Effect of foreign currency exchange adjustment	**12.2**	**(2.8)**	**9.4**
Decrease in liability adequacy provision	**(4.3)**	**–**	**(4.3)**
At 31 December 2013	**5,757.4**	**(917.3)**	**4,840.1**
Claims reported	**3,636.4**	**(467.5)**	**3,168.9**
Incurred but not reported	**1,992.7**	**(449.8)**	**1,542.9**
Claims handling provision	**128.3**	**–**	**128.3**
Liability adequacy provision	**–**	**–**	**–**
At 31 December 2013	**5,757.4**	**(917.3)**	**4,840.1**

Movement in prior-year net claims liabilities by operating segment

	2013 £m	2012 £m
Motor	**(291.9)**	(174.3)
Home	**(43.3)**	(37.4)
Rescue and other personal lines	**(9.0)**	(23.9)
Commercial	**(51.6)**	(56.2)
International	**(39.3)**	(30.2)
Total ongoing	**(435.1)**	(322.0)
Run-off	**(52.1)**	(67.5)
Total	**(487.2)**	(389.5)

30. Insurance liabilities, unearned premium reserve and reinsurance assets continued

Movement in unearned premium reserve

	Gross £m	Reinsurance £m	Net £m
At 1 January 2012	1,931.6	(59.0)	1,872.6
Net decrease in the year	(47.1)	(38.9)	(86.0)
Effect of foreign currency exchange adjustment	(11.6)	–	(11.6)
At 31 December 2012	1,872.9	(97.9)	1,775.0
Net (decrease) / increase in the year	**(61.8)**	**5.0**	**(56.8)**
Effect of foreign currency exchange adjustment	**7.6**	**(0.8)**	**6.8**
At 31 December 2013	**1,818.7**	**(93.7)**	**1,725.0**

31. Life insurance liabilities and reinsurance assets

	2013 £m	2012 £m
Gross life insurance		
Long-term insurance contracts:		
With fixed and guaranteed terms	**–**	102.9
Benefits outstanding	**–**	4.3
Total	**–**	107.2
Reinsurers' share of life insurance		
Long-term insurance contracts:		
With fixed and guaranteed terms	**–**	(91.1)
Benefits outstanding	**–**	(3.6)
Total	**–**	(94.7)
Net life insurance		
Long-term insurance contracts:		
With fixed and guaranteed terms	**–**	11.8
Benefits outstanding	**–**	0.7
Total	**–**	12.5

Movements in life insurance liabilities and reinsurance assets

	Gross £m	Reinsurance £m	Net £m
At 1 January 2012	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
Provisions in respect of new and existing business	**34.5**	**(21.4)**	**13.1**
Expected change in existing business provisions	**(19.8)**	**17.3**	**(2.5)**
Variance between actual and expected experience	**(3.0)**	**(5.0)**	**(8.0)**
Other movements	**(3.7)**	**–**	**(3.7)**
Disposal[1]	**(110.9)**	**100.2**	**(10.7)**
At 31 December 2013	**–**	**–**	**–**

Note:

1. The Group's Life business was sold on 28 November 2013.

32. Retirement benefit obligations

Defined contribution scheme

The pension charge in respect of the defined contribution scheme for the year ended 31 December 2013 was £25.3 million (2012: £26.0 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 2012. 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 the Group remains the sponsoring employer for obligations to current and deferred pensioners based on qualifying years service and final salaries. The defined benefit scheme is legally separated from the Group with trustees who are required by law to act in the interest of the scheme and of all the relevant stakeholders. The trustees of the pension scheme are responsible for the investment policy with regard to the assets of the scheme.

The weighted average duration of the defined benefit obligations at 31 December 2013 is 20 years (2012: 20 years) using accounting assumptions.

The table below sets out the principal assumptions in respect of the defined benefit scheme.

	2013 %	2012 %
Rate of increase in pension payment	**2.1**	2.1
Rate of increase of deferred pensions	**2.6**	2.1
Discount rate	**4.4**	4.5
Inflation rate	**3.5**	2.8

No assumption has been made for salary growth as there are no obligations in the scheme that are linked to future increases in salaries.

Post-retirement mortality assumptions

	2013	2012
Life expectancy at age 60 now:		
Males	**88.4**	87.5
Females	**90.1**	89.4
Life expectancy at age 60 in 20 years' time:		
Males	**90.3**	89.5
Females	**92.2**	91.5

The table below analyses the market value of the scheme assets by type of asset.

	2013 £m	2012 £m
Equities	**3.5**	13.9
Index-linked bonds	**13.1**	10.2
Government bonds	**5.7**	6.5
Corporate bonds	**42.9**	32.5
Other	**0.8**	0.6
Total market value of assets	**66.0**	63.7

Virtually all debt and equity instruments have quoted prices on active markets.

32. Retirement benefit obligations continued

Movement in net pension (deficit) / surplus

	Fair value of scheme assets £m	Present value of defined benefit obligations £m	Net pension surplus / (deficit) £m
At 1 January 2012	56.7	(54.1)	2.6
Income statement:			
Net interest income / (cost)[1,2]	3.5	(2.7)	0.8
Statement of comprehensive income:			
Actuarial gains / (losses) arising from experience adjustments	2.2	(0.1)	2.1
Actuarial losses arising from changes in financial assumptions	–	(5.5)	(5.5)
Contributions by employer	2.5	–	2.5
Benefits paid	(1.2)	1.2	–
At 31 December 2012	63.7	(61.2)	2.5
Income statement:			
Net interest income / (cost)[1,2]	**2.3**	**(2.7)**	**(0.4)**
Statement of comprehensive income:			
Actuarial losses arising from experience adjustments	**(1.3)**	**(0.2)**	**(1.5)**
Actuarial losses arising from changes in financial assumptions	**–**	**(4.4)**	**(4.4)**
Actuarial losses arising from changes in demographic assumptions	**–**	**(1.0)**	**(1.0)**
Contributions by employer	**2.8**	**–**	**2.8**
Benefits paid	**(1.5)**	**1.5**	**–**
At 31 December 2013	**66.0**	**(68.0)**	**(2.0)**

Notes:

1. The income / (cost) in the income statement has been included under other operating expenses.
2. In accordance with IAS 19 'Employee benefits revised' the net interest cost has been calculated by applying the discount rate to the deficit (2012: surplus) in the scheme. The change in IAS 19 set out in 'Adoption of new and revised standards' in note 1, if applied to the Group's result for the year ended 31 December 2012, would have resulted in a decrease in the net interest income to the income statement of £0.6 million. A charge of this amount has been made to net interest income in the income statement and a credit in the statement of comprehensive income for year ended 31 December 2013.

The table below details the history of the scheme for the current and prior years.

	2013 £m	2012 £m	2011 £m	2010 £m	2009 £m
Present value of defined benefit obligations	**(68.0)**	(61.2)	(54.1)	(54.5)	(60.8)
Fair value of scheme assets	**66.0**	63.7	56.7	54.4	47.2
Net (deficit) / surplus	**(2.0)**	2.5	2.6	(0.1)	(13.6)
Experience adjustment (losses) / gains on scheme liabilities	**(0.2)**	(0.1)	0.4	0.5	2.6
Experience adjustment (losses) / gains on scheme assets	**(1.3)**	2.2	(2.6)	3.1	5.4

Sensitivity analysis

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. This sensitivity analysis has been selected to reflect the changes to discounted cash flows as a result of changes to the discount rate, inflation rate and mortality assumptions. The methodology adopted involves actuarial techniques.

	2013		2012	
	Impact on pension cost £m	**Impact on present value of scheme obligations £m**	Impact on pension cost £m	Impact on present value of scheme obligations £m
Discount rate				
0.25% increase in discount rate	**(0.2)**	**(3.5)**	(0.2)	(3.0)
0.25% decrease in discount rate	**0.1**	**3.6**	0.1	3.2
Inflation rate				
0.25% increase in inflation rate	**–**	**1.8**	0.1	3.1
0.25% decrease in inflation rate	**–**	**(1.8)**	(0.1)	(3.0)
Life expectancy				
1 year increase in life expectancy	**0.1**	**1.5**	0.1	1.5
1 year decrease in life expectancy	**(0.1)**	**(1.6)**	(0.1)	(1.5)

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 to meet the funding deficit, and does not anticipate any material change to the level of contributions before the next valuation, which is due on 1 October 2014.

33. Share-based payments

The Group operates equity-settled, share-based compensation plans in the form of free shares awards, a Long Term Incentive Plan, Direct Line Share Incentive Plans and an Annual Incentive Plan, details of which are set out below together with their financial impact:

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 have no performance criteria attached, vest on the third anniversary of the award grant date subject to completion of three years' continuing employment (or on leaving employment in certain circumstances) and will be satisfied using market-purchased shares. The number of shares initially granted was 1.9 million with an estimated fair value at grant of £3.9 million.

Long-Term Incentive Plan

Senior management are eligible to participate in the LTIP and awards are granted in the form of nil-cost options. Under the plan, 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.

Conditional awards were made in the year ended 31 December 2013 over 3.0 million Ordinary Shares with an estimated fair value at grant of £4.9 million in March and 2.5 million Ordinary Shares with an estimated fair value at grant of £4.3 million in August (2012: 3.2 million Ordinary Shares with an estimated fair value at grant of £5.0 million in November) under the Group's LTIP.

The estimated fair value of the LTIP share awards with market-based performance conditions was calculated using the Monte-Carlo simulation model.

The table below details the inputs into the model.

	2013	2012
Weighted average assumptions during the year:		
Share price	**208p**	194p
Exercise price	**0p**	0p
Volatility of Company share price	**26%**	27%
Average comparator volatility	**32%**	32%
Expected life	**3 years**	3 years
Risk-free rate	**0.5%**	0.3%

33. Share-based payments continued

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. These comparable companies are classified as being in the insurance sector in the FTSE 350.

Plan participants are entitled to receive additional shares in respect of dividends paid to shareholders over the vesting period. Therefore no deduction has been made from the fair value of awards in respect of dividends.

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.

RBS Group LTIP awards

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 employees. 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 the year ended 31 December 2011 – expected to vest in March 2014
- LTIP awards in the year ended 31 December 2012 – expected to vest in March 2015

The 2011 and 2012 LTIP awards will be settled with Company Ordinary Shares currently held by RBS Group. Details of the RBS Group legacy share based payments are set out in the Directors' remuneration report on page 98.

Direct Line Share Incentive Plans

The HMRC approved Buy-As-You-Earn Plan in the UK and an International plan, mirroring the UK plan for Italy, were both launched during the year ended 31 December 2013. The International plan is being further rolled out to employees in Germany and it is expected that this process will be completed in 2014.

The Group's Share Incentive Plans entitle employees to purchase shares from pre-tax pay for between £10 and £125 per month, or Euro equivalent, and receive one matching share for every two shares purchased.

Since commencement of the Share Incentive Plans during the year ended 31 December 2013, matching share awards have been granted over 0.3 million Ordinary Shares in relation to these schemes in the year with an estimated fair value of £0.6 million. The fair value of each matching share award is estimated using the market value at the date of grant.

Under the Share Incentive Plans, the shares vest at the end of a three-year period dependent upon the following: continued employment by the Group (or on leaving employment in certain circumstances) and continued ownership of the associated purchased shares up to the point of vesting.

Annual Incentive Plan

Executive Directors and certain members of senior management are eligible for awards under the AIP, of which at least 40% is granted in the form of a nil-cost option.

In March 2013 awards were made over 1.1 million Ordinary Shares under this plan with an estimated fair value of £2.2 million based on the market value on the date of grant.

The awards outstanding at 31 December 2013 have no performance criteria attached, other than the requirement that the employee remains in employment with the Group for three years from the date of award (with the exception of the awards to the Chief Executive – specific terms in this case are set out in the Directors' remuneration report).

The following table details the outstanding number of share awards in issue (all nil-cost).

	2013 Number of share options million	2012 Number of share options million
At 1 January	**5.1**	–
Granted during the year	**6.9**	5.1
Forfeited during the year	**(0.4)**	–
Exercised during the year	**(0.2)**	–
At 31 December	**11.4**	5.1
Exercisable at 31 December	**0.2**	–

In respect of the outstanding options at 31 December 2013, the weighted average remaining contractual life is 2.20 years (2012: 2.85 years). No share options expired during the year (2012: nil).

The weighted average share price during the period of exercise was £2.17 in the year ended 31 December 2013 (2012: not applicable).

The Group recognised total expenses of £4.1 million in the year ended 31 December 2013 (2012: £0.3 million) relating to equity settled share-based compensation plans.

Further information on share based payments in respect of Directors is provided in the Directors' remuneration report.

34. Trade and other payables including insurance payables

	2013 £m	2012 £m
Due to agents, brokers and intermediaries	**6.2**	6.9
Due to reinsurers	**81.0**	81.9
Due to insurance companies	**13.6**	13.8
Due to related parties	**58.7**	34.7
Trade creditors and accruals	**255.8**	201.0
Other creditors	**174.3**	107.8
Other taxes	**80.6**	81.7
Provisions	**134.9**	114.2
Deferred income	**13.2**	12.6
Total	**818.3**	654.6

Movement in provisions during the year

	Regulatory levies £m	Restructuring £m	Other[1] £m	Total £m
At 1 January 2013	33.2	30.9	50.1	114.2
Additional provision	**36.3**	**51.9**	**67.2**	**155.4**
Utilisation of provision	**(42.2)**	**(45.9)**	**(39.3)**	**(127.4)**
Releases to income statement	**–**	**(3.3)**	**(4.0)**	**(7.3)**
At 31 December 2013	**27.3**	**33.6**	**74.0**	**134.9**

Note:

1. Other provisions include £22.5 million (2012: £11.0 million) for costs associated with onerous contracts in respect of leasehold properties.

35. Notes to the consolidated cash flow statement

	2013 £m	2012 £m
Profit for the year	**312.8**	184.3
Adjustments for:		
Investment income	**(188.6)**	(199.3)
Instalment income	**(117.8)**	(125.4)
Other operating losses	**0.7**	2.1
Net fair value (gain) / loss on assets at fair value through income statement	**(7.5)**	4.8
Finance costs	**37.7**	28.7
Equity-settled share-based payment transactions	**4.1**	0.3
Tax charge	**111.1**	64.8
Depreciation and amortisation expenses	**58.2**	43.1
Non-cash movement in demerger reserve	**–**	24.6
Impairment of property, plant and equipment, goodwill and intangible assets	**5.5**	10.7
Impairment movements on reinsurance contracts	**(7.5)**	6.8
Profit on sale of AFS financial investments	**(25.7)**	(89.4)
Loss on sale of property, plant and equipment	**2.9**	4.8
Profit on disposal of subsidiary	**(12.0)**	–
Operating cash flows before movements in working capital	**173.9**	(39.1)
Movements in working capital:		
Net decrease in net insurance liabilities including reinsurance assets and deferred acquisition costs	**(594.8)**	(532.5)
Net (increase) / decrease in prepayments and accrued income and other assets	**(13.1)**	9.6
Net decrease in insurance and other receivables	**34.3**	86.5
Net increase / (decrease) in trade and other payables including insurance payables	**175.9**	(253.4)
Contribution to retirement benefit obligations	**(2.8)**	(2.5)
Cash used by operations	**(226.6)**	(731.4)
Taxes paid	**(80.2)**	(232.4)
Finance costs	**–**	(2.0)
Cash flow hedges	**(0.2)**	(0.2)
Net cash flow used by operating activities before investment of insurance assets	**(307.0)**	(966.0)
Interest received	**574.2**	327.7
Rental income received from investment property	**11.4**	4.4
Purchases of investment property	**(87.0)**	(133.7)
Proceeds on disposal of investment property	**–**	69.5
Distributions received from other investment funds	**–**	3.1
Proceeds on disposal / maturity of AFS financial investments	**3,147.8**	4,021.6
Net decrease in investment balances held with credit institutions	**209.3**	844.6
Purchases of AFS financial investments	**(3,422.7)**	(3,132.4)
Cash generated from investment of insurance assets	**433.0**	2,004.8

36. Contingent liabilities

The Group did not have any contingent liabilities at 31 December 2013 (2012: none).

37. Commitments

Operating lease commitments

The Group has entered cancellable and non-cancellable operating lease agreements for vehicles and other assets.

	2013 £m	2012 £m
Minimum lease payments under operating leases recognised as an expense in the year	**35.0**	7.5

The following table analyses the outstanding commitments under cancellable and non-cancellable operating leases by the period in which they fall due.

	2013 £m	2012 £m
Within one year	**29.8**	33.0
In the second to fifth years inclusive	**85.0**	92.3
After five years	**248.9**	250.5
Total	**363.7**	375.8

Operating lease commitments where the Group is the lessor

The following table analyses future aggregate minimum lease payments receivable under non-cancellable operating leases.

	2013 £m	2012 £m
Within one year	**13.3**	7.8
In the second to fifth years inclusive	**45.3**	26.6
After five years	**85.9**	41.2
Total	**144.5**	75.6

38. Classification of financial instruments

The following tables analyse 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, with the exception of subordinated liabilities, equals their fair value.

	Financial assets / liabilities					
At 31 December 2013	At fair value £m	Available-for-sale £m	Loans and receivables £m	At amortised cost £m	Non-financial assets / liabilities £m	**Total £m**
Assets						
Goodwill and other intangible assets	–	–	–	–	500.1	**500.1**
Property, plant and equipment	–	–	–	–	102.3	**102.3**
Investment property	–	–	–	–	223.4	**223.4**
Reinsurance assets	–	–	–	–	1,011.0	**1,011.0**
Deferred tax assets	–	–	–	–	19.3	**19.3**
Current tax assets	–	–	–	–	1.3	**1.3**
Deferred acquisition costs	–	–	–	–	321.5	**321.5**
Insurance and other receivables	–	–	1,122.0	–	–	**1,122.0**
Prepayments, accrued income and other assets	–	–	–	–	95.7	**95.7**
Derivative financial instruments	40.7	–	–	–	–	**40.7**
Financial investments	–	7,005.5	435.7	–	–	**7,441.2**
Cash and cash equivalents	–	–	908.3	–	–	**908.3**
Assets held for sale	–	–	–	–	1.0	**1.0**
Total assets	**40.7**	**7,005.5**	**2,466.0**	**–**	**2,275.6**	**11,787.8**
Liabilities						
Subordinated liabilities	–	–	–	486.6	–	**486.6**
Insurance liabilities	–	–	–	–	5,757.4	**5,757.4**
Unearned premium reserve	–	–	–	–	1,818.7	**1,818.7**
Retirement benefit obligations	–	–	–	–	2.0	**2.0**
Borrowings	–	–	–	55.1	–	**55.1**
Derivative financial instruments	19.3	–	–	–	–	**19.3**
Trade and other payables including insurance payables	–	–	–	683.4	134.9	**818.3**
Deferred tax liabilities	–	–	–	–	19.3	**19.3**
Current tax liabilities	–	–	–	–	21.1	**21.1**
Total liabilities	**19.3**	**–**	**–**	**1,225.1**	**7,753.4**	**8,997.8**
Total equity						**2,790.0**
Total equity and liabilities						**11,787.8**

At 31 December 2012	Financial assets / liabilities At fair value £m	Available-for-sale £m	Loans and receivables £m	At amortised cost £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
Total assets	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
Total liabilities	6.5	–	–	1,418.8	8,441.0	9,866.3
Total equity						2,831.6
Total equity and liabilities						12,697.9

39. Related parties

On 13 March 2013, RBS Group sold 16.8% of the Company's Ordinary Shares and ceased to be the controlling shareholder of Direct Line Group. On 20 September 2013, RBS Group sold a further 20.0% of the Company's Ordinary Shares, which is a further step towards complete disposal by the end of 2014. At 31 December 2013, RBS Group held 28.5% of the issued Ordinary Share capital and the Group is treated as an associated undertaking in the RBS Group results. The UK Government through HM Treasury is the ultimate controlling party of RBS Group and is as a consequence a related 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.

Transactions with RBS Group

	2013 £m	2012 £m
Sale of insurance contracts and other services	**3.2**	6.9
Purchase of services	**145.8**	270.7

Sale and purchase of products and services are conducted on an arm's length basis.

Purchase of services, in the year ended 31 December 2012 above, include share-based payment costs for key managers and other staff.

Year end balances arising from cash and investment transactions with members of the RBS Group

	2013 £m	2012 £m
Cash at bank	**64.7**	69.1
Short-term bank deposits	**–**	28.8
Bank overdrafts	**(55.1)**	(90.9)
Derivative financial assets	**20.0**	25.4
Derivative financial liabilities	**(18.5)**	(2.4)
Term deposits	**35.0**	50.0
AFS debt securities	**48.6**	75.0
Total	**94.7**	155.0

Year end balances arising from sales and purchases of products and services to and from RBS Group

	Amounts owed by related parties		Amounts owed to related parties	
	2013 £m	2012 £m	2013 £m	2012 £m
Total	**0.9**	5.1	**58.7**	34.7

Movement in amounts owed by / to RBS Group

	Amounts owed by related parties		Amounts owed to related parties	
	2013 £m	2012 £m	2013 £m	2012 £m
At 1 January	**5.1**	7.7	**34.7**	158.7
Transactions in the year	**0.2**	68.0	**147.1**	294.6
Settled in the year	**(4.4)**	(70.6)	**(123.1)**	(418.6)
At 31 December	**0.9**	5.1	**58.7**	34.7

Included in transactions within amounts owed by related parties in the year ended 31 December 2012 is £69.5 million, invoiced to and paid by RBS Group for the purchase of investment properties.

Included in transactions within amounts owed to related parties in the year ended 31 December 2012 is an amount of £39.3 million, 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 32 for further details).

Loans from RBS Group

	2013 £m	2012 £m
Total	–	–

Movement in loans from RBS Group

	2013 £m	2012 £m
At 1 January	–	247.7
Loan repayments made	–	(246.4)
Interest charged	–	2.7
Interest settled	–	(2.7)
Effect of foreign currency exchange adjustment	–	(1.3)
At 31 December	–	–

During the year ended 31 December 2012, the Group repaid its loans from RBS Group in preparation for operational separation.

Compensation of key management

	2013 £m	2012 £m
Short-term employee benefits	**9.1**	7.1
Post-employment benefits	**0.2**	0.6
Termination benefits	**0.2**	2.2
Share-based payments	**1.9**	0.1
Total	**11.4**	10.0

For the purposes of IAS 24 'Related party disclosures', key management personnel comprise the Directors of the Company, Non-Executive Directors and members of the Executive Committee.

40. Post balance sheet events

On 5 February 2014 the Group sold 100% of the share capital of Tracker Network (UK) Limited to Lysanda Limited.

During the first quarter of 2014 the UK has seen adverse weather conditions resulting from storm damage and severe flooding. The Group's preliminary estimate of the costs of Home claims, until the 22 February 2014, is in the range of £70 million to £90 million. The Group has also experienced weather-related claims of approximately £20 million in its Commercial division.

Parent Company balance sheet
As at 31 December 2013

	Notes	2013 £m	2012 £m
Assets			
Investments in subsidiary undertakings	2	**3,181.5**	3,226.1
Other receivables	3	**528.8**	521.7
Current tax assets	4	**1.6**	4.5
Cash and cash equivalents	5	**6.8**	268.3
Total assets		**3,718.7**	4,020.6
Equity			
Share capital	6	**150.0**	150.0
Capital redemption reserve		**1,450.0**	1,450.0
Share based payment reserve		**3.9**	0.3
Retained earnings		**1,611.9**	1,661.5
Total equity		**3,215.8**	3,261.8
Liabilities			
Subordinated liabilities	7	**502.4**	501.7
Derivative financial instruments	8	**–**	1.7
Borrowings	9	**–**	255.4
Trade and other payables	10	**0.5**	–
Total liabilities		**502.9**	758.8
Total equity and liabilities		**3,718.7**	4,020.6

The attached notes on pages 171 to 174 form an integral part of these separate financial statements.

The financial statements were approved by the Board of Directors and authorised for issue on 25 February 2014. 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 2013

	2013 £m	2012 £m
Profit for the year	**193.1**	1,240.4
Total comprehensive income for the year attributable to owners of the Company	**193.1**	1,240.4

Parent Company statement of changes in equity

For the year ended 31 December 2013

	Share capital £m	Capital redemption reserve £m	Share based payment reserve £m	Retained earnings £m	Total equity £m
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)
Credit to equity for equity-settled share based payments	–	–	0.3	–	0.3
Balance at 31 December 2012	150.0	1,450.0	0.3	1,661.5	3,261.8
Total comprehensive income for the year	–	–	–	193.1	193.1
Dividends paid	–	–	–	(242.7)	(242.7)
Credit to equity for equity-settled share based payments	–	–	4.1	–	4.1
Shares distributed by employee trusts	–	–	(0.5)	–	(0.5)
Balance at 31 December 2013	**150.0**	**1,450.0**	**3.9**	**1,611.9**	**3,215.8**

The attached notes on pages 171 to 174 form an integral part of these separate financial statements.

Parent Company cash flow statement

For the year ended 31 December 2013

	Notes	2013 £m	2012 £m
Net cash (used by) /generated from operating activities	12	**(3.0)**	7.4
Cash flows from investing activities			
Interest received on loans to subsidiary undertakings		**47.5**	23.8
Dividends received from subsidiary undertakings		**220.8**	1,545.0
Acquisition of investments in subsidiary undertakings		**(9.1)**	(105.2)
Disposal of investments in subsidiary undertakings	2	**39.3**	–
Cash flows from net investment hedges		**(5.3)**	–
Net cash generated from investing activities		**293.2**	1,463.6
Cash flows from financing activities			
Dividends paid		**(242.7)**	(1,000.0)
Proceeds on issue of subordinated liabilities		**–**	493.0
Finance costs		**(46.3)**	(23.1)
Repayment of borrowings from related parties		**(255.0)**	(322.5)
Proceeds of borrowings from related parties		**–**	120.9
Net increase in loans advanced to subsidiary undertakings		**(7.7)**	(503.1)
Net cash used by financing activities		**(551.7)**	(1,234.8)
Net (decrease) / increase in cash and cash equivalents		**(261.5)**	236.2
Cash and cash equivalents at the beginning of the year	5	**268.3**	32.1
Cash and cash equivalents at the end of the year	5	**6.8**	268.3

The attached notes on pages 171 to 174 form an integral part of these separate financial statements

1. Accounting policies

Basis of preparation

Direct Line Insurance Group plc, incorporated in the UK, is the ultimate parent undertaking of the Direct Line Group. The principal activity of the Company is managing its investments in subsidiaries, raising funds for the Group, providing loans to subsidiaries and the receipt and payment of dividends.

The Company's financial statements are prepared in accordance with IFRSs 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

	2013 £m	2012 £m
At 1 January	**3,226.1**	3,415.3
Additions	**13.2**	105.5
Disposals	**(50.7)**	–
Impairments	**(10.8)**	(291.8)
Effect of foreign currency exchange adjustment	**3.7**	(2.9)
At 31 December	**3,181.5**	3,226.1

The Company sold 100% of the share capital of its subsidiary Direct Line Life Insurance Company Limited on 28 November 2013. The carrying value of the investment in the Life business was £50.7 million at the date of sale. The total cash consideration received was £39.3 million generating a loss on disposal of £11.4 million.

Full details of investments in principal subsidiaries are set out in note 19 to the consolidated financial statements.

3. Other receivables

	2013 £m	2012 £m
Loans to subsidiary undertakings[1]	**528.8**	521.4
Receivables from subsidiary undertakings	**–**	0.3
Total	**528.8**	521.7
Current	**28.8**	21.7
Non-current	**500.0**	500.0
Total	**528.8**	521.7

Note:

1. Included in loans to subsidiary undertakings is a £500 million unsecured subordinated loan to U K Insurance Limited. The loan was advanced on 27 April 2012 at a fixed rate of 9.5% with a repayment date of 27 April 2042. There is an option to repay the loan on specific dates from 27 April 2022. If the loan is not repaid on that date, the rate of interest would be reset at a rate of the six-month LIBOR plus 8.16%.

4. Current tax assets

	2013 £m	2012 £m
Corporation tax recoverable	**1.6**	4.5

5. Cash and cash equivalents

	2013 £m	2012 £m
Cash at bank and in hand	**0.1**	–
Short-term deposits with credit institutions:		
Third parties	**6.7**	263.6
Related parties – RBS Group	**–**	4.7
	6.7	268.3
Total	**6.8**	268.3

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

	2013 £m	2012 £m
Subordinated dated notes	**502.4**	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 insolvency, 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 at 31 December 2013 is £625.4 million (2012: £597.6 million).

8. Derivative financial instruments

	2013		2012	
	Notional amounts £m	**Liabilities £m**	Notional amounts £m	Liabilities £m
Forward foreign exchange contracts[1]	**–**	**–**	134.0	1.7

Note:

1. The derivative was held with RBS Group.

9. Borrowings

	2013 £m	2012 £m
Loans from subsidiary undertakings	–	255.4
Total	–	255.4
Current	–	255.4

10. Trade and other payables

	2013 £m	2012 £m
Payables to subsidiary undertakings	0.5	–

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

	2013 £m	2012 £m
Profit for the period	193.1	1,240.4
Adjustments for:		
Impairment in subsidiary undertakings	10.8	291.8
Investment income	(268.4)	(1,578.1)
Other operating (gain) / loss	(0.2)	1.3
Finance costs	47.1	41.6
Loss on disposal of subsidiary undertaking	11.4	–
Tax credit	(1.3)	(5.5)
Operating cash flows before movements in working capital	(7.5)	(8.5)
Net decrease in related party balances	0.8	23.4
Tax received	4.2	2.3
Finance costs	(0.5)	(9.8)
Cash (used by) / generated from operations	(3.0)	7.4

13. Related parties

Direct Line Insurance Group plc, which is incorporated in England and Wales, is the ultimate parent undertaking of the Direct Line Group of companies.

The Company is an associate of RBS Group.

During the year RBS Group sold 551.7 million of the Company's Ordinary Shares, representing 36.8% of the total share capital of the Company. Following the sale, the RBS Group shareholding in Direct Line Group fell to 28.5%. Full details of related parties are set out in note 39 to the consolidated financial statements.

The following transactions were carried out with related parties:

Sale of services

	2013 £m	2012 £m
Interest income from subsidiary undertakings	**47.4**	32.9

Interest income from loans to subsidiary undertakings was charged at rates ranging from 0.5% to 9.50% (2012: 0.51% to 9.50%).

	2013 £m	2012 £m
Dividend income from subsidiary undertakings	**220.8**	1,545.0

Purchase of services

	2013 £m	2012 £m
Management fees payable to subsidiary undertakings	**7.7**	8.7
Interest payable to subsidiary undertakings	**0.1**	7.1
Interest payable to RBS Group	**–**	2.7
Total	**7.8**	18.5

Interest charged on borrowings from related parties were at rates ranging from 0.5% to 2.0% (2012: 0.51% to 1.92%).

14. Share-based payments

Full details of share-based compensation plans are provided in note 33 to the consolidated financial statements.

15. Risk management

The risks faced by the Company are considered to be from its investment in subsidiaries. Its risks 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 aggregate emoluments of the Directors are set out in note 10 of the consolidated financial statements, the compensation for key management is set out in note 39 of the consolidated financial statements and the remuneration and pension benefits payable in respect of the highest paid Director, are included in the Directors' remuneration report in the Governance section of the Annual Report & Accounts.

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 are presented in note 27 to the consolidated financial statements.

Dividends

The Group aims to generate long-term sustainable value for shareholders, while balancing 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/or 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 page 180. Alternatively, shareholders may access their shareholdings online and download a dividend mandate from the Investor Centre, please see page 180 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 180 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

5,000 people contact the FCA about share fraud each year, with victims losing an average of £20,000.

Fraudsters use persuasive and high-pressure tactics to lure investors into scams. They may offer to sell shares that turn out to be worthless or non-existent, or to buy shares at an inflated price in return for an upfront payment. While high profits are promised, if you buy or sell shares in this way you will probably lose your money.

How to avoid share fraud

- Keep in mind that firms authorised by the FCA are unlikely to contact you out of the blue with an offer to buy or sell shares
- Do not get into a conversation; note the name of the person and firm contacting you and then end the call
- Check the Financial Services Register from www.fca.org.uk to see if the person and firm contacting you are authorised by the FCA
- Beware of fraudsters claiming to be from an authorised firm, copying its website or giving you false contact details
- Use the firm's contact details listed on the Register if you want to call it back
- Call the FCA on 0800 111 6768 if the firm does not have contact details on the Register or you are told they are out of date
- Search the list of unauthorised firms to avoid at www.fca.org.uk/scams
- Consider that if you buy or sell shares from an unauthorised firm you will not have access to the Financial Ombudsman Service or Financial Services Compensation Scheme
- Think about getting independent financial and professional advice before you hand over any money
- Remember: if it sounds too good to be true, it probably is

Report a scam

If you are approached by fraudsters please tell the FCA using the share fraud reporting form at www.fca.org.uk/scams, where you can find out more about investment scams.

You can also call the FCA Consumer Helpline on 0800 111 6768.

If you have already paid money to share fraudsters you should contact Action Fraud on 0300 123 2040.

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, deal only 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 180.

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 Direct Line Group shares through a stockbroker or a high street bank, or through the Registrar's share-dealing facility.

The Registrar may be contacted regarding its share-dealing facility by telephone or by email as follows:

- for telephone sales call +44 (0)870 703 0084 between 8.30 am and 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

2014

26 February	Announcement of results 2013
12 March	'Ex-dividend' date for second special interim and 2013 final dividend
14 March	Record date for second special interim and 2013 final dividends
2 May[1]	First quarter 2014 Interim Management Statement
15 May	Annual General Meeting
20 May	Payment date for second special interim and 2013 final dividends
1 August[1]	Half year 2014 Interim Report
13 August[1]	'Ex-dividend' date for 2014 interim dividend
15 August[1]	Record date for 2014 interim dividend
12 September[1]	Payment date for 2014 interim dividend
31 October[1]	Third quarter 2014 Interim Management Statement

Note:
1. These dates are subject to change

Annual General Meeting

The 2014 AGM will be held on 15 May 2014 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
Actuarial best estimate	The probability-weighted average of all future claims and cost scenarios calculated using historical data, actuarial methods and judgement. A best estimate of reserves will therefore normally be designed to include no margin for optimism or conversely, caution.
AIP	Annual Incentive Plan
Available-for-sale ("**AFS**") investment	Financial assets that are classified as available for sale. Please refer to the accounting policy note 1.12 on page 117.
BAYE	Buy-As-You-Earn
BitC	Business in the Community
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 year.
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 considers will ultimately be required to be paid.
Clawback	The ability of the Company to claim repayment of paid amounts as a debt.
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 a profitable business.
Commission	Amounts paid to brokers, partners and price comparison websites for generating 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 claims reserves relating to previous accident years and claims relating to weather events in the Home division.
DAIP	Deferred Annual Incentive Plan
DL4B	Direct Line for Business, an extension of the Direct Line brand, is our direct commercial insurance brand for micro and small-sized businesses in the UK that have straightforward commercial insurance requirements.
Earnings per share	The amount of the Group's profit allocated to each Ordinary Share of the Company.
ERB	Employee Representative Body
Expense ratio	The ratio of operating expenses divided by net earned premium.
Finance costs	The cost of servicing the Group's external borrowings.
Financial Conduct Authority ("**FCA**")	The independent body that regulates firms and financial advisers to help put the interests of their customers and the integrity of the market at the core of what they do.
FOS	Financial Ombudsman Service
FRC	Financial Reporting Council
Gross written premium	The total premiums from contracts that began 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 yet paid. Does not include IBNR (see above).
ICA	Individual capital assessment
ICAS	Individual capital adequacy standards
ICAS+	Introduced by the PRA in 2013, ICAS+ is an extension of the ICAS regime to allow firms to use their developing Solvency II frameworks, in particular the internal model.
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 insurance liabilities and liability adequacy reserve. Together these amount to the reserves an insurance company maintains to meet current and future claims.
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 vale adjustments, while the average AUM for the period is derived by taking the opening and closing balances for the period.

Term	Definition
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 items such as realised gains, fair value adjustments and impairments, divided by the average AUM for each asset class during the same period.
KPI	Key performance indicator
Loss ratio	Net insurance claims divided by net earned premium.
LTIP	Long-Term Incentive Plan
Malus	An arrangement that permits the forfeiture of unvested remuneration awards, in circumstances considered appropriate by the Company.
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 earned 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, the Lord Chancellor and Scottish Ministers, and used to calculate lump sum awards in bodily injury cases.
Ongoing operations	Includes the Group's ongoing segments: Motor, Home, Rescue and other personal lines, Commercial and International. It excludes the Run-off segment and restructuring and other one-off costs.
Operating profit	The pre-tax profit generated by the activities of the Group, including insurance and investment activity, but excluding finance costs.
ORSA	Own Risk and Solvency Assessment
Periodic payment order ("**PPO**")	These are claims payments as awarded under the Courts Act 2003. PPOs are used to settle large personal injury claims and generally provide claimants who require long-term care with a lump sum award together with inflation-linked annual payments.
Prudential Regulation Authority ("**PRA**")	The Prudential Regulation Authority is a part of the Bank of England and responsible for the prudential regulation and supervision of insurers and financial institutions in the UK.
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.
Reserves	Funds that have been set aside to meet outstanding insurance 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 the Run-off segment 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 during 2012 (£1 billion dividend payment and £500 million long-term subordinated debt issue) occurred on 1 January 2012.
Risk mix	This reflects the expected level of claims from the portfolio.
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. It is comprised of three pillars: Pillar I, which sets out capital requirements for an insurer, Pillar II which focuses on systems of governance and Pillar III which deals with disclosure requirements.
Three lines of defence	The 1st line of defence is provided by line managers who are responsible for ownership and management of the risks to the achievement of business objectives on a day-to-day basis. The 2nd line of defence is provided by specialist control functions, including Risk and Compliance, which are responsible for the provision of proportionate oversight of the business and related or emerging risks. Group Audit delivers the 3rd line of defence through the provision of an independent view for the Board or the effectiveness of risk management.
Total shareholder return ("**TSR**")	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 September 2012 and issued by the FRC.
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

Forward-looking statements disclaimer

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, constitutes "forward-looking statements". These forward-looking statements may be identified by the use of forward-looking terminology, including the terms "aims", "anticipates", "believes", "continue", "could", "estimates", "expects", "guidance", "intends", "may", "outlook", "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, among other things: the Group'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 division, 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 Group'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, for example directly or indirectly as a result of, 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 and deflation, the timing impact and other uncertainties of future acquisitions, disposals, joint ventures 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 Group'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 Group 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 document should be construed as a profit forecast.

Neither the content of Direct Line Group's website nor the content of any other website accessible from hyperlinks on the Group's website is incorporated into, or forms part of, this document.

Contact information

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Investor Centre:
To find out more about Investor Centre, go to www.investorcentre.co.uk/directline

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More information

Our Annual Report & Accounts is supplemented by a range of other information about the Group that can be found on our corporate website.

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

www.directlinegroup.com

In conjunction with this report, we have produced a separate online version of key sections.

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