## F: Short-term fluctuations in investment returns on shareholder-backed business

| | 2013 £m | 2012* £m | |
|---|---|---|---|
| | Half year | Half year | Full year |
| Insurance operations: | | | |
| Asia note (ii) | (137) | 26 | 54 |
| US note (iii) | (441) | (125) | (90) |
| UK notes (iv) | (147) | 5 | 136 |
| Other operations: | | | |
| Economic hedge value movements note (v) | – | (15) | (32) |
| Other note (vi) | (30) | 62 | 119 |
| Total note (i) | (755) | (47) | 187 |

* The 2012 comparative results have been adjusted retrospectively from those previously published for the application of the new and amended accounting standards described in note B. In addition, to facilitate comparisons of results that reflect the Group's retained operations, the short-term fluctuations in investment returns attributable to the held for sale Japan Life business are included separately within the supplementary analysis of profit.

**Notes**

(i) **General overview of defaults**
The Group did not experience any defaults on its shareholder-backed debt securities portfolio in half year 2013 and 2012.

(ii) **Asia insurance operations**
In Asia, the negative short-term fluctuations of £(137) million (half year 2012: positive £26 million; full year 2012: positive £54 million) primarily reflect net unrealised movements on bond holdings following a rise in bond yields during the period.

(iii) **US insurance operations**
The short-term fluctuations in investment returns for US insurance operations comprise the following items:

| | 2013 £m | 2012 £m | |
|---|---|---|---|
| | Half year | Half year | Full year |
| Charges in the period in investment returns: | | | |
| Defaults | – | – | – |
| Losses on sales of impaired and deteriorating bonds | (2) | (16) | (23) |
| Bond write downs | (5) | (25) | (37) |
| Recoveries/reversals | 6 | 8 | 13 |
| Total charges in the period note (a) | (1) | (33) | (47) |
| Less: risk margin charge included in operating profit based on longer-term investment returns note (b) | 44 | 38 | 79 |
| | 43 | 5 | 32 |
| Interest-related realised gains (losses): | | | |
| Arising in the period | 34 | 29 | 94 |
| Less: amortisation of gains and losses arising in current and prior periods to operating profit based on longer-term investment returns | (45) | (44) | (91) |
| | (11) | (15) | 3 |
| Related change to amortisation of deferred acquisition costs | (8) | 2 | (3) |
| Total short-term fluctuations in investment returns related to debt securities | 24 | (8) | 32 |
| Derivatives (other than equity-related): market value movement (net of related change to amortisation of deferred acquisition costs) note (c) | (380) | 179 | 135 |
| Net equity hedge results (net of related change to amortisation of deferred acquisition costs) note (d) | (166) | (320) | (302) |
| Equity type investments: actual less longer-term return (net of related change to amortisation of deferred acquisition costs) note C | 63 | 22 | 23 |
| Other items (net of related change to amortisation of deferred acquisition costs) | 18 | 2 | 22 |
| Total | (441) | (125) | (90) |

The short-term fluctuations in investment returns shown in the table above are stated net of the related change to amortisation of deferred acquisition costs of £242 million (half year 2012: £80 million; full year 2012: £76 million). See note N.

# Notes on the IFRS basis results continued

## F: Short-term fluctuations in investment returns on shareholder-backed business continued

**Notes**

(a) The charges on the debt securities of Jackson comprise the following:

| | 2013 £m | 2012 £m | |
|---|---|---|---|
| | Half year | Half year | Full year |
| Prime (including agency) | 2 | 1 | (4) |
| Alt-A | – | 1 | (1) |
| Sub-prime | (1) | (3) | (3) |
| Total residential mortgage-backed securities | 1 | (1) | (8) |
| Corporate debt securities | (2) | (12) | (14) |
| Other | – | (20) | (25) |
| Total | (1) | (33) | (47) |

(b) The risk margin reserve (RMR) charge for longer-term credit-related losses included in operating profit based on longer-term investment returns of Jackson for half year 2013 is based on an average annual RMR of 25 basis points (half year 2012: 27 basis points; full year 2012: 26 basis points) on average book values of US$54.3 billion (half year 2012: US$44.2 billion; full year 2012: US$47.6 billion) as shown below:

| | Half year 2013 | | | |
|---|---|---|---|---|
| | | | Annual expected loss† | |
| Moody's rating category (or equivalent under NAIC ratings of MBS) | Average book value US$m | RMR % | US$m | £m |
| A3 or higher | 27,411 | 0.11 | (31) | (20) |
| Baa1, 2 or 3 | 24,187 | 0.25 | (61) | (40) |
| Ba1, 2 or 3 | 1,633 | 1.14 | (19) | (12) |
| B1, 2 or 3 | 608 | 2.73 | (17) | (11) |
| Below B3 | 423 | 2.15 | (9) | (6) |
| Total | 54,262 | 0.25 | (137) | (89) |
| Related change to amortisation of deferred acquisition costs | | | 26 | 17 |
| Risk margin reserve charge to operating profit for longer-term credit related losses | | | (111) | (72) |

| | Half year 2012 | | | |
|---|---|---|---|---|
| | | | Annual expected loss† | |
| Moody's rating category (or equivalent under NAIC ratings of MBS) | Average book value US$m | RMR % | US$m | £m |
| A3 or higher | 21,149 | 0.11 | (23) | (15) |
| Baa1, 2 or 3 | 20,655 | 0.26 | (54) | (34) |
| Ba1, 2 or 3 | 1,616 | 1.11 | (18) | (11) |
| B1, 2 or 3 | 560 | 2.97 | (17) | (11) |
| Below B3 | 174 | 3.77 | (6) | (4) |
| Total | 44,154 | 0.27 | (118) | (75) |
| Related change to amortisation of deferred acquisition costs | | | 18 | 11 |
| Risk margin reserve charge to operating profit for longer-term credit related losses | | | (100) | (64) |

† Annual expected loss as shown in the summary table above. The charge for the half year 2013 was £(44) million (half year 2012: £(38) million).

| | Full year 2012 | | | |
|---|---|---|---|---|
| | | | Annual expected loss | |
| Moody's rating category (or equivalent under NAIC ratings of MBS) | Average book value US$m | RMR % | US$m | £m |
| A3 or higher | 23,129 | 0.11 | (26) | (16) |
| Baa1, 2 or 3 | 21,892 | 0.26 | (56) | (36) |
| Ba1, 2 or 3 | 1,604 | 1.12 | (18) | (11) |
| B1, 2 or 3 | 597 | 2.82 | (17) | (11) |
| Below B3 | 342 | 2.44 | (8) | (5) |
| Total | 47,564 | 0.26 | (125) | (79) |
| Related change to amortisation of deferred acquisition costs | | | 21 | 13 |
| Risk margin reserve charge to operating profit for longer-term credit related losses | | | (104) | (66) |

Consistent with the basis of measurement of insurance assets and liabilities for Jackson's IFRS results, the charges and credits to operating profits based on longer-term investment returns are partially offset by related changes to amortisation of deferred acquisition costs.

(c) Derivatives (other than equity-related): loss of £(380) million (half year 2012: gain of £179 million; full year 2012: gain of £135 million) net of related change to amortisation of deferred acquisition costs.

These losses and gains are in respect of duration lengthening interest rate swaps and swaptions and for the GMIB reinsurance. The swaps and swaptions are undertaken to manage interest rate exposures and durations within the general account and the variable annuity and fixed index annuity guarantees (as described in note (d) below). The GMIB reinsurance is in place so as to fully insulate Jackson from the GMIB exposure.

The amounts principally reflect the fair value movement on these instruments, net of related changes to amortisation of deferred acquisition costs.

Under the Group's IFRS reporting of Jackson's derivatives (other than equity-related) programme significant accounting mismatches arise. This is because:

- The derivatives are required to be fair valued with the value movements booked in the income statement;
- As noted above, part of the derivative value movements arises in respect of interest rate exposures within Jackson's guarantee liabilities for variable annuity and fixed index annuity business which are only partially fair valued under IFRS (see below);
- The GMIB liability is valued under the US GAAP insurance measurement basis applied for IFRS in a way that substantially does not recognise the effect of market movements. However, notwithstanding that the liability is fully reinsured, as the reinsurance asset is net settled it is deemed a derivative under IAS 39 which requires fair valuation; and
- Fair value movements on Jackson's debt securities are booked in other comprehensive income rather than the income statement.

(d) Net equity hedge result: loss of £(166) million (half year 2012: loss of £(320) million; full year 2012: loss of £(302) million).

These amounts are in respect of the equity-based derivatives and associated guarantee liabilities of Jackson's variable and fixed index annuity business. The equity-based derivatives are undertaken to manage the equity risk exposure of the guarantee liabilities. The economic exposure of these guarantee liabilities also includes the effects of changes in interest rates which are managed through the swaps and swaptions programmes described in note (c) above.

The amounts reflect the net effect of:

- Fair value movements on free-standing equity derivatives;
- The accounting value movements on the variable annuity and fixed index annuity guarantee liabilities;
- Fee assessments and claim payments in respect of guarantee liabilities; and
- Related changes to DAC amortisation.

Under the Group's IFRS reporting of Jackson's equity-based derivatives and associated guarantee liabilities significant accounting mismatches arise. This is because:

- The free standing derivatives and GMWB 'not for life' embedded derivative liabilities are required to be fair valued. These fair value movements include the effects of changes to levels of equity markets, implied volatility and interest rates. The interest rate exposure is managed through the derivative programme explained above in note (c); and
- The GMDB and GMWB 'for life' guarantees are valued under the US GAAP insurance measurement basis applied for IFRS in a way that substantially does not recognise the effect of equity market and interest rate changes.

In addition to the items discussed above, for US insurance operations, included within the statement of Other Comprehensive Income is a decrease in net unrealised gains on debt securities classified as available-for-sale of £1,707 million (half year 2012: increase in net unrealised gains of £482 million; full year 2012: an increase in net unrealised gains of £862 million). Temporary market value movements do not reflect defaults or impairments. Additional details on the movement in the value of the Jackson portfolio are included in note R.

(iv) **UK insurance operations**

The negative short-term fluctuations for UK insurance operations of £(147) million (half year 2012: positive £5 million; full year 2012: positive £136 million) reflect net investment movements arising in the period on fixed income assets backing the capital of the annuity business following the rise in bond yields during the period.

(v) **Economic hedge value movements**

This item represented the costs on short-dated hedge contracts taken out in first half of 2012 to provide downside protection against severe equity market falls through a period of particular uncertainty with respect to the Eurozone. The hedge contracts were terminated in the second half of 2012.

(vi) **Other**

Short-term fluctuations in investment returns of other operations, in addition to the previously discussed economic hedge value movement, were negative £(30) million (half year 2012: positive £62 million; full year 2012: positive £119 million) representing unrealised value movements on investments, including centrally held swaps to manage foreign exchange and certain macroeconomic exposures of the Group.