

The logo for Chesnara, featuring the word "Chesnara" in a white, sans-serif font. The letters are set against a dark blue rectangular background that has a subtle horizontal gradient, transitioning from a slightly lighter blue on the left to a darker blue on the right.

Chesnara

Chesnara plc

Financial Statements
for the Year Ended
31 December 2006

Financial Calendar

29 March 2007	Results for the year ended 31 December 2006 announced
4 April 2007	Ex dividend date
10 April 2007	Dividend record date
12 April 2007	Published Financial Statements issued to shareholders
10 May 2007	Annual General Meeting
14 May 2007	Dividend payment date
September 2007	Interim results for the six months ending 30 June 2007 announced

Forward looking statements

This document may contain forward-looking statements with respect to certain of the plans and current expectations relating to future financial condition, business performance and results of Chesnara plc. By their nature, all forward-looking statements involve risk and uncertainty because they relate to future events and circumstances that are beyond the control of Chesnara plc including, amongst other things, UK domestic and global economic and business conditions, market-related risks such as fluctuations in interest rates, inflation, deflation, the impact of competition, changes in customer preferences, delays in implementing proposals, the timing, impact and other uncertainties of future acquisitions or other combinations within relevant industries, the policies and actions of regulatory authorities, the impact of tax or other legislation and other regulations in the jurisdiction in which Chesnara plc and its subsidiaries operate. As a result, Chesnara plc's actual future condition, business performance and results may differ materially from the plans, goals and expectations expressed or implied in these forward looking statements.

Key Contacts

Registered and Head Office	Harbour House Portway Preston Lancashire PR2 2PR Tel: 01772 840000 Fax: 01772 840010 www.chesnara.co.uk	
Legal Advisers	Pinsent Masons Solicitors 1 Park Row Leeds LS1 5AB	Eversheds 70 Great Bridgewater Street Manchester M1 5ES
Auditor	KPMG Audit Plc St James' Square Manchester M2 6DS	
Registrars	Capita The Registry 34 Beckenham Road Beckenham Kent BR3 4TU	
Stockbrokers	Numis Securities 10 Paternoster Square London EC4M 9BR	Panmure Gordon Moorgate Hall Moorgate London EC2M 6XB
Bankers	National Westminster Bank plc 135 Bishopsgate London EC2M 3UR Lloyds TSB plc 3rd Floor, Black Horse House Medway Wharf Road Tonbridge Kent TN9 1QS	The Royal Bank of Scotland 8th Floor, 135 Bishopsgate London EC2M 3UR
Public Relations Consultants	Cubitt Consulting 30 Coleman Street London EC2R 5AL	
Corporate Advisers	Hawkpoint Partners Limited 41 Lothbury London EC2R 7AE	

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Note on Terminology

As explained in the Chairman’s Statement on page 5, on 30 June 2006 the long-term business of City of Westminster Assurance Company Limited, a Group subsidiary, acquired on 2 June 2005, was transferred, under the provisions of Part VII of the Financial Services and Markets Act 2000, to the Group’s other principal operating subsidiary, Countrywide Assured plc. The former company is referred to as “CWA” in this document and the latter as “CA”. Following the transfer, the whole of the life operations of the Group subsist within one legal regulated entity, CA. However, within this document reference is made to the “CWA business” and to the “CA business” to continue to identify respectively the long-term business conducted within CWA and the long-term business conducted within CA prior to the transfer.

Financial Highlights

	Year ended 31 December	
	2006	2005
IFRS basis		
Operating profit	26.5	21.3
Financing costs	(1.2)	(0.8)
Loss on sale of subsidiary company	(0.3)	–
Profit before income taxes	£25.0m	£20.5m
Basic earnings per share	18.41p	19.26p
Dividend per share	13.1p	12.45p
Shareholders' net equity	£114.3m	£108.3m
European Embedded Value basis (EEV)		
Operating profit	15.0	10.7
Exceptional item		
Profit on acquisition of subsidiary company	–	30.3
Investment variances and economic assumption changes	15.6	10.9
Profit before tax	£30.6m	£51.9m
Covered Business		
Shareholder net worth	84.5	84.5
Value of in-force business	109.9	110.0
Embedded value	194.4	194.5
Acquired embedded value financed by debt	(16.8)	(21.0)
Shareholders' equity in other Group companies	11.5	2.7
Shareholders' equity on EEV basis	£189.1m	£176.2m
Life annual premium income (AP)	£113.4m	£118.0m
Life single premium income (SP)	£54.8m	£60.1m
Life annualised premium income (AP + 1/10 SP)	£118.9m	£124.0m

In contrast with the IFRS basis of reporting the EEV basis recognises the discounted value of the expected future cash flows, arising from the long-term business contracts in force at the year end, as a component of shareholder equity. Accordingly, the EEV result recognises, within profit, the movement in this component.

The Group presents supplementary financial information, prepared in accordance with the EEV basis, with effect from 1 January 2006. This first-time adoption of EEV principles and associated disclosures represents a change from the Achieved Profit ("AP") basis of reporting, which was previously adopted by the Group as the basis for presenting supplementary financial information. Restatement of information for the comparative period from the AP basis to the EEV basis, together with explanatory notes, is set out on pages 125 to 127.

Under the EEV basis of reporting, the exceptional profit arising during the year ended 31 December 2005 relates to the acquisition of CWA Life Holdings plc and represents the excess of the embedded value of that company, at the acquisition date, over the total purchase price. Investment variances and economic assumption changes for the year ended 31 December 2006 are stated net of a £0.3m loss arising on the sale of a subsidiary company.

I am pleased to present the third annual financial statements of Chesnara plc ("Chesnara").

Background

Chesnara, owner of Countrywide Assured plc ("CA") since its listing in May 2004, seeks to participate actively in the consolidation of the closed life business sector in the UK. In 2005 it acquired City of Westminster Assurance Company Limited ("CWA"), another closed life assurance company, from Irish Life and Permanent plc.

CA now manages a portfolio of some 228,000 life assurance and pension policies and is substantially closed to new business. It writes Guaranteed Bonds, a small amount of protection business and accepts top-ups to existing contracts. As a substantially closed book it is expected that the embedded value of the business will decline over time as the number of policies in force reduces and as the surpluses emerging in the business are distributed by way of dividends. As the portfolio runs off, the regulatory capital supporting it may also be reduced and returned to shareholders.

In order to prolong the yield delivery, Chesnara seeks to acquire similar businesses. We believe, however, that such potential acquisitions should not detract from our key objective of delivering a steady and attractive dividend yield.

Review

New acquisition opportunities in the closed life sector in the UK slowed considerably in 2006, particularly within our £50m to £200m target value range. Our main focus has, therefore, been on enhancing shareholder value in the existing business and I am pleased to report a number of significant developments, which prolong and secure the dividend yield from those businesses.

- At the end of June 2006 the long-term business of CWA was transferred to CA under the provisions of Part VII of the Financial Services and Markets Act 2000 (the "Part VII Transfer"). Besides realising significant financial savings and synergies in resources required to manage the combined businesses, the transfer has given rise to more efficient use of capital required for regulatory purposes. In the second half of the year, following a successful application to the High Court, £3m of CWA share capital was released;
- In January 2007 we entered into a contract with Capita Life and Pensions Regulated Services Limited for the provision of administration services to the CWA business for an initial term of 15 years. This followed discussions with the incumbent administration services provider, whose contract was due to expire in February 2009, which indicated that terms for renewal beyond this date were unlikely to be attractive to us. Although the terms of the new contract have given rise to a reduction of some £5m in the value of the in-force portfolio to reflect increased administration costs over the life of the contract, they provide certainty of the administration expense base for some time to come;
- During 2006 we have begun to witness a fall in the number of mortgage endowment misselling complaints received. This follows less intense media attention and a lower pitch of advertising by complaints handling firms, as more policyholders have become time-barred from making successful complaints. Approximately 70% of our in-force endowment policies are now time-barred, this proportion being expected to increase to a maximum of 80% over the course of 2007. These circumstances, together with the strength of investment markets during 2006, have contributed to a position where assumptions previously adopted to fix the level of associated provisions have proved to be adequate. In addition, the 2006 results have benefited from a Professional Indemnity ("PI") insurance recovery of £1.1m in respect of administration costs incurred in the handling of misselling claims; and
- Policy lapse experience and, accordingly, the rate of policy retention within the in-force portfolio were favourable over 2006, particularly with respect to protection policies. While this experience to some extent follows naturally as the closed books proceed along their run-off cycle, the underlying persistency was reinforced by investment market experience over 2006. The strength of the markets has both enhanced the short-term surplus and improved the longer-term outlook, as it has the effect of increasing deductions made from unit funds.

The positive effects of these developments have more than compensated for the negative impact of revised expense assumptions in relation to third-party administration contracts and have translated into a strong earnings performance for 2006 on both of our principal bases of financial reporting.

On the IFRS basis, we have posted a pre-tax profit of £25.0m for the year ended 31 December 2006, compared with £20.5m for the corresponding period in 2005. This improvement is underpinned by the continuing strong

emergence of surpluses in the life business, together with the absence of additional charges required to strengthen misselling provisions.

This result allows the Board to recommend a final dividend of 8.05p per share (2005: 7.55p per share), in respect of the year ended 31st December 2006, representing an increase of 6.6% over the final dividend for 2005. The resulting total dividend for the year of 13.1p (2005: 12.45p) represents a 5.2% increase.

On the EEV basis of reporting, the Group recognises a pre-tax profit of £30.6m for the year ended 31 December 2006, compared with £21.6m, before an exceptional item, for the corresponding period in 2005, and compared with an underlying return of £10.4m expected to arise from the unwind of the risk discount rate within the embedded value. This significant improvement reflects:

- The positive impact of economic assumption changes, which have been driven principally by strength in the investment markets and by a reduction of £4.3m in projected policyholder tax arising as a result of the Part VII Transfer;
- A positive variance of £6.3m in the longer-term investment return; to which investment market strength also contributed;
- The release of a reinsurer default reserve, measured for EEV purposes at £3.5m;
- Favourable lapse experience, across both the CA and CWA businesses, amounting to some £2.9m; and
- The adequacy of the additional provisions in respect of misselling redress exposure, together with the related PI insurance recovery of £1.1m.

offset by:

- A reduction of some £7.7m in respect of revised expense assumptions relating to third-party administration contracts.

In addition to the reduction in projected policyholder tax of £4.3m, arising as a result of the Part VII Transfer, there is also a reduction in projected shareholder tax of £5.7m. These amounts, together with an associated release of a deferred tax provision of £0.6m, give rise to total projected tax synergies over the whole life of the in-force portfolio arising as a result of the Part VII Transfer of £10.6m in EEV terms.

Total shareholder equity, as stated on the EEV basis, pre final dividend appropriations has increased from £176.2m at 31 December 2005 to £189.1m at 31 December 2006 which reflects the strong net EEV earnings performance in the period.

CA's capital solvency ratio at 205% post dividend is at a healthy premium to the target set by the Board of 150%, having increased from the combined CA and CWA post-dividend level of 178% at 31 December 2005. The Group's solvency ratio has strengthened to 225% from the 31 December 2005 level of 158%, stated after allowing for the respective final dividends.

Outlook

Experience during the year in the two key areas of mortgage endowment complaints and persistency has proved favourable. This leads the Board to continue to look to the future with optimism. We remain aware of the importance of these issues and, in the light of some continuing uncertainty with regard to the application and interpretation of regulatory rules, will continue to manage them closely. The key outsourcing contracts for the CA and CWA businesses now provide greater certainty regarding the overall expense base for some time to come. During 2006 investment market performance has provided a positive underpin and, although returns in the medium term have been encouraging, the equity market performance during the first quarter of 2007 serves to remind us of the potential for future volatility. Following its acquisition, CWA is providing a strong surplus flow and, following the Part VII Transfer, the expected financial and operational synergies are being realised. We believe we are well placed to fulfil our stated objective of continuing to deliver a reliable and progressive dividend flow.

The flow of closed life book consolidation opportunities remains slow. Whilst continuing to pursue our activity in this marketplace we will also consider other opportunities which could leverage value from our existing capabilities. If there is no clearly superior investment alternative the possibility of a return of surplus capital remains.

The Board wishes to extend its thanks to all employees for their continued contribution to the Group.

Christopher Sporborg

Chairman

28 March 2007

Christopher H Sporborg CBE is the Non-executive Chairman of Chesnara plc. He is also Chairman of the Nomination Committee. He was formerly Deputy Chairman of Hambros PLC, Deputy Chairman of Hambros Bank Limited and Chairman of Hambro Insurance Services Group PLC. At Hambros he was responsible for the acquisition of Bairstow Eves PLC in 1986 and the formation of Hambro Countrywide plc, now Balanus Limited, a subsidiary of Countrywide plc, and, in 1988, the creation of the life company then called Hambro Guardian Assurance plc and now part of the Chesnara plc group of companies. He is Chairman of Countrywide plc and a director of Getty Images Inc. and Cunningham Lindsey Group Inc.

Graham Kettleborough is the Chief Executive of Chesnara plc. He joined Countrywide Assured plc in July 2000 with responsibility for marketing and business development and was appointed as Managing Director and to the Board in July 2002. Prior to joining Countrywide Assured plc, he was Head of Servicing and a Director of the Pension Trustee Company at Scottish Provident. He has lifetime experience of the life assurance industry, primarily in customer service, marketing, product and business development, gained with Scottish Provident, Prolific Life, City of Westminster Assurance and Target Life.

Ken Romney is the Finance Director and Company Secretary of Chesnara plc. He joined Countrywide Assured plc in 1989 and became a member of the Board in 1997. He has worked in the life assurance industry for the last 23 years. He was Chief Accountant at Laurentian Life (formerly Imperial Trident) up to 1987 and was Financial Controller at Sentinel Life between 1987 and 1989. He worked for Price Waterhouse in their audit division until 1983 in both the UK and South Africa. He is a Fellow of the Institute of Chartered Accountants in England and Wales.

Frank Hughes is the Business Services Director of Chesnara plc. He joined Countrywide Assured plc in November 1992 as an IT Project Manager and was appointed to the Board as IT Director in May 2002. He has 22 years' experience in the life assurance industry gained with Royal Life, Norwich Union and CMG.

Peter Mason is the Senior Independent Non-executive Director of Chesnara plc and is Chairman of the Audit Committee. He also serves on the Remuneration and Nomination Committees. He joined the Board of Countrywide Assured Group plc as Non-executive Director in May 1992 and is currently a Non-executive Director of Countrywide plc, Homeowners Friendly Society and Countrywide Assured plc. He is the Investment Director and Actuary of Neville James Group, an investment management company. He was admitted as a Fellow of the Institute of Actuaries in 1979.

Mike Gordon is an Independent Non-executive Director of Chesnara plc and is Chairman of the Remuneration Committee. He also serves on the Audit Committee and the Nomination Committee. He spent 12 years as Group Sales Director of Skandia Life Assurance Holdings. He is the Senior Independent Non-executive Director of Countrywide plc and Chairman of Bankhall Investment Management Limited, a Skandia-owned subsidiary.

Terry Marris is a Non-executive Director of Chesnara plc and serves on the Audit Committee, the Remuneration Committee and the Nomination Committee. He joined Countrywide Assured Group plc in 1992 and was Managing Director of Countrywide Assured plc until July 2002 and is currently Chairman of Countrywide plc's Conveyancing Division. He was formerly a Director of Countrywide Assured Group plc. Previous roles included senior management positions at Lloyds Bank and General Accident.

Directors' Report

The Directors present their report and the audited consolidated accounts of Chesnara plc ("Chesnara") for the year ended 31 December 2006.

Results and Dividends

The Group consolidated income statement for the year ended 31 December 2006, prepared in accordance with International Financial Reporting Standards and set out on page 44, shows:

	2006 £000	2005 £000
Profit for the year	19,256	18,615

An interim dividend of 5.05p per ordinary share was paid by Chesnara on 11 October 2006. The Board recommends payment of a final dividend of 8.05p per ordinary share on 14 May 2007 to shareholders on the register at the close of business on 10 April 2007.

Business Review

Strategic aims

Chesnara seeks to participate actively in the consolidation of the closed life business sector in the UK. In 2004, at the same time that we listed on the London Stock Exchange, we acquired Countrywide Assured plc ("CA") on CA's effective demerger from the estate agency business which now forms the core of the operations of Countrywide plc, while in 2005 we acquired City of Westminster Assurance Company Limited ("CWA") from Irish Life and Permanent plc.

As both CA and CWA are substantially closed to new business their primary focus is on the efficient run-off of their existing life and pensions portfolios. This gives rise to the emergence of surplus which supports our primary aim of delivering an attractive long-term dividend yield to our shareholders. By the very nature of the life business assets the surplus arising will deplete over time as the policies mature, expire or are the subject of a claim. Therefore, to prolong the yield delivery we seek to acquire similar businesses.

In recent years there has been a spate of activity in the UK closed life sector. This has been driven by the realisation that closed books offer the opportunity to rationalise operations and to achieve financial and operational synergies. These may in turn be enhanced by merging the closed books into one legal entity, which also provides the potential for more efficient use, and potential release, of capital from the combined businesses. As a result the returns from the books are underpinned by the prospect of a reasonably predictable emergence of surplus.

Chesnara, by virtue of its market capitalisation, primarily targets acquisitions with a value of between £50m and £200m although other opportunities are considered. Such opportunities are assessed against a number of key criteria including size, risk (including actual or potential product liabilities), mix of business, and pattern and quality of predicted surplus emergence. It is a cornerstone of our strategic approach, however, that such potential acquisitions should not detract from the key aim of delivering a steady and attractive dividend yield.

How we achieve our strategic aims

The operating model of our life businesses is directed towards maintaining shareholder value by outsourcing all support activities to professional specialists. This typically embraces policy administration, systems, accounting and investment management and reduces the impact of potential fixed and semi-fixed cost issues which would otherwise occur as the income streams arising from a declining in-force portfolio diminish. By securing long-term contracts to support these activities we obtain a relatively fixed cost per policy per year, which ensures that the overall cost is more predictable and reduces in line with the size of the policy portfolio. It also leads to the avoidance of the full weight of systems development costs, as these will, generally, be shared with other users of the outsourcers' platforms.

At the centre we maintain a small, professional corporate governance team, whose efforts are directed towards:

- Oversight of the outsourced functions;
- Maintaining regulatory compliance;

- Pursuing value-enhancing initiatives on the existing business, including the effective management of financial exposures; and
- Promoting customer retention, thereby extending the longevity of the income stream from the in-force portfolio.

The UK life assurance industry is highly regulated, in terms of both the conduct of business operations and of financial reporting. We place particular emphasis on managing our regulatory compliance through a proactive and prudent approach and maintaining a positive relationship with our principal regulator, the Financial Services Authority (“FSA”). Accordingly, a significant part of the efforts of the corporate governance team is directed towards ensuring that the operations are effectively managed in terms of conduct of business regulations and of prudential solvency requirements.

We consider the knowledge, skills and experience of the corporate governance team to be a valuable Company asset, which also has the capability of assessing acquisition opportunities in the wider UK and offshore Financial Services sector. The team is intentionally small and focused in the interests of keeping the overall Group expense base tight, but it is supplemented from time to time by temporary resource if justified by operational or strategic demands.

In ensuring that this small team is properly incentivised we place emphasis both on retention and on reward for past performance. Accordingly we maintain an annual bonus scheme which is currently guaranteed as to 50%, provided that the individuals remain in Company employment on a specified date, while the remaining 50% is related to Company performance. The three Executive Directors also have the benefit of a longer-term incentive plan, details of which are set out in the Directors’ Remuneration Report on page 36. The training and competence needs of individuals are regularly assessed as an integral part of our risk management regime described below.

We take our responsibilities for social and environmental issues seriously and recognise the importance of developing and maintaining high standards. However, in view of the scope of the Group’s activities and the nature and small size of the organisation we do not consider that these aspects are critical to the achievement of our strategic aims.

Developments during 2006

During 2006 the emergence of new acquisition opportunities in the UK closed life sector slowed considerably, particularly within our £50m to £200m value target range. While we do believe that more closed life and pensions books will become available in the medium term, we have begun to investigate other opportunities which could leverage value from our existing capabilities.

As to the existing life and pensions portfolios, we have made significant progress in maintaining and improving shareholder value through 2006, the most significant developments being:

Realising Synergies

Part of the challenge set for 2006 was to realise the potential synergies of merging the CWA business into the CA business through a Part VII Transfer under the provisions of the Financial Services and Markets Act 2000 (the “Part VII Transfer”). This was duly achieved at the end of June and has resulted in a more efficient use of regulatory capital and in other significant financial and synergistic savings. In the second half of the year it also enabled a capital reduction of £3m in, and subsequent release from, CWA following a successful application to the High Court.

Managing the Expense Base

The acquisition of CWA presented one significant issue in that its existing administration outsourcing contract was due to terminate in February 2009. Discussions with the incumbent provider identified that they were not looking to extend the contract beyond this date on terms that would be attractive to us. We therefore took steps, leveraging the outsourcing knowledge we had in both the CA and CWA operations, to procure an alternative supplier. This has resulted in the signing of a contract (on 10 January 2007) with Capita Life and Pensions Regulated Services Limited (“Capita”) to provide administration services for the CWA book of business from 1 April 2007. While the contract has necessitated a reduction of just under £5m in the value of the in-force portfolio to reflect increased expected administration costs over the life of the portfolio, it provides certainty of base administration costs for some time to come. The arrangement is for an initial term of 15 years with the option to extend to an ‘evergreen’ basis, on agreed terms, within the first two years.

Managing Financial Exposure

The Group pays particular attention to any area in which it has a significant financial exposure. In life and pensions portfolios these typically arise in the areas of onerous policy options and guarantees and of compensation claims for past misselling of products. While the Group's portfolios have very little exposure to the impact of investment market performance on options and guarantees, it does have significant exposure to the misselling of policies sold in connection with an endowment mortgage. We are required to pay redress to a subset of endowment policyholders who may have been missold their product and are required to write to policyholders on a biennial basis setting out their potential returns based on specified growth rates. We are emerging from a period where there has been significant media attention and ever present advertising by claims management firms which gave rise to a significant increase in the number of claims being received. Such activity has declined as policyholders have become time-barred from making a successful complaint. Approximately 70% of our in-force mortgage endowment policies are now time-barred and this proportion is expected to increase over the course of 2007 up to a maximum of around 80%. The balance of the population will not have received the requisite red letter mailings which implies that their policies are on target to reach the expected maturity value and therefore any complaint, if upheld, is likely to receive low level, if any, compensation based on current market performance. We are pleased to report that during 2006 we have not had to make any significant adjustments to future redress cost provisions or future complaints handling cost provisions, which have reduced over the year as they have been utilised to meet related claims.

Promoting Customer Retention

A key determinant of our ongoing profitability and of the level and longevity of the emergence of surplus, which underpins our dividend-paying capacity, is the rate at which customers leave us. The number of policies we manage will, of course, reduce as policies mature or as claims are made. Equally, some customers' circumstances change and their need for the relevant policy ends. We have continued to maintain a strong focus on the retention of policies where it is in the interests of customers to continue with their arrangements. We retain a qualified office-based sales team who provide advice on our key protection and endowment product lines. They offer advice on retaining the policy where appropriate or possible alternative arrangements if necessary.

An important element of our customer retention strategy is the pursuit of superior investment performance in the unit-linked funds. These underpin our unit-linked products, which account for a significant proportion of our overall policy portfolio. With effect from February 2006 the CA funds are primarily managed by Schroder Investment Management Limited ("Schroders"). The CWA funds continue to be managed by Irish Life Investment Managers Limited ("ILIM"). We meet formally with both fund managers on a quarterly basis to assess past performance and future strategy. The returns on all funds are measured against relevant benchmarks.

Managing Regulatory Requirements

2006 witnessed significant developments on the regulatory front, both in terms of business conduct and practice and in terms of financial reporting, which we have endeavoured to manage proactively. These included:

On business conduct and practice – the investment of significant effort in our Treating Customers Fairly project as required by the FSA. Gap analyses were substantially completed and progress is being made on the implementation of identified action points. We fully expect to meet the FSA's stated requirement of being 'substantially into the implementation stage' by the end of March 2007. In addition to this project the Association of British Insurers ("ABI") has issued a number of Good Practice guides through 2006 (e.g. Unit Linked Funds, Pension Maturities) and we have assessed our procedures and practice against these. Where we believe it necessary, we have taken steps to comply with the content of these guides.

On financial reporting – the first-time provision of supplementary financial information in accordance with European Embedded Value ("EEV") principles. We provide financial information supplementary to our primary financial statements which are prepared in accordance with International Financial Reporting Standards. With effect from 2006 financial reporting we have adopted EEV principles as the basis for providing this supplementary information in lieu of the Achieved Profit ("AP") basis of reporting. AP and EEV methodologies are similar insofar as both aim to measure the underlying embedded value of the life and pensions businesses. EEV principles, however, provide a framework which is intended to improve the comparability and transparency of embedded value reporting across Europe.

In addition we have continued to maintain a conservative approach to our core regulatory capital and solvency requirements, targeting a minimum cover of 150% of the Long-term Insurance Capital Requirement and 100% of the Resilience Capital Requirement. During the course of the year we have, in addition to the impact of the Part VII Transfer referred to above, undertaken two key initiatives which have considerably strengthened the underlying regulatory solvency position. First we have disposed of Premium Life International Limited (“PLI”), a small subsidiary life and pensions company, for which CA was required to hold minimum regulatory capital of €3m (£2.0m), notwithstanding the fact that it had a portfolio of less than 100 policies. This capital has now been released by way of a reduction in regulatory capital requirements. Furthermore, as a result of obtaining a pari passu charge on assets held by Guardian Assurance plc (“Guardian”), a major reinsurer, against which we had, as a result of the Insurers (Reorganisation and Winding Up) Regulations 2004, previously been required to maintain a reserve relating to their possible default, we have now been able to release the full reserve of £6m. This has given rise to an increase in available regulatory capital resources of the same amount. These activities, together with the underlying emergence of surplus, result in a healthy excess of regulatory capital over the required target level at both a subsidiary and a group level.

Risk management

Overlaying all the day-to-day and project activity we undertake is a strong risk management culture and regime.

We maintain a process for identifying, evaluating and managing the significant risks faced by the Group which is regularly reviewed by the Board. Our risk processes have regard to the materiality of risks, the likelihood of their occurrence and the costs of mitigating them. The process is designed to manage rather than eliminate risk and, as such, provides reasonable, but not absolute assurance against loss.

At the subsidiary level we maintain, in accordance with the regulatory requirements of the FSA, a risk and responsibility regime. During the course of the year we have combined the previously established regimes of CA and CWA. This has given us the opportunity of re-examining our practice and allowed us to ensure that the identification, assessment and control of risk is firmly embedded within the organisation and that the procedures for the monitoring and updating of risk are robust. As part of this we have established a CA Risk Committee which comprises solely of Non-executive Directors. This committee receives quarterly updates of the Key Risk Register, as maintained by the executive management, for review and challenge. The Risk Committee reports directly to the CA Board. These reports are also reviewed at the Chesnara Audit Committee on a quarterly basis.

The Key Risk Register has been designed to complement the production of our Individual Capital Assessment, which we are required to submit to the FSA on request and maintain on an ongoing basis. We categorise all risks against the following relevant categories – Insurance, Market, Credit, Liquidity, Operational and Group – and identify potential exposures and the necessary capital requirements accordingly. It is inherent in the operations of the life businesses that they carry significant insurance and financial risk. The nature, scope and management of these particular risks is articulated in detail in Note 4 to the Financial Statements on pages 60 to 69.

We acknowledge that, as a consequence of our strategy of maintaining a small central corporate governance team, this does concentrate knowledge and experience in a relatively small number of people. To minimise the risk of knowledge loss we maintain a succession plan and incentivise the team with graded company performance and loyalty bonuses dependent upon their skills and knowledge. Should a skills gap appear we look to utilise external resource until such time as a permanent solution can be identified. These processes are supplemented by the maintenance of explicit procedures to assess the competence of, and training requirements for, all key individuals within the corporate governance team.

Key performance indicators

Set out below are those indicators which we consider to be key in assessing the Group’s performance. They are either in the nature of lead operational indicators or are measurements which reflect outcomes. We explain the significance of each indicator and also set out the way in which it has been formulated to the extent necessary to appreciate its characteristics.

Information on the pre-tax results of the Group is presented within the Operating and Financial Review on pages 17 to 29.

Per Policy Expenses

A key area of focus for the Group is the management of expenses incurred in servicing the in-force life and pensions policy base. In particular we seek, through outsourcing arrangements, to maximise the proportion of costs which vary with policy volume. Through the assumptions we set for reporting on an EEV basis (details of which are set out on pages 111 to 124 of these financial statements), we project anticipated policy volumes in force and anticipated expenses in managing those policies over the run-off life of the policy base. Under EEV principles these expenses include, critically, the projected stream of Chesnara holding company expenses. From these projections we derive, for each period end, a projected average expense per policy per year, which is reflected in the overall value of policies in force and, therefore, in the embedded value of the life business. This measurement will have an expected variation through lapse of time as the policy base diminishes in relation to an expense base which does not diminish in the same proportion on account of expenses which do not vary with policy volume.

Following from this, the key indicators set out below show the actual EEV-based projected expense per policy per year. The variation over time comprises:

- (i) the expected variation;
- (ii) the extent to which the in-force policy base is higher or lower than previously anticipated; and
- (iii) the extent to which projected expenses are higher or lower than previously anticipated.

Should the Group acquire further life and pension books it would usually expect to achieve economies of scale which would feed through into a reduced per policy per year cost.

	As at 31 December 2005	Variation due to			As at 31 December 2006
		Expected variation	Policy volume projection	Expenses projection	
EEV projected expense per policy per year (£'s)	61.68	4.04	(2.48)	2.32	65.56

The stated amounts are not adjusted for projected inflation rates and are therefore stated in terms of current-year pounds.

Favourable policy lapse experience over the year, particularly with respect to Protection policies, has led to higher projected policy volumes and this has translated into a favourable impact on per policy costs. This has virtually been wholly offset by revised expense projections following from the new administration outsourcing arrangements for the CWA business referred to above (see also the commentary on the EEV result in the Operating and Financial Review on pages 21 to 24).

Policy Attrition Rate

The longer that life and pensions policies remain in force the more profit accrues to the Group. Over time the value of the in-force policies is realised into surplus within CA and this is in turn distributable to Chesnara, subject to the regulatory constraints referred to in "Regulatory Capital Resources and Requirements" below. It is important therefore that the Company maximises policy retention through influencing policyholder behaviour. Different policy product types will naturally be subject to lapse, claim or surrender to varying extents and it is a detailed review and analysis of the experience of each of these types which gives rise to the projected policy in-force assumptions underpinning the projected value of policies in force within the embedded value. A globalised statement of the annual rate of attrition of policies is provided as a broad indicator of the trend in longevity of the in-force base:

Number of in-force policies (000's)

	2006	2005
Beginning of year	256	294
End of year	228	256
Rate of attrition over the year	11%	14%

The improvement in the year-on-year attrition rate follows from the fact that the further the closed businesses are into their run-off cycle, the less their rate of attrition tends to be. This has been reinforced in 2006 by strong investment fund performance.

The beginning 2005 figures have been adjusted to include policy numbers relating to the CWA business, although it was only acquired in June 2005. This has been done to facilitate year-on-year comparison to illustrate the underlying trend in the combined businesses.

Unit-linked Fund Performance

Superior performance in the unit-linked funds helps promote policy retention and increases the embedded value of the Group as future management charges will be of a higher magnitude. The CA Managed Fund, which represents a significant proportion of CA policyholder funds under management returned 9.82% over the year ended 31 December 2006 (31 December 2005: 16%), while the CWA Global Managed Fund, which represents a significant proportion of CWA policyholder funds under management, returned 9.34% over the same period (31 December 2005: 17%). These returns compare favourably with the average of 9% achieved by the ABI Life Balanced Managed Funds sector.

Mortgage Endowment Misselling Complaints

We continue to carry significant exposure to mortgage endowment misselling complaints, which may become the subject of redress payments to policyholders. Three of the key drivers which define and limit the extent of this exposure are set out below:

Mortgage endowment misselling complaints

	2006	2005
Number received during the year	7,300	9,947
% upheld during the year	26%	32%
% time-barred at end of year	63%	35%

The % time-barred relates to those mortgage endowment policies for which a misselling complaint is potentially not admissible through the application of rules and guidance issued by the FSA and ABI and is stated as a proportion of the total number of in-force policies on which a complaint could be made. We expect the percentage of time-barred cases to peak at around 80% towards the end of 2007.

The favourable trend in these indicators underpins the adequacy of existing complaints redress provisions during 2006.

Regulatory Capital Resources and Requirements

The Operating and Financial Review sets out in detail a comparison between available capital resources and regulatory capital requirements for CA on pages 17 to 29. These amounts, the operation of which act as an effective constraint on distributions from CA to Chesnara, are calculated by reference to FSA prudential regulations. The following summarises the CA Regulatory Capital position after making allowance for dividend payments from CA to Chesnara after the respective period ends:

	31 December	
	2006	2005
Ratio of available capital resources (CR) to capital resources requirement (CRR)	205%	186%
Excess of CR over target requirements	£30.2m	£11.0m

The CA Board sets a minimum target for CR as the sum of 150% of the long-term insurance capital requirement and of 100% of the resilience capital requirement components of the CRR. The excess above this amount is regarded as freely distributable from CA to Chesnara from a regulatory viewpoint and to the extent that it is represented by retained earnings in the regulated life business there are currently no further constraints on its distribution.

The improvement in the year-on-year position arises from:

- (i) Emergence of underlying surplus at a rate which is currently higher than that required to service debt principal repayment and interest, together with the servicing of equity in line with our current dividend policy;

- (ii) The release of a reserve of £6m held in respect of possible default by a reinsurer;
- (iii) A reduction of £2.0m in CRR arising as a result of the disposal of PLI; and
- (iv) The absence of additional provision requirements in respect of mortgage endowment misselling redress.

Future trends and developments

In line with our primary aim of delivering an attractive long-term dividend yield we remain focused on the efficient management of the emergence of surplus. We will continue to seek to maintain balance between the risks we accept and the cost of mitigating them. However, we recognise that, without further acquisitions, support for the dividend at its current level will eventually diminish and that the expense base, however well managed, will become an issue as we will have a diminishing income stream to cover fixed and semi-fixed costs. With the current lack of opportunity in the closed life book sector, we have begun to look at other propositions that would utilise the skill sets of the corporate team whilst offering value to shareholders. We remain committed to assessing any opportunities that present in the closed life sector and believe that, in time, such opportunities will arise from ongoing structural change in the marketing and distribution of life and pensions products, or from restructuring and strategic change driven by the existing owners.

While we have taken measures to de-risk the life business and to make the operational structure more efficient, we can now predict the medium-term flow of surplus from the life business with a reasonable degree of certainty. However, key uncertainties remain, particularly with respect to:

- (i) The state of investment markets: while their strength in the last quarter of 2006 had a positive impact on the Group's key performance indicators, global equity markets have become unsettled during the first quarter of 2007;
- (ii) Ongoing domestic- or European-driven regulatory change, including (a) HMRC's prospective clarification of the operation of certain aspects of the current life taxation regime and (b) the ongoing review of insurance companies under the European Solvency II initiative; and
- (iii) Changes in the application or interpretation of regulatory-based rules relating to mortgage endowment misselling claims.

Provided that these areas do not adversely impact the prospects of the Group, the short- to medium-term outlook is positive for the ongoing emergence of surplus, the life business's excess over target capital requirements and, accordingly, for ongoing dividend support.

Financial Risk

Disclosure with respect to financial risk is included in Note 4 to the financial statements.

Directors

The present Directors, all of whom served from 1 January 2005 to 31 December 2006 are listed on page 7. No other Directors served during that period and there have been no changes between that date and 28 March 2007.

The Non-executive Directors who served as Chairmen and members of the Nominations and Audit Committees of the Board are set out in the Corporate Governance Report on pages 30 to 35. Information in respect of the Chairman and members of the Remuneration Committee and in respect of Directors' service contracts is included in the Directors' Remuneration Report on pages 36 to 40, which also includes details of Directors' interests in shares and share options.

On 29 January 2007 Terry Marris, whose existing term of appointment expired on 1 March 2007, was re-appointed for a further three years so that his term of appointment now ends on 1 March 2010.

Pursuant to the Articles of Association, Christopher Sporborg, Ken Romney and Frank Hughes will retire by rotation at the Annual General Meeting and, being eligible, offer themselves for re-election. No Director seeking re-election has a service contract with the Company of more than one year's duration.

No Director had any material interest in any significant contract in the Company or in any of the subsidiary companies during the year.

The Directors benefited from qualifying third party indemnity provisions in place during the year ended 31 December 2006 and at 28 March 2007.

The Company also provided qualifying third party indemnity provisions to certain directors of associated companies during the year ended 31 December 2006 and at 28 March 2007.

Substantial Shareholdings

The following substantial interests in the Company's ordinary share capital at 31 December 2006 have been notified to the Company:

Name of substantial shareholder	Total number of ordinary shares held	Percentage of the issued share capital as at 31 December 2006
Allianz AG (including 16,679,641 (15.95%) held by Veer Palthe Voute NV, a subsidiary company)	16,706,667	15.97%
Lloyds TSB Group plc	5,151,609	4.93%
Witmer Asset Management LLC	3,896,173	3.73%
Legal and General Group Plc	3,507,808	3.35%
Standard Life Group	3,287,883	3.14%
Morgan Stanley Securities Limited	3,220,216	3.08%

Subsequent to 31 December 2006, the following changes in shareholdings have been notified to the Company:

Name of substantial shareholder	Date of Notification	Total number of ordinary shares held	Percentage of the issued share capital
Legal and General Group Plc	22 February 2007	3,381,967	3.23%
Threadneedle Asset Management Holdings Limited	27 February 2007	6,658,928	6.37%
Morgan Stanley Securities Limited	6 March 2007	3,242,751	3.10%
Lloyds TSB Group plc	19 March 2007	4,310,619	4.12%
New Star Asset Management Ltd	20 March 2007	10,004,204	9.57%
Allianz AG (including Veer Palthe Voute NV)	20 March 2007	13,385,539	12.80%

The other substantial shareholder interests remained unchanged at 23 March 2007 and no other person holds 3% or more of the issued share capital of the Company.

There were no significant contracts with substantial shareholders during the year.

Charitable Donations and Political Contributions

Charitable donations made by Group companies during the year ended 31 December 2006 were £nil (2005: £nil). No political contributions were made during the year ended 31 December 2006 (2005: £nil).

Employees

The average number of employees during the year was 33 (2005: 44).

Chesnara has a policy of keeping employees informed of its affairs through regular internal communication and meetings with the Directors. Employees are encouraged to involve themselves in the performance of the Company and to suggest initiatives that will lead to improvement or the mitigation of risk. Chesnara strives to provide its employees with clear and fair terms of employment and clean, healthy and safe working conditions. The Company has a fair remuneration policy and offers equal opportunities to all present and potential employees. It believes that its best interests are served by encouraging its employees to develop skills and to progress in their careers and recognises the value and significant contribution its employees are able to make to the success of the business.

Equal Opportunities

Chesnara is committed to a policy of equal opportunity in employment and believes that this is essential to ensuring its success. Chesnara will continue to select, recruit, train and promote the best candidates based on suitability for the role and treat all employees and applicants fairly regardless of race, gender, marital status, ethnic origin, religious beliefs or disability. Chesnara will ensure that no employee suffers harassment or intimidation.

Disabled Employees

Chesnara will provide employment for disabled persons wherever the requirements of the Group allow and if applications for employment are received from suitable applicants. If existing employees become disabled, every reasonable effort will be made to achieve continuity of employment.

Health, Safety and Welfare at Work

Chesnara places great importance on the health, safety and welfare of its employees. Relevant policies, standards and procedures are reviewed on a regular basis to ensure that any hazards or material risks are removed or reduced to minimise or, where possible, exclude the possibility of accident or injury to employees or visitors.

The policies, standards and procedures are communicated to employees through contracts of employment, the staff handbook and employee briefings and all employees have a duty to exercise responsibility and do everything possible to prevent injury to themselves and others.

Social, Environmental and Ethical Issues

Chesnara aims to be sensitive to the cultural, social and economic needs of our local community and endeavour to protect and preserve the environment where it operates.

We seek to be honest and fair in our relationships with our customers and provide the standards of products and services that have been agreed.

Being an office-based financial services company, the Directors believe that its activities do not materially contribute to pollution or cause material damage to the environment. However, the Company takes all practicable steps to minimise its effects on the environment and encourages its employees to conserve energy, minimise waste and recycle work materials.

Creditors' Payment Policy

It is Chesnara's policy to pay creditors in accordance with the CBI Better Practice Payment Code (available at www.payontime.co.uk) on supplier payments. The number of creditor days outstanding at 31 December 2006, based on the consolidated Financial Statements, was 3 for the Group (2005: 3) and 9 for the Company (2005: 3).

Going Concern Statement

After making appropriate enquiries, the Directors confirm that they are satisfied that the Company and the Group have adequate resources to continue in business for the foreseeable future. Accordingly, they continue to adopt the going concern basis in the preparation of the financial statements.

Disclosure of Information to the Auditor

The Directors who held office at the date of approval of this directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's Auditor is unaware; and each Director has taken all the steps that they ought to have taken as a Director to make themselves aware of any relevant audit information and to establish that the Company's Auditor is aware of that information.

Auditor

In accordance with section 384 of the Companies Act 1985, a resolution for the re-appointment of KPMG Audit Plc as Auditor of the Company is to be proposed at the forthcoming Annual General Meeting.

Approved by the Board on 28 March 2007 and signed on its behalf by:

Ken Romney
Director

The Business Review, presented in the Directors' Report on pages 8 to 14, sets out the strategic aims of the Company, how the Company meets these aims and developments and trends in realising them. This Operating and Financial Review, which should be read in conjunction with the Business Review, provides more detailed information about the characteristics and structure of the business, its operating results for 2006 under both the IFRS and EEV bases of reporting, together with further analysis of the Embedded Value and of other key financial aspects.

Characteristics and Structure of the Business

Background

Chesnara plc ("Chesnara"), which was listed on the London Stock Exchange in May 2004, was formed to become the holding company of the life assurance activities of Countrywide plc ("Countrywide"), from which they were demerged. Its principal operating subsidiary, Countrywide Assured plc ("CA"), was established in 1988 as the life assurance division of Countrywide and sold mortgage-related life assurance products through Countrywide's financial services division. As a substantially closed life business it continues to administer its in-force portfolio which comprises predominantly endowment and protection policies, this reflecting CA's history of providing mortgage-related policies to clients of an estate-agency based financial services group.

In June 2005 Chesnara acquired City of Westminster Assurance ("CWA") for a total purchase consideration of £47.8m. CWA was, on acquisition, approximately 40% of the size of the existing life business, CA, and is also substantially closed to new business. This transaction delivered on the Company's stated strategy of the consolidation of value-enhancing closed life businesses. The funding for the purchase, which was settled in cash, was made by the raising of further equity of £22m from shareholders by way of a placing and an open offer, and by the provision of a bank loan of £21m, with the balance being sourced from internal retained funds. The Board believes the bank loan, which is repayable in five equal annual amounts on the anniversary of the draw down date, introduces an element of gearing to the balance sheet, which is proportionate to both the size of the acquisition and to the existing capital base of the Company.

In common with the CA business, the policies comprising the CWA business include a mix of endowment, protection and pension policies. However, unlike CA, there is a relatively high proportion of pension policies and this helps to improve the overall mix of Chesnara's business by spreading the risk subsisting within the different policy types. As the CWA business has been in run off since 1995 and as it has outsourced its administration since 1999, its future surplus flows can be predicted with a reasonable degree of certainty.

On 30 June 2006, the long-term business of CWA was transferred to CA under the provisions of Part VII of the Financial Services and Markets Act 2000 (the "Part VII Transfer"). Besides reducing the reporting and regulatory burden, financial and operational synergies are now being recognised. These include the more efficient use of regulatory capital, the relief of tax losses in CA and savings in the resource required to manage the business. In terms of regulatory capital, CWA's long-standing requirement to hold £5m in excess of its stand-alone Capital Resource Requirement has been subsumed into the overall CA solvency position, resulting in a lower overall regulatory capital requirement. Total tax synergies of £10.6m arise from projected reductions in notional policyholder tax of £4.3m, a reduction in projected shareholder tax of £5.7m and the release of a deferred tax provision of £0.6m. We are working to maximise other synergies from the merger of the two businesses.

During 2006 we undertook other initiatives to further rationalise and make more efficient the operations and structure of the Group, including the regulatory de-authorisation of, and capital reduction in, CWA and the disposal of Premium Life International Limited ("PLI"), a minor subsidiary. Following the completion of the Part VII Transfer, CWA remained an authorised entity carrying £3m of capital which was in excess of the requisite regulatory minimum of €3m. Therefore we initiated a process with the FSA to de-authorise CWA and, on receipt of this permission, applied to the High Court to sanction a capital reduction. This process was completed in October 2006 with the result that £3m of capital has been released to the Group. In March 2006 we completed the disposal of PLI to LCL Group at a book loss of £0.3m. As well as rationalising the Group structure further and reducing reporting requirements the key benefit is a reduction of £2.0m in the Long-Term Insurance Capital Requirement, while the concomitant reduction in capital resources was £0.3m.

Overall CA now manages a portfolio of some 228,000 policies of which a significant proportion is unit-linked. There is a small proportion of with-profits policies (less than 2% by policy count) which are wholly reassured to Guardian Assurance plc ("Guardian"), a subsidiary of Aegon NV. CA has continued to market and sell Guaranteed Income and Guaranteed Growth Bonds through Independent Financial Advisers and directly to investors, resulting in £34.4m of single premium income in 2006 (2005: £48.6m). CA also sells a small amount

of protection business to existing customers while both the CA and CWA businesses benefit from additional inward flows on their existing life and pension contracts by way of inflation-linked increases and rebates received from the government in respect of contracted-out pension policies.

Structure of the Business

The Chesnara Group operating model is to maintain a small, centralised corporate governance team and to outsource all core operating activities. Both the administration of its life assurance and pensions books and the allied investment management functions are outsourced to professional specialists.

Our agreement with Liberata Financial Services Limited (“Liberata”) to outsource back office functions for the CA business with effect from 1 February 2005 continues. The agreement, which runs for 10 years, provides Chesnara with a defined level of cost per policy during the term and mitigates the risks and significant cost inefficiencies that arise from a diminishing policy base. Service levels have been in line with the agreed standards and the transition project, which will migrate the business to Liberata’s systems, continues to progress.

The CWA business is also outsourced on a defined per policy cost basis, albeit to a different supplier – Computer Sciences Corporation (“CSC”). This agreement was due to expire in early 2009. However, in January 2007, we entered into an agreement with Capita Life and Pension Regulated Services Limited (“Capita”) for them to provide these services from 1 April 2007 for a period of 15 years. As part of this transaction a project to facilitate migration of CWA’s policy administration to Capita’s systems has already begun.

The agreements with our outsourcers provide the life business with a closer relationship between the size of its policy base and the level of expenses incurred in administering those policies during the terms of the agreements and this mitigates a number of risks including:

- the impact of increasing per policy costs which would affect both policy competitiveness and returns to shareholders;
- the failure to retain resource with key skills, knowledge and experience against a backdrop of reducing policy numbers and consequent headcount reductions; and
- the inevitable disparity between maintaining key resource levels and funding necessary systems developments to meet ongoing business requirements (e.g. of a legal or regulatory nature) and the reducing income with which to support them.

Chesnara Group activities are now based on two sites: Chesnara Head Office and CA business functions operate from a single base in Preston, Lancashire, while the CWA business is currently a stand-alone entity operating from a single base in Luton, Bedfordshire. It is expected that the Luton base will close in Q2 2008 following the completion of the migration of the book to Capita’s systems.

The Chesnara Head Office and CA business functions share resources and now have 15 employees who are engaged on the identification of development and consolidation opportunities, with a view to maximising shareholder returns, management of the Liberata contract and on corporate governance and the fulfilment of regulatory responsibilities.

The CWA business, which has 9 employees, is based in Luton at the same site as Computer Services Corporation (CSC), its current third party services provider. CSC provides services as described above, except that, unlike CA, the CWA business has retained direct responsibility for its Actuarial and Accounting functions. On transfer to Capita we are taking the opportunity to transfer some of the Actuarial and Accounting functions and staff into the outsourcer in order to align the arrangements more closely with the Group’s operating model.

Chesnara is now a small professional knowledge-based team which is resourced to deliver known requirements. As such it will, from time to time, require external resource to facilitate new and/or unexpected developments. In the main, it aims to build on its existing relationships but will closely monitor the availability, quality and cost of suitable alternatives.

Key Dependencies

The Chesnara Group continues to rely on a number of key relationships for the successful and efficient conduct of its business:

Reinsurance – the CA and CWA businesses have transferred part of their exposure to certain risks to other insurance companies through reinsurance arrangements. Under such arrangements, other insurers have assumed a portion of the losses and expenses associated with reported and unreported losses in exchange for a portion of the policy premiums.

Outsourcing – the CA and CWA businesses have transferred most of their operational functions to third party service providers under agreements described above. Both businesses maintain a close relationship with the providers to monitor their financial and operational performance and to ensure that their performance is in accordance with agreed service standards.

Systems – Chesnara is required to maintain, and regularly test, a business continuity plan. With the transfer of the Preston-based operations to Liberata the relevant systems and the continuity plan have been transferred to them. As part of its agreement with Liberata Chesnara will support Liberata's intention to migrate the systems supporting CA's business to their modern and flexible Amarta system: this migration is scheduled for completion in 2007. The related agreement also provides for Liberata to manage the systems, including provision for business continuity, to support the operation of the Preston-based governance team. Similar business continuity and governance systems support arrangements exist with CSC in respect of the Luton-based operations. These will be transferred to Capita who will be migrating the systems supporting CWA's business to their specialist administration system: this migration is due for completion in Q2 2008.

Investment management – the CA and CWA businesses have both outsourced the management of their own and policyholder investments to third party investment managers. Ongoing monitoring of their performance is maintained and is formally reviewed each month by internal management and every quarter with the Investment Managers. Schroder Investment Management Limited provides investment management services to the CA business whilst those of the CWA business are provided by Irish Life Investment Managers Limited.

Actuarial function – CA, which is required to appoint a Head of Actuarial Function and a With-Profits Actuary, appointed its former Appointed Actuary, Peter Wright of Tillinghast-Towers Perrin, to both these roles. In order to maintain consistency he was also appointed Head of Actuarial Function to CWA up to the date of its de-authorisation in September 2006.

Operating Review

Basis of Accounting

The Group reports primarily in accordance with International Financial Reporting Standards ("IFRS"). As IFRS essentially permits the "grandfathering" of the principles and bases used to measure profit arising on long-term insurance contracts under previously-adopted UK GAAP and, as the business of the Group predominantly relates to life contracts in run off, so the earnings profile of the Group will continue to be dominated by the underlying emergence of surplus in these businesses as measured for UK regulatory reporting purposes.

The Group continues to provide financial information supplementary to the IFRS basis. With effect from reporting periods commencing on 1 January 2006, the Group has adopted European Embedded Value ("EEV") principles as the basis for providing this supplementary information in lieu of the Achieved Profit ("AP") basis of reporting. AP and EEV methodologies are similar, insofar as both aim to measure the underlying embedded value of the Group's life assurance, pensions and annuity businesses. However, EEV principles provide a framework which is intended to improve the comparability and transparency of embedded value reporting across Europe.

IFRS Result

(a) Analysis of results

The following summarises pre-tax earnings information reflected in the IFRS Income Statement, showing, for the year ended 31 December 2006, the contribution from the constituent businesses of the Group.

	CA business £000	CWA business £000	Parent company £000	Amortisation of AVIF £000	Total £000
Year ended 31 December 2006					
Operating profit	17,184	12,506	313	(3,502)	26,501
Finance costs	–	–	(1,206)	–	(1,206)
Loss on sale of subsidiary company	(248)	–	–	–	(248)
Profit before income taxes	16,936	12,506	(893)	(3,502)	25,047
Year ended 31 December 2005					
Operating profit	8,591	14,607	105	(2,042)	21,261
Finance costs	–	–	(805)	–	(805)
Profit before income taxes	8,591	14,607	(700)	(2,042)	20,456

Notes

- (1) The CWA component of the 2005 pre-tax result is for the 7-month post-acquisition period, whereas the component for 2006 is for a 12-month period.
- (2) Financing costs arise in respect of a bank loan raised to part finance the acquisition of CWA.
- (3) Amortisation of Acquired Value In-Force (AVIF) represents a post acquisition charge to profits of the write down of the acquired value of CWA in-force business, as measured at the acquisition date. The pattern of amortisation, is broadly intended to match the pattern of surplus arising from the run off of the underlying CWA insurance and investment contract portfolios.

(b) Commentary on overall result

Overall, the result for the year ended 31 December 2006 reflects the continuing strong emergence of surplus in both the CA and CWA life businesses, as the underlying in-force insurance and investment contracts run off. The CA results for the year ended 31 December 2005 were materially adversely affected by increases in provisions for redress and administration costs in connection with mortgage endowment misselling claims. As explained in the Business Review on pages 10 and 11, we do not consider it necessary to make further increases to these provisions as at 31 December 2006 and this, together with a £1.1m recovery from PI insurers for misselling claims administration costs, underpins the significant improvement in the results compared with the preceding year.

Other significant factors which have impacted the result attributable to CA for the year ended 31 December 2006 are:

- (1) The recognition of £0.4m of costs incurred in connection with the Part VII Transfer. While, under the IFRS basis of reporting, the synergistic benefits arising from the transfer arise principally in future periods, the results for the current year benefit from the release of some £0.6m of deferred tax provisions, thus reducing income tax expense for the year ended 31 December 2006;
- (2) The recognition of a pre-tax book loss of £0.3m arising on the disposal of PLI. The related benefit arises from a reduction in the cost of maintaining regulatory capital, as the disposal has given rise to a reduction of £2.0m in the Long Term Insurance Requirement (see “Solvency and Regulatory Capital” section in the Financial Review below); and
- (3) A charge of £1.1m in respect of the amortisation of deferred acquisition costs relating to insurance contracts (compared with £4.0m for the year ended 31 December 2005). As these costs are now fully amortised there will, in future, be a greater degree of correlation between distributable surplus arising from the run off of the life businesses and the reported IFRS profits attributable to them.

The CWA result continues to make a significant contribution to Group earnings. Net of related parent company debt financing costs and of amortisation of acquired in-force value, both of which are identified in the table above, the pre-tax contribution was £7.8m for the year ended 31 December 2006 (£11.8m for the 7-month post-acquisition period ended 31 December 2005). While the prior-period post-acquisition result benefited from a change in statutory valuation assumptions, resulting in part from favourable mortality

experience which we indicated would not necessarily replicate in future periods, the 2006 result has been impacted by:

- (1) A reduction of £1.4m in respect of the recapture of certain reinsurance arrangements. This recapture, which became effective from 31 December 2006, gives rise to future offsetting surpluses as the underlying policy contracts run off; and
- (2) A net reduction of £2m in respect of statutory expense assumptions which have been revised to reflect fully the anticipated impact of changed outsourcer administration arrangements for the in-force policy portfolio. This is explained more fully in the following section.

(c) Management of the policy portfolio expense base

A key aspect of the ongoing profitability of the Group's life businesses is the extent to which they are able to secure appropriate third-party administration arrangements. These arrangements, which are explained more fully in the Business Review on pages 8 to 14, seek to avoid fixed and semi-fixed expense issues that would otherwise arise from a diminishing income stream as the in-force policy base runs off. Accordingly, the expense assumptions underlying the result give recognition to a projected expense stream which is more certain and which effectively reflects a higher proportion of expenses which are variable with policy volume.

Following from these arrangements:

- (1) For the CA business, a 15% decline in policy-based surplus, driven principally by the reduced size of the policy portfolio, comparing 2006 with the previous year, has been sheltered by a reduction in the expense base, which was largely anticipated by the expense assumptions established at the end of 2005; and
- (2) For the CWA business, the expense assumptions adopted at the end of 2006 reflect the anticipated impact of the replacement of CSC by Capita as the third-party administration partner with effect from 1 April 2007, leading to a net reduction of some £2.0m in the CWA pre-tax result. Significantly, as the CSC contract was due to expire in 2009, while the Capita contract expires in 2022, there is now a greater degree of certainty regarding the expense base over a longer contractual term.

The expense assumptions relating to both the CA and CWA businesses also reflect a revised view of anticipated costs, over the life of the contracts, relating to core systems developments, which may be necessary for business and operational purposes, but which are not otherwise provided for in the contracts.

The Business Review on pages 8 to 14 sets out and provides a commentary on per policy expense information, which correlates projected expenses with the projected in-force policy base over the run-off life of the policy portfolios. It identifies key influences which underlie changes in this performance indicator over the year.

EEV Result

Supplementary information prepared in accordance with EEV principles and set out in the financial statements on pages 113 to 124 is presented to provide alternative information to that presented under IFRS. EEV principles recognise profits as they are earned over the life of insurance and investment contracts and assist in identifying the value being generated by the life businesses. The result determined under this method represents principally the movement in the life businesses' embedded value, before transfers made to the Parent Company and ignoring any capital movements. As the Group's life assurance operations are now substantially closed to new business, the principal underlying components of the EEV result are the expected return from the business in force (being the yield at the risk discount rate on the related policy cash flows as they fall into surplus) together with (1) variances of actual experience from that assumed for each component of the policy in force cash flows and (2) the impact of resetting assumptions for each component of the prospective cash flows.

The following is a summarised statement of the EEV pre-tax result:

	Year ended 31 December	
	2006 £000	2005 £000
Operating profit of covered business	15,684	11,353
Other operational loss	(699)	(700)
Exceptional item		
Profit on acquisition of subsidiary company	—	30,324
Operating profit before tax	14,985	40,977
Variation from longer term investment return	6,307	14,525
Economic assumption changes	9,284	(3,598)
Profit before tax	30,576	51,904

Operating profit of covered business before tax at £15.7m is significantly greater than the underlying return of £10.4m expected to arise from the unwind of the risk discount rate within the embedded value. The principal factors which have contributed to the net excess are:

- (1) Favourable lapse experience within both the CA and CWA businesses amounting to some £2.9m;
- (2) £3.5m arising on the release of the Guardian default reserve; this is explained more fully in the Financial Review on pages 25 to 29; and
- (3) £1.1m recovery from PI insurers for misselling claims administration costs, as also referred to in the commentary under “IFRS Result” above.

The net excess has also been adversely affected by operating assumption changes of £7.7m, which relates principally to the strengthening of expense assumptions in connection with third-party administration arrangements. These arrangements, which are considered more fully under “Structure of the Business” above and in the Business Review on pages 8 to 14, were changed significantly during the year.

The absence of the need for additional provisions in respect of redress for mortgage endowment misselling claims has contributed to the improvement in the operating profit of the covered business compared with 2005.

Profit before tax of £30.6m has also benefited from the impact in both the CA and CWA businesses of a strong performance in investment markets during the last quarter of 2006. Besides giving rise to a favourable effect on current-year investment returns, this has also given rise to a resetting of assumptions regarding future investment returns within the cashflows underlying the in-force value. This is reflected in “Economic assumption changes” in the table above, which also include the favourable impact of a £4.3m reduction in notional policyholder tax as a consequence of the Part VII Transfer. Together with concomitant projected future tax savings of £5.7m in shareholder tax and a release of a deferred tax provision of £0.6m, this gives rise to a projected total saving in future tax of £10.7m arising as a result of the Part VII Transfer and the net of tax result for the year has benefited by this amount.

The results for the year ended 31 December 2005 reflect an exceptional credit of £30.3m (£20.3m net of tax) relating to the acquisition of CWA. This amount represents the difference between the total purchase price and the embedded value of CWA on acquisition, which has now been re-stated in accordance with EEV principles. Under the AP basis the exceptional credit was reported as £18.3m (£13.1m net of tax) for the year ended 31 December 2005. The upward revaluation at the acquisition date arises principally from the application of a lower risk discount rate to the projected cashflows from the acquired in-force business.

Shareholders' Equity and Embedded Value of Covered Business – EEV Basis

The consolidated balance sheet prepared in accordance with EEV principles may be summarised as:

	31 December	
	2006 £000	2005 £000
Value of in-force business	109,941	109,961
Other net assets	79,167	66,212
	189,108	176,173
Represented by:		
Embedded value ("EV") of covered business	194,401	194,437
Less: amount financed by borrowings	(16,800)	(21,000)
EV of covered business attributable to shareholders	177,601	173,437
Net equity of other Group companies	11,507	2,736
Shareholders' equity	189,108	176,173

The tables below set out the components of the value of in-force business by major product line at each period end:

	31 December	
	2006 000	2005 000
Number of policies		
Endowment	75	85
Protection	86	102
Annuities	4	4
Pensions	53	55
Other	10	10
Total	228	256

	31 December	
	2006 £m	2005 £m
Value in-force		
Endowment	70.3	76.7
Protection	73.1	80.7
Annuities	2.8	3.4
Pensions	41.7	39.6
Other	0.8	4.7
Total at product level	188.7	205.1
Valuation adjustments		
Holding company expenses	(21.7)	(25.5)
Other	(16.9)	(28.9)
Cost of capital	(3.4)	(3.1)
Value in-force pre-tax	(146.7)	147.6
Taxation	(36.8)	(37.6)
Value in-force post-tax	109.9	110.0

The value in force represents the discounted value of the future surpluses arising from the insurance and investment contracts in force at each respective period end. The future surpluses are calculated by using realistic assumptions for each component of the cash flow.

The amount in respect of “other valuation adjustments” has reduced significantly over the year following a refinement of the projection processes, whereby certain elements previously contained within this category are now identifiable at product level and have accordingly been allocated to the product lines shown. The 2005 amounts have not been re-stated to reflect this.

Policyholder Funds Investment Return

The CA Managed Fund, which is managed by Schroder Investment Management Limited and which represents a significant proportion of CA policyholder funds under management, returned 9.82% over the year ended 31 December 2006. The CWA Global Managed Fund, which is managed by Irish Life Investment Managers Limited and which represents a significant proportion of CWA policyholder funds under management, returned 9.34% over the same period. Both funds outperformed the average of 9% achieved by the ABI Life Balanced Managed Fund sector.

The absolute level of growth has had a positive effect on policyholder values, reduced the level of mortgage endowment misselling redress and led to an increase in the value in-force, as projected future charges, based on fund values, have increased.

Returns to Shareholders

Returns to shareholders are underpinned by the emergence of surplus in, and transfer of surplus from, the life business’ long-term insurance fund to shareholder funds and by the return on shareholder net assets representing shareholder net equity. These realisations are utilised in the first instance for the repayment and servicing of the bank loan on the basis set out in Note 30 to the IFRS Financial Statements (on page 97). The surplus arises from the realisation of value in-force, which effectively unwinds at the risk discount rate used to discount the underlying cash flows: at 31 December 2006 this rate was reset to 6.1% (31 December 2005: 5.6%). The return on shareholder net assets is determined by the Group’s investment policy. Shareholder funds bear central corporate governance costs which cannot be fairly attributed to the long-term insurance funds and which arise largely in connection with the status of Chesnara as a listed company.

Dividend distributions are currently set in the context of the Board’s target for a minimum level of regulatory capital resources. This target, together with the excess over it at 31 December 2006 is set out in the Financial Review below.

The Board’s continuing primary aim is to provide a reliable and progressive dividend flow to shareholders within the context of the emergence of surplus in the life business. The Company’s share price strengthened progressively through the second and third quarters of 2005, stabilising at a range between 155p and 170p per share. This growth was driven in part by (i) the well publicised consolidation of that part of the life industry which focuses on the run off of closed life and pensions policy portfolios and by a positive reaction to Chesnara’s participation in this marketplace through the acquisition of CWA in 2005 and by (ii) the recognition that, in accordance with its current strategy, Chesnara is essentially a yield stock, which, in the absence of the acquisition of further closed-book propositions, holds out the prospect of a return of capital to shareholders. After some volatility in the early months of 2006 the shares have generally traded within a range of 170p to 185p. With total proposed dividends in respect of the year ended 31 December 2006 at 13.1p per share, this implies a yield of between 7.1% and 7.7%. At a market price of 170p per share, the shares may be characterised as trading at a discount of 6% to the embedded value of the Group as now reported on the EEV basis as at 31 December 2006. Similarly, at a market price of 185p per share, they may be characterised as trading at a premium of just over 2% to Group embedded value.

Financial Review

Solvency and Regulatory Capital

Regulatory capital resources and requirements

The regulatory capital of life insurance companies in the UK is calculated by reference to FSA prudential regulations. The rules are designed to ensure that companies have sufficient assets to meet their liabilities in specified adverse circumstances. As such, there is a restriction on the full transfer of surplus from the long-term business fund to shareholder funds of the life company and on the full distribution of reserves from the life company to Chesnara.

The following summarises the capital resources and requirements of the life company for regulatory purposes, before and after making provision for dividend payments from the life company to Chesnara, which were approved after the respective period ends.

Subsequent to the Part VII Transfer on 30 June 2006, referred to on page 17, the capital requirements and, accordingly, the regulatory solvency position of the life businesses, subsist entirely within one regulated entity, Countrywide Assured plc ("CA"). Prior to that date the capital requirements and regulatory position were determined separately for the two regulated life companies, being CA and City of Westminster Assurance Company Limited ("CWA"). The prior period information presented below shows the information in a pro forma aggregated format, for the sake of comparison with the current period. The Directors do not consider that it is misleading to present the prior period information, which was previously reported on a separate-entity basis, in this way.

	31 December	
	2006 £m	2005 £m
Pre-dividend		
Available capital resources ("CR")	84.4	84.5
Long-term insurance capital requirement ("LTICR")	28.8	34.1
Resilience capital requirement ("RCR")	2.6	2.8
Total capital resources requirement ("CRR")	31.4	36.9
Target capital requirement cover	45.8	54.7
Excess of CR over target requirement	38.6	29.8
Ratio of available CR to CRR	269%	229%
Post dividend		
Available capital resources ("CR")	64.4	65.7
Long-term insurance capital requirement ("LTICR")	28.8	34.1
Resilience capital requirement ("RCR")	2.6	2.8
Total capital resources requirement ("CRR")	31.4	36.9
Target capital requirement cover	45.8	54.7
Excess of CR over target requirement	18.6	11.0
Ratio of available CR to CRR	205%	178%

The CA Board, as a matter of policy, continues to target CR cover for total CRR at a minimum level of 150% of the LTICR and 100% of the RCR. Up until 30 June 2006, the CWA target capital requirement cover was expressed as a £5m excess over the regulatory CRR, as a consequence of a long-standing agreement with the FSA. With effect from 30 June 2006 the CRR of the transferred business is determined on the same basis as the existing CA business, so that, overall, the Group benefits to the extent that the total CRR is lower than if the £5m excess had continued to be applied to the transferred business.

£5.8m of the target capital requirement cover set out above (2005: £11.7m) is represented by shareholder retained earnings: to the extent that the target cover is maintained, this amount is not currently distributable from the life business.

Available capital resources at 31 December 2006 and, therefore, the overall solvency position have benefited from the full release of the £6m reserve held against the possible default of Guardian, a major reinsurer (see below).

Further, CA's solvency position has benefited from the disposal of PLI, referred to under IFRS Result in the Operating Review above, which has reduced the LTICR by £2.0m, while capital resources reduced by £0.3m.

It can be seen from this information that Chesnara, which relies on dividend distributions from its life company, is currently in a favourable position to service its loan commitments and to continue to pursue a progressive dividend policy.

Insurance Group Directive

In accordance with the EU Insurance Group Directive, the Group calculates the excess of the aggregate of regulatory capital employed over the aggregate minimum solvency requirement imposed by local regulators. The following sets out these calculations pre and post the recognition of interim and final dividends for the financial year, but approved by the Board and paid to Group shareholders after the respective dates:

	31 December	
	2006 £m	2005 £m
Pre-dividend		
Available group capital resources	79.2	66.2
Group regulatory capital requirement	(31.4)	(36.9)
Excess	47.8	29.3
Cover	252%	179%
Post-dividend		
Available group capital resources	70.8	58.3
Group regulatory capital requirements	(31.4)	(36.9)
Excess	39.4	21.4
Cover	225%	158%

The regulatory requirement is that available group capital resources should be at least 100% of capital requirements.

Individual Capital Assessments

The FSA Prudential Sourcebooks require an insurance company to make its own assessment of its capital needs to a required standard (a 99.5% probability of being able to meet its liabilities to policyholders after one year). In the light of scrutiny of this assessment, the FSA may impose its own additional individual capital guidance. The Individual Capital Assessment is based on a realistic liability assessment, rather than the statutory mathematical reserves, and involves stress testing the resultant realistic balance sheet for the impact of adverse events.

Following the Part VII Transfer as at 30 June 2006, an Individual Capital Assessment for the life businesses was established on a combined basis during the second half of 2006. As a result, it has been concluded that the effective current- and medium-term capital requirement constraints on distributions to Chesnara will continue to be on the basis set out under "Regulatory capital resources and requirements" above.

FSA Policy Statement

The FSA published a policy statement, PS06/14, in December 2006 implementing various changes to the valuation of liabilities for statutory solvency purposes, effective from 31 December 2006. These changes are permissive rather than mandatory in operation and after due consideration the CA Board has concluded that, in view of the current financial position of CA, these changes should not be reflected in the year-end statutory valuation basis adopted by CA.

Guardian Default Reserve

Following the implementation of the Insurers (Reorganisation and Winding Up) Regulations 2004, CA, in establishing its regulatory solvency position, maintained a reserve of £6m at 31 December 2005 relating to possible default by Guardian, with whom it had aggregate reinsured liabilities at that time of £221.3m. During 2006 Guardian granted a legal charge to CA over the related investment assets, as a result of which the CA Board determined that the reserve is no longer required.

The reserve was established in determining the regulatory capital resource position and, therefore, served to restrict the amount of surplus within CA's long-term business fund. It was also recognised at £3.5m in establishing the Embedded Value of the covered business in accordance with EEV principles, which employ a market-consistent embedded value methodology (see below). Accordingly, the release of the reserve during 2006 has increased available capital resources, as determined for regulatory solvency purposes by £6m and has also increased the profit of the covered business, as reported in the EEV supplementary information on page 122, by £3.5m.

Neither the establishment nor the release of the reserve have been recognised for IFRS reporting purposes, as the likelihood of default by Guardian under the reinsurance arrangements was considered by the CA Board to be remote.

EEV Reporting

As explained in the Notes to the Supplementary Information on pages 116 to 124, the Group has adopted European Embedded Value ("EEV") principles as the basis for reporting supplementary financial information in lieu of the Achieved Profit ("AP") basis. This first-time adoption of EEV principles involves the restatement of supplementary financial information previously reported under the AP basis. The supplementary financial information presented in this report sets out more fully, on pages 125 to 127, the impact of the adoption of EEV on shareholder net equity and profit after tax as previously reported on the AP basis. This may be summarised as follows:

	Year ended or as at 31 December 2005	
	AP £000	EEV £000
Shareholders' equity	185,688	176,173
Profit after tax	26,291	39,934

The main factors which have impacted shareholder equity are:

- (1) Accretion to the embedded value ("EV") of the life insurance, pensions and annuity businesses resulting from the application of the difference between (i) the risk discount rate determined for AP reporting and (ii) the risk discount rate calibrated to a market-consistent valuation, to the cash flows arising on the business in force. This difference arises from the determination of the risk margin on a best-estimate basis in accordance with EEV principles, whereas the AP risk margin was intentionally determined by the Directors on a conservative basis. The diversification of risk through the acquisition of CWA and strengthening of experience assumptions, together with recent improvements in operational experience, lead to a reduction in the appropriate risk margin;
- (2) Reduction of EV arising from the recognition of holding company expenses, which it is anticipated will be allocated to the life insurance, pensions and annuity businesses over the life of those businesses. These expenses, which relate to Chesnara Group functions, are recognised under the AP basis only in the financial period in which they are recharged from the holding company; and
- (3) Reduction of EV arising from recognition of a reinsurer default reserve to a market-consistent valuation. This contrasts with the treatment under the AP basis, which effectively only reduces the EV for the time cost of maintaining the reserve.

As regards the statement of profit after tax, the main factor which has impacted this is the upward restatement of an exceptional credit arising on the acquisition of CWA on 2 June 2005. This item represents the difference between the purchase price and the value of CWA at the date of acquisition, which has been restated in accordance with EEV principles. This restatement was principally impacted by the adoption of a

risk discount rate calibrated to a market-consistent valuation of the acquired cash flows of the in-force business.

Both the EV and AP methodologies recognise profits as they are earned over the life of the underlying long-term businesses and assist in identifying the value being generated by those businesses. As CA and CWA are now substantially closed to new business, the principal underlying components of the results, under both bases, are the expected return from the business in force (being the yield at the risk discount rate on the related policy cash flows as they fall into surplus), together with (1) variations in actual experience from that assumed for each component of the in-force policy cash flows and (2) the impact of resetting assumptions for each component of the prospective cash flows. There are, however, significant differences between the profit recognised in accordance with EEV principles and that which would have been reported under the AP basis. It follows from the explanations set out above that these differences will relate principally to:

- (1) The yield on the business in force, as the discounted cash flows unwind at a rate which is currently some 1.5 to 2.0 percentage points lower than it would otherwise have been on the AP basis;
- (2) The recognition of the future stream of holding company expenses, which are a period charge under AP reporting, but which have been recognised up-front under EEV methodology; and
- (3) The effect of the mitigation of the reserve required in the event of reinsurer default, where the full amount of the reserve reduction is recognised under EEV principles, whereas the AP basis would reflect only a reduction in the time cost of holding the reserve. As stated under “Guardian Default Reserve” above the circumstances giving rise to the reserve have, in fact, been mitigated during the year ended 31 December 2006 and an amount of £3.5m has therefore been recognised in EEV pre-tax earnings for that period.

The adoption of reporting in accordance with EEV principles does not affect the basis of reporting the statutory results, the regulatory capital position or the dividend paying capacity of the Group.

Capital Structure, Treasury Policy and Liquidity

The Group’s operations are ordinarily financed through retained earnings and through the current emergence of surplus in the life businesses. It normally does not make use of financial reinsurance or similar arrangements. There is no trading in any currencies other than sterling. Cash available for more than twelve months is normally transferred to fund managers for longer-term investment.

During 2005 the Group finalised the acquisition of CWA, which was settled for cash, by raising further equity of £22m from shareholders by way of a placing and open offer and by the provision of a bank loan of £21m, with the balance of £4.5m of the total purchase consideration being sourced from internal retained funds. The Board believes that the bank loan, which is repayable in five equal amounts on the anniversary of the draw down date, introduces an element of gearing to the balance sheet, which is proportionate to both the size of the acquisition and to the existing capital base of the Company.

The Board continues to have a conservative approach to the investment of shareholder funds in the life businesses, which underpins our strong solvency position. This approach targets the investment of 100% of available funds in cash and fixed interest securities.

The profile and mix of investment asset holdings between fixed interest stocks and cash on deposit is such that realisations to support dividend distributions can be made in an orderly and efficient way.

Other factors which may place a demand on capital resources in the future include the costs of unavoidable large scale systems development such as those which may be involved with changing regulatory requirements and the requirement to finance further possible acquisitions of other closed life books and businesses in run-off. To the extent that ongoing administration of CA’s life businesses is performed within the terms of its third party outsource agreement, the Group is sheltered, to a degree, from these development costs as they are likely to be on a shared basis, as common platforms are developed.

To the extent that the Group proposes to acquire closed life businesses in the future, it is intended that this could be done through a suitable combination of equity and debt financing and, to a lesser degree, from internal resources. This would be done, however, within the constraints of not diluting returns to shareholders and of the operation of regulatory rules regarding the level of debt finance which may be borne by Insurance Groups.

Cash flows

The Group's longer-term cash flow cycle is currently characterised by the inflow to shareholders funds of transfers from the long-term insurance funds, which are supported by the emergence of surplus within those funds. These flows are used to support dividend distributions to shareholders.

Going concern

The Group's cash flow position described above supports its ability to trade in the short term. Projections of surplus arising in the insurance funds indicate that these are at levels which should be able to continue to withstand normal business risks. In addition, CA and CWA, prior to the Part VII Transfer each prepared an annual Financial Condition Report, as recommended by the Institute of Actuaries. These reports were based on a review of each company's ability to withstand a number of adverse scenarios and indicated that they were able to withstand, over the medium to longer term, the impact of these adverse scenarios, including a number of them in combination.

The base expectation is that, notwithstanding the existence of risks addressed in these adverse scenarios, the Group will generate surplus in its long-term business sufficient to meet its debt obligations as they fall due and to pursue a reliable and progressive dividend policy.

Corporate Governance

The Directors are committed to achieving a high standard of corporate governance including compliance with the principles and practices of the Combined Code on Corporate Governance (the “Code”), as published by the Financial Reporting Council in July 2003 and as appended to the Listing Rules.

The following statement, together with the Directors Remuneration Report on pages 36 to 40, describes how the principles set out in the Code have been applied by the Company and details the Company’s compliance with the Code’s provisions for the year ended 31 December 2006.

Compliance with the Combined Code

The Company has complied throughout the year with all of the provisions of the Combined Code.

The Board

The Board comprises a Non-executive Chairman, three other Non-executive Directors and three Executive Directors, each of whom served throughout the period under review.

Biographical details of all Directors are given on page 7. The Board, which plans to meet eight times during the year, has a schedule of matters reserved for its consideration and approval. These matters include:

- setting corporate strategy
- approving the annual budget and medium-term projections
- reviewing operational and financial performance
- approving major acquisitions, investments and capital expenditure
- reviewing the Group’s system of financial and business controls and risk management
- approving appointments to the Board
- appointment of the Company Secretary
- approval of policies relating to Directors’ remuneration

This schedule is reviewed annually. In addition, the Directors of the Company are also directors of Countrywide Assured plc (“CA”), the principal subsidiary company in which the life business of the Group subsists. Under FSA Prudential Regulation the directors of CA have responsibility for maintenance and projections of solvency and for assessment of capital requirements, based on risk assessments, and for establishing the level of long-term business provisions, including the adoption of appropriate assumptions.

The responsibilities that the Board has delegated to the Executive Management of the business include: the implementation of the strategies and policies of the Group as determined by the Board; monitoring of operational and financial results against plans and budget; prioritising the allocation of capital, technical and human resources and developing and managing risk management systems.

The Roles of the Chairman and Chief Executive

The division of responsibilities between the Chairman of the Board, Christopher Sporborg, and the Chief Executive, Graham Kettleborough, is clearly defined and has been approved by the Board. The Chairman leads the Board in the determination of its strategy and in the achievement of its objectives and is responsible for organising the business of the Board, ensuring its effectiveness and setting its agenda. The Chairman has no day-to-day involvement in the management of the Group. The Chief Executive has direct charge of the Group on a day-to-day basis and is accountable to the Board for the financial and operational performance of the Group.

Senior Independent Director

The Board has appointed Peter Mason as Senior Independent Director. He is available to meet shareholders on request and to ensure that the Board is aware of shareholder concerns not resolved through the existing mechanisms for shareholder communication.

Directors and Directors’ Independence

The Board considers that Peter Mason, Mike Gordon and Terry Marris are independent Non-executive Directors.

In making this determination, the Board has carefully considered the following matters:

Terry Marris has within the last five years been an employee of a subsidiary company within the Countrywide Assured Life Holdings Limited Group (“CALH”), which was acquired by the Company on 24 May 2004. He also held the position of Managing Director of Countrywide Assured plc, the principal operating life assurance subsidiary of CALH prior to the acquisition of CALH by the Company. He resigned these positions in July 2002.

Peter Mason and Mike Gordon are also directors of Countrywide plc, the ultimate holding company of Countrywide Assured Group plc (“CAG”), which was, until 22 May 2004, the ultimate holding company of CALH, whose subsidiary companies had material business relationships with fellow subsidiary companies within the CAG group.

Peter Mason is also a Non-executive Director of Countrywide Assured plc, a position which he has held since 1 October 1990, and a Non-executive Director of CALH, the parent company of Countrywide Assured plc, a position which he has held since 18 November 1991.

The Board considers that the characteristics, aims and mode of operation of the relevant activities are sufficiently different from those prevailing when these Directors held the relevant positions, that the judgement and independence of mind they exercise on behalf of the Company are not adversely affected or circumscribed. The Board is of the view that the considerable specific experience and knowledge of these three Directors in the business of the Group outweighs any residual risk in the historic relationships described above, while the overall balance of the Board provides significant independence of mind and judgement. The Board further considers that, taking the Board as a whole, the Independent Directors are of sufficient calibre and number that their views carry sufficient weight in the Company’s decision making.

The Directors are given access to independent professional advice, at the Company’s expense, when the Directors deem it necessary in order for them to carry out their responsibilities.

Details of the Chairman’s professional commitments are included in his biography on page 7. He does perform a number of pro-bono roles, but the Board is satisfied that these are not such as to interfere with his performance, which is based around a commitment of between fifty and sixty hours in any three-month period.

Professional Development

The Directors were advised, on their appointment, of their legal and other duties and obligations as Directors of a listed Company. This has been supplemented by the adoption and circulation to each Director of a written Code of Conduct, covering all aspects of the specific operation of Corporate Governance standards and of policies and procedures within the Group. Throughout their period in office, the Directors have, through the conduct of business at scheduled Board meetings, been continually updated on the Group’s business and on the competitive and regulatory environment in which it operates. Through their continuing membership of the Board of the principal operating life subsidiary of the Group all of the Directors who served during the period under review continue to have considerable knowledge and experience of the business of the Chesnara plc Group, including, significantly, the wider FSA regulatory environment as to Conduct of Business and Prudential Regulation.

There have been no new appointments to the Board during the period covered by this report. A detailed induction programme will be undertaken for all such future appointments embracing the Code of Conduct referred to above and up to date information on the strategy and financial and operating performance of the Group.

Information

Regular reports and information are circulated to the Directors in a timely manner in preparation for Board and Committee meetings.

As stated above all of the Company’s Directors are also members of the Board of the Company’s principal operating life assurance subsidiary which holds scheduled quarterly meetings. These meetings are serviced by detailed regular reports and information, which cover all of the key areas relevant to the direction and operation of that subsidiary including:

- Earnings report
- Report from and recommendations by the Head of Actuarial Function

- Compliance report
- Investment report
- Outsourcing report

The life assurance subsidiary monitors risk management procedures, including the identification, measurement and control of risk through the offices of a Risk Management Committee. This committee is accountable to and reports to its Board on a quarterly basis.

In addition annual reports are produced which cover an assessment of the capital requirements of the life assurance subsidiary, its financial condition and a review of its internal financial and business controls.

The quarterly meetings of the life assurance subsidiary are timed to be held immediately prior to Chesnara plc Board meetings.

On a monthly basis, the Directors receive summary high level information which enables them to maintain continuing oversight of the Group's and management's performance against objectives.

In addition to these structured processes, the papers are supplemented by information which the Directors require from time to time in connection with major events and developments, where critical views and judgements are required of Board members outside the normal reporting cycle.

Performance Evaluation

During the period under review the Chairman undertook a formal performance evaluation of the Board, individual Directors and of the Audit, Remuneration and Nomination Committees. To that end he devised a series of questionnaires to provide a framework for the evaluation process and to provide a means of making year-on-year comparisons. Individual Director assessments were supplemented by discussions between the Chairman and each Director on a one-to-one basis.

In addition, and using similar methods to those described above, the Non-executive Directors, led by the Senior Independent Director, met to conduct a performance evaluation of the Chairman.

The Company Secretariat facilitated the process to ensure that it was conducted in a timely and objective manner while the Head of Internal Audit, reporting to the Senior Independent Director, monitors the assessment and follow through of the issues arising in the evaluation process.

Company Secretary

The Company Secretary, Ken Romney, is responsible for advising the Board, through the Chairman, on all governance matters. The Directors have access to the advice and services of the Company Secretary.

Board Committees

The Board has established the committees set out below to assist in the execution of its duties. Each of these committees operates according to written terms of reference and the Chairman of each committee reports to the Board. The constitution and terms of reference of each committee are reviewed annually to ensure that the committees are operating effectively and that any changes considered necessary are recommended to the Board for approval. The terms of reference of each committee are available on the Company's website at www.chesnara.co.uk or, upon request, from the Company Secretary. There have been no changes to any of the Committees' terms of reference during the period covered by this review.

The attendance record of each of the Directors at scheduled Board and Committee meetings for the period under review is:

	Scheduled Board	Nomination Committee	Remuneration Committee	Audit Committee
Non-executive Chairman – Christopher Sporborg	7(8)	1(2)	n/a	n/a
Non-executive Director – Peter Mason	8(8)	2(2)	2(2)	5(5)
Non-executive Director – Terry Marris	8(8)	2(2)	2(2)	5(5)
Non-executive Director – Mike Gordon	7(8)	2(2)	2(2)	4(5)
Executive Director – Graham Kettleborough	8(8)	n/a	n/a	n/a
Executive Director – Ken Romney	8(8)	n/a	n/a	n/a
Executive Director – Frank Hughes	8(8)	n/a	n/a	n/a

The figures in brackets indicate the maximum number of meetings in the period during which the individual was a Board member. The information above relates to the period from 1 February 2006 to 31 January 2007.

Nominations Committee

During the period under review, the Nominations Committee comprised Christopher Sporborg (who also served as Chairman of the Committee), Peter Mason, Terry Marris and Mike Gordon. The Committee considers the mix of skills and experience that the Board requires and seeks the appointment of Directors to meet its assessment of what is required to ensure that the Board is effective in discharging its responsibilities.

During the period, the Committee met twice and considered the continuing mix of skills and experience of the Directors. There were no new appointments during the period.

Remuneration Committee

Full details of the composition and work of the Remuneration Committee are provided in the Directors' Remuneration Report on pages 36 to 40.

Audit Committee

During the period under review, the Audit Committee comprised Peter Mason (who also acted as Chairman), Mike Gordon and Terry Marris the other independent Non-executive Directors. The Board is satisfied that Peter Mason has recent and relevant financial experience. On invitation, the Chief Executive, the Finance Director, the Head of Internal Audit and the external Auditor attend meetings to assist the Committee in fulfilment of its duties. The Committee met five times during the period under review.

The role of the Audit Committee is to assist the Board in discharging its duties and responsibilities for financial reporting, corporate governance and internal control. The Committee is also responsible for making recommendations to the Board in relation to the appointment, re-appointment, and removal of the external Auditor. The Committee's duties include keeping under review the scope and results of the audit work, its cost effectiveness and the independence and objectivity of the Auditor.

During the period under review, the Audit Committee discharged its responsibilities by:

- reviewing the Group's draft Financial Statements prior to Board approval and reviewing the external Auditor detailed reports thereon, in respect of the half year ended 30 June 2006 and the year ended 31 December 2006
- reviewing the appropriateness of the Group's accounting policies
- reviewing the implementation of the provision of supplementary reporting of financial information in accordance with European Embedded Value principles, including the methodology undertaken and the assumptions adopted
- reviewing and approving the audit fee estimates
- reviewing the external Auditor plan for the audit of the Group's financial statements which included an assessment of key risks and confirmation of Auditor independence
- reviewing and approving the Internal Audit plan for the internal audit of the Group's internal controls, embracing operating, financial and business controls
- reviewing an annual report on the Group's systems of internal control and its effectiveness and reporting to the Board on the results of the review
- reviewing regular reports from the Head of Internal Audit
- reviewing the report on key risks by executive management
- reviewing the appointment of the external Auditor
- meeting the external Auditor without an Executive Director or a member of the Company's senior management being present
- reviewing the nature and volume of non-audit services provided by the external Auditor to ensure that a balance is maintained between objectivity and value added
- reviewing and approving the audit fee and non-audit fees
- reviewing the Group's fraud and whistle-blowing policies and procedures

Auditor Independence and Objectivity

The external Auditor, KPMG Audit Plc and its associates, provide some non-audit services primarily in the provision of taxation and regulatory advice and in relation to Corporate transactions that may arise from time to time. In order to ensure that auditor objectivity and independence are safeguarded, the following procedures have been put in place:

Audit-related services

These relate to formalities such as shareholder and other circulars, regulatory reports and work on acquisitions. This is work that the external Auditor performs in its capacity as Auditor, where the nature of the work is closely allied to that on the audit of the annual financial statements. Accordingly, this work will be undertaken by the external Auditor unless unusual circumstances apply.

Tax advice

The external Auditor will be used when particularly relevant and all other significant tax advice will be put out to tender.

General advice

All sizeable projects are put out to tender. The external Auditor will be invited to tender, provided that both parties are satisfied that the nature of the contract will not present a threat to the independence of the Auditor.

These safeguards have been approved by the Audit Committee and it is intended that they will be reviewed when required in the light of internal developments or of changes in the external circumstances of the Company. The Auditor reports to both the Directors and the Audit Committee with regard to compliance with professional and regulatory requirements and best practice.

Details of the fees paid to the Auditor, and its associates, for non-audit services during the year are provided in Note 13 to the financial statements (on page 75).

Relations with Shareholders

The Chief Executive, Graham Kettleborough, and the Finance Director, Ken Romney, meet with institutional shareholders on a regular basis and are available for additional meetings when required. Should they consider it appropriate, institutional shareholders are able to meet with the Chairman, Christopher Sporborg, the Senior Independent Director, Peter Mason and any other Director. The Chairman is responsible for ensuring that appropriate channels of communication are established between the Chief Executive and the Finance Director on the one part and the shareholders on the other and is responsible for ensuring that the views of shareholders are known to the Board. This includes twice yearly feedback prepared by the Group's brokers on meetings the Executive Directors have held with institutional shareholders.

Annual and interim reports are distributed to other parties who may have an interest in the Group's performance and those reports, together with a wide range of information of interest to existing and potential shareholders, are made available on the Company's website, www.chesnara.co.uk.

Regular meetings are also held with industry analysts and commentators so that they are better informed in formulating opinions and making judgements on the Group's performance. Private investors are encouraged to attend the Annual General Meeting ("AGM") at which the opportunity is provided to ask questions on each proposed resolution. The Chairmen of the Board Committees will be available to answer such questions as appropriate. Details of the resolutions to be proposed at the AGM on 10 May 2007 can be found in the notice of the meeting on pages 128 and 131.

Internal Control

The Board is ultimately responsible for the Group's system of internal control and for reviewing its effectiveness. In establishing the system of internal control, the Directors have regard to the materiality of relevant risks, the likelihood of risks occurring and the costs of mitigating risks. It is, therefore, designed to manage rather than eliminate the risks which prevent the Company meeting its objectives and, accordingly, only provides reasonable and not absolute assurance against the risk of material misstatement or loss.

In accordance with "Internal Control: Guidance for Directors on the Combined Code" (The "Turnbull Guidance") the Board confirms that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the Group, that this process has been in place for the year under review and up to the

date of approval of the Annual Financial Statements and that the process is regularly reviewed by the Board and accords with the guidance.

In accordance with the regulatory requirements of the FSA, the Group's principal life assurance subsidiary has established and maintained a risk and responsibility regime. This ensures that the identification, assessment and control of risk is firmly embedded within the organisations and that there are procedures for monitoring and update of the same. The Compliance function of the life assurance subsidiary reviews and reports quarterly on this regime to the subsidiary's Board. This process is supplemented by the establishment and maintenance of key risk registers for both the life assurance subsidiary and for the Company, which ensure that, against various appropriate classes of risk, there is identification, assessment and control of the material risks subsisting within these organisations. The maintenance of the key risk registers is the responsibility of the executive management, who report on them quarterly to the Risk Committee of the Board of the life assurance subsidiary and to each Chesnara Audit Committee meeting.

As stated above, all of the Company's Directors are also members of the principal life assurance subsidiary's Board and the scheduled quarterly Board Meetings of the life assurance subsidiary are immediately followed by corresponding Board meetings of the Company, which thereby has effective oversight of the maintenance and effectiveness of controls subsisting within the life assurance subsidiary. In addition the Chesnara Board confirms that it has undertaken a formal annual review of the effectiveness of the system of internal control for the year ended 31 December 2006 and that it has taken account of material developments between that date and the date of approval of the Annual Financial Statements. The Board confirms that these reviews took account of reports by the Internal Audit Department on the operation of controls, internal financial controls, management assurance on the maintenance of controls and reports from the external Auditor on matters identified in the course of statutory audit work.

The Board also confirms the continuing appropriateness of the maintenance of an Internal Audit Function, which reports to the Senior Independent Director.

Going Concern

The Directors Statement on Going Concern is included in the Directors' Report on page 16.

Directors' Remuneration Report

The Remuneration Committee

The Remuneration Committee (the "Committee") determines the overall pay policy, the remuneration packages and service contracts of the Executive Directors of the Company including the operation of bonus schemes. It also monitors the remuneration of other senior employees of Chesnara plc.

During the period under review the Committee comprised of three Non-executive Directors: Mike Gordon (who also acted as Chairman), Peter Mason and Terry Marris. The Company Secretary, Ken Romney, acts as Secretary to the Committee, and provides advice on legal and regulatory issues relating to remuneration policy. At the request of the Committee, Graham Kettleborough, the Chief Executive, also attends and makes recommendations to the Committee regarding changes to the remuneration packages of individual directors (excluding himself) or policy generally. Such recommendations are discussed by the Committee and adopted or amended as it sees fit. No Director is present at any part of the Committee meeting at which his own remuneration or contractual terms are being discussed. The membership and terms of reference of the Committee are reviewed annually and the terms of reference are available on the Company's website at www.chesnara.co.uk or, upon request, from the Company Secretary. Details of the number of meetings held and the attendance can be found in the Corporate Governance Report on page 32.

Remuneration Policy

The Committee aims to set remuneration at an appropriate level to attract, retain and motivate executives of the necessary calibre. An annual review of remuneration is undertaken to ensure reward levels are appropriate to the duties and responsibilities of the roles with a suitable balance between the fixed and variable elements of overall reward. In determining salary levels due regard is given to external market data relating to both financial services sector companies and listed companies of similar size. Lower quartile and market median reward levels are used when formulating and reviewing policy.

The annual bonus scheme and the long-term incentive plan are designed to incentivise and retain the Executive Directors. The plans, which are cash based, reward the achievement of corporate targets set for the year and are therefore aligned with the delivery of value to shareholders. The annual bonus plan is pensionable whilst the long-term plan is not. The Committee may award other discretionary bonuses to the Executive Directors where they consider extraordinary value has been created or significant achievement has occurred.

The Company has established frameworks for approved and unapproved discretionary Share Option Plans and a Sharesave Plan, none of which has been utilised.

Basic Salary

The Committee reviews salaries annually taking into consideration individual and Company performance, the responsibilities and accountabilities of each role, the experience of each individual and his or her marketability and future potential, and market data relating to both financial services sector companies and listed companies of similar size.

Executive Directors' remuneration also includes non-pensionable benefits in kind by way of a company car, life assurance and private medical insurance.

Bonus Schemes

The 2006 Annual Bonus Scheme was designed to incentivise the Executive Directors. In order to align performance with shareholder interests, Directors are incentivised on achievement of the budgeted IFRS pre-tax profit. In the previous year the target was based on budgeted UK GAAP pre-tax profit and the scheme was necessarily amended to reflect the change in the basis of reporting. However the operation of the scheme remained the same in that the maximum award is 50% of basic salary. Of this half is payable as a retention measure on completion of service to the end of the year. This is designed to reflect the specific nature of the business, which, in the absence of further acquisitions, is a run-off proposition that requires particular skill sets and does, inherently, offer limited career opportunities. If less than 90% of the budgeted target is achieved, then no performance-related bonus is payable. On achievement of 90% of the target a bonus of 12.5% of salary becomes payable. This increases pro rata to a maximum award of 25% of salary on achievement of, or exceeding, the budgeted target. As in the previous year the Committee has no right to vary the award in the light of exceptional factors. This is to ensure that the Executive Directors' awards are closely aligned to shareholders' interests in respect of the non-guaranteed element of the scheme.

The table below sets out the details of the awards made to the Executive Directors under the scheme in 2006.

Annual Bonus Scheme – awards made in respect of year ended 31 December 2006

Graham Kettleborough	£67,275
Ken Romney	£51,750
Frank Hughes	£46,575

Awards made under the Annual Bonus Scheme are pensionable as this is considered to be a significant retention feature of such an arrangement.

The Long-term Incentive Plan was designed as a long-term cash based incentive for Executive Directors. In order to align performance with shareholder interests, Directors were incentivised on achievement of budgeted IFRS pre-tax profits. In the previous year the target was based on UK GAAP profit before tax. As with the Annual Plan the Committee reviewed the basis and decided that the IFRS basis is now appropriate. The operation of the scheme was unaltered with half the target bonus being awarded as a loyalty incentive for the same reasons as those outlined under the Annual Bonus Scheme above. As the business is a run-off proposition in its current form the Committee believe that a share-based plan would be inappropriate and therefore the scheme has continued on a cash basis. The threshold for the payment of bonuses is 75% of the target profit. At this level a performance-related element of basic salary becomes payable. If the target profit is achieved then the performance element is 33.33% of basic salary. Achievement of profit between these levels or above the target level is rewarded on a pro rata basis. The scheme awards are made on a rolling half-year basis and they become payable three years after they have been earned.

The table below summarises the awards made to the Executive Directors under the above scheme for each of the relevant periods covered by this report.

Management Performance Incentive Plan – awards made in 2005 and 2006

	Amount awarded in respect of the half-year ended			
	31 December 2006	30 June 2006	31 December 2005	30 June 2005
Graham Kettleborough	£64,510	£46,670	£80,347	£21,667
Ken Romney	£49,623	£35,900	£61,805	£16,667
Frank Hughes	£44,661	£32,310	£55,624	£15,000

Awards made under the Long-term Incentive Plan are non-pensionable.

Share Options

The Board has established frameworks for a Sharesave Plan and approved and unapproved discretionary Share Option Plans which may, at the discretion of the Remuneration Committee, be utilised for granting options to Executive Directors and other employees. During 2006 no such options were granted.

Service Contracts

The Executive Directors, who were all appointed on 1 March 2004, have service contracts with a rolling twelve-month notice period. Compensation on termination of service contracts will be decided on a case-by-case basis having regard to the particular circumstances.

Pension Policy

Until the end of May 2005 the Executive Directors, with the permission of Countrywide Assured Group plc ("CAG"), from which Chesnara was demerged in May 2004, and of the Trustees of their pension scheme, continued membership of the defined contribution section of the CAG pension scheme. Both they, and the Company contributed to this scheme of which they are now deferred members. From 1 June 2005 they became eligible to enter, and entered, the Chesnara plc Stakeholder Scheme of which they continued to be members during the period covered by this report and to which employer contributions are made at the same rate as would have been payable had their membership of the CAG scheme continued. Employer contributions were made to the respective schemes as detailed on page 40.

Non-executive Directors

The remuneration of the Non-executive Directors is determined by the Board as a whole in accordance with the Articles of Association. Non-executive Directors do not have service contracts with the Company,

neither are they eligible for bonuses, pensions or participation in Company share option schemes. The date of expiry of their terms of appointment are:

	Date of expiry of term of appointment
Christopher Spborg (Chairman)	31 December 2008
Peter Mason	31 October 2008
Mike Gordon	30 April 2008
Terry Marris	1 March 2010

On 29 January 2007, the Board agreed to reappoint Terry Marris for a period of three years further to the date of expiry of his current appointment, being 1 March 2007, which is in line with the normal practice of the Board. Christopher Spborg retires by rotation at the end of the forthcoming AGM, at which a resolution proposing his re-election will be tabled.

Directorate

The Directors who served during the period, all of whom were appointed on 1 March 2004, were:

Chairman

Christopher Spborg

Non-executive Directors

Peter Mason
Terry Marris
Mike Gordon

Executive Directors

Graham Kettleborough
Ken Romney
Frank Hughes

Performance Graph



The above graph shows a comparison of the Company's total shareholder return ("TSR") performance against the FTSE Life Assurance sector index. The Company considers this to be the most appropriate index, given that its activities are centred on life assurance. The graph has been prepared in accordance with section 234B of the Companies Act 1985, except that it shows the TSR for the Company and the relevant index from 25 May 2004 only to 14 February 2007. The Company was first listed on the London Stock Exchange on 25 May 2004.

Directors' Interests in Shares

Directors interests in the ordinary shares of Chesnara plc were as set out below (number of shares):

	31 December 2006		31 December 2005	
	Beneficial	Non-beneficial	Beneficial	Non-beneficial
Christopher Sporborg	75,000	–	75,000	–
Peter Mason	2,500	–	2,500	–
Terry Marris	52,708	–	52,708	–
Mike Gordon	–	–	–	–
Graham Kettleborough	19,659	–	19,659	–
Ken Romney	15,476	–	15,476	–
Frank Hughes	5,163	–	5,163	–

On 5 January 2007 Graham Kettleborough sold 9,659 shares and purchased 10,000 shares for tax planning purposes. His resultant beneficial holding was 20,000 shares.

There were no other changes in the Directors' shareholdings in Chesnara plc between 31 December 2005 and 28 March 2007.

Directors' Remuneration

The auditors are required to report on this and the remaining sections of the Remuneration Report.

Total Directors' remuneration for the year ended 31 December 2006 is shown below with comparative figures for the year ended 31 December 2005.

	Year ended 31 December	
	2006 £000	2005 £000
Aggregate emoluments:		
Fees to non-executive directors	140	130
Emoluments to executive directors	809	680
Company contributions to pension schemes	55	51
Total	1,004	861

The following table, which has been prepared in accordance with regulatory requirements, sets out the constituents of Directors emoluments for the year ended 31 December 2006:

	Salaries and fees £000	Bonuses £000	Deferred bonuses £000	Benefits £000	Total 2006 £000	Total 2005 £000
Executive Directors						
Graham Kettleborough	135	67	111	12	325	273
Ken Romney	104	52	86	15	257	213
Frank Hughes	93	47	77	10	227	194
	<u>332</u>	<u>166</u>	<u>274</u>	<u>37</u>	<u>809</u>	<u>680</u>
Non-executive Directors						
Christopher Sporborg	50	–	–	–	50	50
Peter Mason	40	–	–	–	40	30
Terry Marris	25	–	–	–	25	25
Mike Gordon	25	–	–	–	25	25
	<u>140</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>140</u>	<u>130</u>
Total	<u>472</u>	<u>166</u>	<u>274</u>	<u>37</u>	<u>949</u>	<u>810</u>

The fees payable to Terry Marris were paid, with the addition of VAT, to his employing company, Countrywide Property Lawyers Limited, a subsidiary of Countrywide plc.

The following table sets out each Executive Director's pension benefits for the years ended 31 December 2006 and 31 December 2005.

	Company contributions to money purchase scheme	
	2006 £000	2005 £000
Graham Kettleborough	16	15
Ken Romney	28	26
Frank Hughes	11	10
	<u>55</u>	<u>51</u>

The pension arrangements for the Executive Directors are set out on page 37.

No pension contributions were made by companies within the Chesnara plc Group from 1 January 2005 to 31 December 2006 in respect of any of the Non-executive Directors.

Directors' Share Options

No options were granted in respect of any Chesnara plc Share Option Scheme between 1 January 2005 and 28 March 2007, nor were there any options outstanding as at 31 December 2005, 31 December 2006 or 28 March 2007.

Approved by the Board of Directors on 28 March 2007 and signed on its behalf by:

Christopher Sporborg

Graham Kettleborough

Statement of Directors' Responsibilities in respect of the Financial Statements and the financial statements

The Directors are responsible for preparing the Group and Parent Company financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare Group and Parent Company financial statements for each financial year. Under that law they are required to prepare the Group financial statements in accordance with IFRSs as adopted by the EU and applicable law and have elected to prepare the Parent Company financial statements on the same basis.

The Group and Parent Company financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position of the Group and the Parent Company and the performance for the period; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

In preparing each of the Group and Parent Company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state they have been prepared in accordance with IFRSs as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and Parent Company will continue in business

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Parent Company and enable them to ensure that the financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and detect fraud and other irregularities.

Under applicable law and regulations, the Directors are also responsible for preparing a Directors' Report, Directors' Remuneration Report and the Corporate Governance Statement that comply with that law and those regulations.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Report of the Independent Auditor to the Members of Chesnara plc

We have audited the Group and Parent Company financial statements (the "financial statements") of Chesnara plc for the year ended 31 December 2006 which comprise Group Income Statement, the Group and Parent Company Balance Sheets, the Group and Parent Company Cash Flow Statements, the Group and Parent Company Statements of Changes in Equity, and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

This report is made solely to the Company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The Directors' responsibilities for preparing the Financial Statements, the Directors' Remuneration Report and financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU are set out in the Statement of Directors' Responsibilities on page 41.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Operating and Financial Review that is cross referred from the Business Review section of the Directors' Report.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2003 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Financial Statements and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at 31 December 2006 and of its profit for the year then ended;
- the Parent Company financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU as applied in accordance with the provisions of the Companies Act 1985, of the state of the Parent Company's affairs as at 31 December 2006;
- the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation; and
- the information given in the Directors' Report is consistent with the financial statements.

KPMG Audit Plc

Chartered Accountants and Registered Auditor
St James' Square
Manchester M2 6DS

28 March 2007

Consolidated Income Statement for the year ended 31 December 2006

	Note	Year ended 31 December	
		2006 £000	2005 £000
Insurance premium revenue		112,800	115,673
Insurance premium ceded to reinsurers		(22,194)	(26,691)
Net insurance premium revenue	6	90,606	88,982
Fee and commission income			
Insurance contracts	7	43,519	49,405
Investment contracts	7	9,085	5,971
Investment income	8	151,470	214,691
Total revenue (net of reinsurance payable)		294,680	359,049
Other operating income	9	1,195	1,226
Net income		295,875	360,275
Policyholder claims and benefits incurred	10	(218,541)	(291,921)
Reinsurers' share of claims and benefits incurred	10	32,761	61,300
Net policyholder claims and benefits incurred		(185,780)	(230,621)
Change in investment contract liabilities	11	(58,905)	(85,130)
Reinsurers' share of investment contract liabilities	11	1,304	3,742
Net change in investment contract liabilities		(57,601)	(81,388)
Fees, commission and other acquisition costs	12	(2,881)	(5,699)
Administrative expenses	13	(17,184)	(18,675)
Other operating expenses			
Charge for amortisation of intangible assets	14	(3,773)	(2,364)
Reinsurance recapture premium	14	(1,374)	–
Other	14	(781)	(267)
Total expenses		(269,374)	(339,014)
Operating profit		26,501	21,261
Financing costs	15	(1,206)	(805)
Loss on sale of subsidiary company	5	(248)	–
Profit before income taxes		25,047	20,456
Income tax expense	16	(5,791)	(1,841)
Profit for the year		19,256	18,615
Basic earnings per share	41	18.41p	19.26p
Diluted earnings per share	41	18.41p	19.26p

The notes and information on pages 51 to 110 form part of these financial statements.

The Group considers that it has no product or distribution based segmentation and, as it only has significant business activity within the UK, it has no geographic segmentation. Accordingly, no segmented reporting is presented.

Consolidated Balance Sheet at 31 December 2006

	Note	31 December	
		2006 £000	2005 £000
Assets			
Intangible assets			
Deferred acquisition costs	17	10,687	13,000
Acquired value of in-force business			
Insurance contracts	18	22,144	24,900
Investment contracts	18	13,644	14,661
Property and equipment	19	–	–
Reinsurers' share of insurance contract provisions	28	207,279	199,563
Amounts deposited with reinsurers	29	63,721	62,697
Investment properties	20	27,750	25,422
Financial assets			
Equity securities at fair value through income	21	738,487	688,478
Holdings in collective investment schemes at fair value through income	21	342,352	340,379
Debt securities at fair value through income	21/	350,524	383,817
Loans and receivables including insurance receivables	22	17,310	19,810
Derivative financial instruments	23	30,642	16,108
Total financial assets		1,479,315	1,448,592
Reinsurers share of accrued policyholder claims	34	4,191	4,810
Income taxes	24	260	199
Cash and cash equivalents	25	301,218	282,452
Total assets		2,130,209	2,076,296
Liabilities			
Insurance contract provisions	28	1,115,197	1,072,064
Financial liabilities			
Investment contracts at fair value through income	29	812,979	803,146
Borrowings	30	16,574	20,638
Derivative financial instruments	23	1,421	416
Total financial liabilities		830,974	824,200
Provisions	31	597	1,433
Deferred tax liabilities	32	13,946	13,327
Reinsurance payables	33	3,059	2,049
Payables related to direct insurance and investment contracts	34	24,927	23,866
Deferred income	35	18,231	20,195
Income taxes	36	2,023	3,345
Other payables	37	7,000	7,550
Total liabilities		2,015,954	1,968,029
Net assets		114,255	108,267
Shareholders' equity			
Share capital	38	41,501	41,501
Share premium	38	20,458	20,458
Other reserves		50	50
Retained earnings	39	52,246	46,258
Total shareholders' equity		114,255	108,267

The notes and information on pages 51 to 110 form part of these financial statements.

Approved by the Board of Directors on 28 March 2007 and signed on its behalf by:

Christopher Sporborg

Graham Kettleborough

Company Balance Sheet at 31 December 2006

	Note	31 December	
		2006 £000	2005 £000
Assets			
Non-current assets			
Financial assets			
Investment in subsidiaries	21	52,006	52,006
Current assets			
Loans and receivables	22	551	1,472
Income taxes	24	153	150
Cash and cash equivalents	25	11,555	1,211
Total current assets		12,259	2,833
Total assets		64,265	54,839
Current liabilities			
Borrowings	30	4,102	4,063
Other payables	37	1,523	940
Total current liabilities		5,625	5,003
Non-current liabilities			
Borrowings	30	12,472	16,575
Total liabilities		18,097	21,578
Net assets		46,168	33,261
Shareholders' equity			
Share capital	38	5,229	5,229
Share premium	38	20,458	20,458
Other reserves		50	50
Retained earnings	39	20,431	7,524
Total shareholders' equity		46,168	33,261

The notes and information on pages 51 to 110 form part of these financial statements.

Approved by the Board of Directors on 28 March 2007 and signed on its behalf by:

Christopher Sporborg

Graham Kettleborough

Consolidated Statement of Cash Flows for the year ended 31 December 2006

	Year ended 31 December	
	2006 £000	2005 £000
Profit for the year	19,256	18,615
Adjustments for:		
Depreciation	–	105
Amortisation of deferred acquisition costs	2,312	4,998
Amortisation of acquired in-force value	3,772	2,363
Tax expense	5,791	1,841
Interest receivable	(26,331)	(7,929)
Dividends receivable	(30,266)	(17,901)
Interest expense	1,206	805
Change in fair value of investment properties	(2,328)	(1,344)
Fair value gains on financial assets	(54,154)	(75,786)
Loss on sale of property and equipment	–	300
Loss on sale of subsidiary company	248	–
Interest received	28,981	9,545
Dividends received	27,099	18,473
Changes in operating assets and liabilities (excluding the effect of acquisitions)		
Increase in intangible assets related to investment and insurance contracts	–	(8,936)
Decrease/(increase) in financial assets	20,039	(3,537)
Increase in reinsurers share of insurance contract provisions	(7,097)	(37,818)
Increase in amounts deposited with reinsurers	(1,024)	(4,021)
Decrease in other loans and receivables	2,932	9,706
Increase in insurance contract provisions	44,056	122,572
Increase in investment contract liabilities	9,833	52,510
(Decrease)/Increase in provisions	(836)	507
Increase/(decrease) in reinsurance payables	1,010	(1,284)
Increase in payables related to direct insurance and investment contracts	1,061	9,515
Decrease in other payables	(1,650)	(5,199)
Cash generated from operations	43,910	88,100
Income tax paid	(6,470)	(4,217)
Net cash generated from operating activities	37,440	83,883
Cash flows from investing activities		
Acquisition of subsidiary, net of cash acquired	–	124,497
Disposal of subsidiary, net of cash disposed of	(295)	–
Purchases of property and equipment	–	(2)
Net cash (utilised by)/generated from investing activities	(295)	124,495
Cash flows from financing activities		
Proceeds from the issue of share capital	–	23,533
(Repayment of)/proceeds from borrowings	(4,200)	21,000
Payment of transaction costs	–	(2,539)
Dividends paid	(13,268)	(11,249)
Interest paid	(911)	(604)
Net cash (utilised by)/generated from financing activities	(18,379)	30,141
Net increase in cash and cash equivalents	18,766	238,519
Cash and cash equivalents at beginning of period	282,452	43,933
Cash and cash equivalents at end of period	301,218	282,452
In the cash flow statement proceeds from the sale of property and equipment comprise:		
Net book amount	–	300
Loss on sale	–	(300)
Proceeds from sale	–	–

The notes and information on pages 51 to 110 form part of these financial statements.

Company Statement of Cash Flows for the year ended 31 December 2006

	Year ended 31 December	
	2006 £000	2005 £000
Profit for the year	26,175	18,773
Adjustment for		
Tax recovery	(182)	(148)
Interest expense	1,206	805
Dividends received from subsidiary company	(26,886)	(19,325)
Changes in operating assets and liabilities		
Decrease/(Increase) in loans and receivables	1,100	(1,039)
Increase in payables	424	303
Cash generated from/(utilised by) operations	1,837	(631)
Cash flows from investing activities		
Acquisition of subsidiary company	–	(47,778)
Dividends received from subsidiary company	26,886	19,325
Net cash generated from/(utilised by) investing activities	26,886	(28,453)
Cash flows from financing activities		
Net proceeds from the issue of share capital	–	23,533
Payment of transaction costs	–	(2,074)
(Repayment of)/ net proceeds from borrowings	(4,200)	20,535
Dividends paid	(13,268)	(11,249)
Interest paid	(911)	(604)
Net cash (utilised by)/generated from financing activities	(18,379)	30,141
Net increase in cash and cash equivalents	10,344	1,057
Cash and cash equivalents at beginning of period	1,211	154
Cash and cash equivalents at end of period	11,555	1,211

The notes and information on pages 51 to 110 form part of these financial statements.

Consolidated Statement of Changes in Equity for the year ended 31 December 2006

	Year ended 31 December 2006				
	Share capital £000	Share premium £000	Capital redemption reserve £000	Retained earnings £000	Total £000
Equity shareholders' funds at 1 January 2006	41,501	20,458	50	46,258	108,267
Profit for the period representing total recognised income and expenses	–	–	–	19,256	19,256
Dividends paid	–	–	–	(13,268)	(13,268)
Equity shareholders' funds at 31 December 2006	<u>41,501</u>	<u>20,458</u>	<u>50</u>	<u>52,246</u>	<u>114,255</u>

	Year ended 31 December 2005				
	Share capital £000	Share premium £000	Capital redemption reserve £000	Retained earnings £000	Total £000
Equity shareholders' funds at 1 January 2005	40,500	–	50	38,892	79,442
Profit for the period representing total recognised income and expenses	–	–	–	18,615	18,615
Dividends paid	–	–	–	(11,249)	(11,249)
Issue of ordinary shares pursuant to exercise of option	84	1,449	–	–	1,533
Issue of ordinary shares pursuant to placing and open offer	917	21,083	–	–	22,000
Expenses incurred in connection with issue of ordinary shares pursuant to placing and open offer	–	(2,074)	–	–	(2,074)
Equity shareholders' funds at 31 December 2005	<u>41,501</u>	<u>20,458</u>	<u>50</u>	<u>46,258</u>	<u>108,267</u>

The notes and information on pages 51 to 110 form part of these financial statements.

Company Statement of Changes in Equity for the year ended 31 December 2006

	Year ended 31 December 2006				
	Share capital £000	Share premium £000	Capital redemption reserve £000	Retained earnings £000	Total £000
Equity shareholders' funds at 1 January 2006	5,229	20,458	50	7,524	33,261
Profit for the period representing total recognised income and expenses	–	–	–	26,175	26,175
Dividends paid	–	–	–	(13,268)	(13,268)
Equity shareholders' funds at 31 December 2006	5,229	20,458	50	20,431	46,168

	Year ended 31 December 2005				
	Share capital £000	Share premium £000	Capital redemption reserve £000	Retained earnings £000	Total £000
Equity shareholders' funds at 1 January 2005	4,228	–	50	–	4,278
Profit for the period representing total recognised income and expenses	–	–	–	18,773	18,773
Dividends paid	–	–	–	(11,249)	(11,249)
Issue of ordinary shares pursuant to exercise of option	84	1,449	–	–	1,533
Issue of ordinary shares pursuant to placing and open offer	917	21,083	–	–	22,000
Expenses incurred in connection with issue of ordinary shares pursuant to placing and open offer	–	(2,074)	–	–	(2,074)
Equity shareholders' funds at 31 December 2005	5,229	20,458	50	7,524	33,261

The notes and information on pages 51 to 110 form part of these financial statements.

Notes to the Consolidated Financial Statements (forming part of the financial statements)

1 General information

Chesnara plc (the Company) is a limited liability company incorporated and domiciled in England and Wales and has primary listings on the London Stock Exchange. The address of the registered office is Harbour House, Portway, Preston PR2 2PR, UK.

The Company and its subsidiaries, together forming the Group, underwrite life risks such as those associated with death, disability and health. The Group also provides a portfolio of investment contracts for the savings and retirement needs of customers through asset management. These activities are performed almost entirely in the UK. The Group is substantially closed to new business, such that new insurance contracts are only issued to existing customers, dependent on their changing needs. New investment contracts relate to the sale of Guaranteed Growth and Guaranteed Income Bonds.

These financial statements were authorised for issue by the Directors on 28 March 2007.

2 Accounting policies

(a) Statement of compliance

EU law (IAS Regulation EC1606/2002) requires that the annual consolidated financial statements of the Company for all reporting periods beginning on or after 1 January 2005 be prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU ("Adopted IFRSs").

Both the Parent Company financial statements and the Group financial statements have been prepared and approved by the Directors in accordance with Adopted IFRSs. In publishing the Parent Company financial statements together with the Group financial statements the Company has taken advantage of the exemption in s230 of the Companies Act 1985 not to present its individual income statement and related notes that form a part of these approved financial statements.

All IFRSs and interpretations that had been adopted by the EU as at the date the financial statements were authorised for issue by the Directors have been applied with the exception of IFRS 7 Financial Instruments: Disclosure and the amendments to IAS 1 Presentation of Financial Statements: Capital Disclosures which are effective for annual periods beginning on or after 1 January 2007 and have not been adopted early.

When IFRS 7 and the amendments to IAS 1 are eventually applied, the balance sheets, income statements and cash flows of the Parent Company and the Group will be unaffected. Changes will be required to the information disclosed in the notes to the financial statements about financial instruments, insurance contracts and the capital position of the Group.

(b) Basis of preparation

General

The Group financial statements consolidate those of the Company and its subsidiaries (together referred to as the "Group"). The Parent Company financial statements present information about the Company as a separate entity and not about its group.

The financial statements are presented in pounds sterling, rounded to the nearest thousand and are prepared on the historical cost basis except that the following assets and liabilities are stated at their fair value: derivative financial instruments, financial instruments at fair value through income, investment property and investment contract liabilities at fair value through income.

Assets and liabilities are presented on a current and non-current basis in the notes to the financial statements. If assets are expected to be recovered and liabilities expected to be settled within a year, they are classified as current. If they are expected to be recovered or settled in more than one year, they are classified as non-current.

The preparation of financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the result of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

2 Accounting policies (continued)

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the year in which the estimate is revised if the revision affects only that year, or in the year of the revision and future years if the revision affects both current and future years. Judgements made by management in the process of applying the Group's accounting policies that have a significant effect on the financial statements and estimates with a significant risk of material adjustment in the next year are set out in Note 3 (on pages 59 to 60).

The accounting policies set out below have been applied consistently to all years presented in these consolidated financial statements.

Financial Reporting Standard 27, Life Assurance (FRS27) was issued by the Accounting Standards Board (ASB) in December 2004. A number of major insurance companies and the Association of British Insurers (ABI), signed a Memorandum of Understanding (MoU) with the ASB relating to its implementation. These financial statements have been prepared in accordance with the disclosure provisions of FRS27 and the guidance within the MoU.

Life business demerger and acquisition by Chesnara plc: reverse acquisition accounting

On 24 May 2004, Chesnara plc acquired the whole of the issued ordinary share capital of Countrywide Assured Life Holdings Limited ("CALH") from Countrywide plc ("Countrywide"), which had, itself, acquired the whole of the issued ordinary share capital of CALH on 22 May 2004 from Countrywide Assured Group plc ("CAG"). These arrangements were effected to secure the demerger from CAG of CALH, which, together with its subsidiary companies, comprised the life business of CAG.

On the acquisition of CALH, Chesnara plc issued, as fully paid, 2.5p ordinary shares to the shareholders of Countrywide ("the Countrywide shareholders") as recorded on the shareholders register on 21 May 2004, pro rata to their holding in Countrywide, such that they received one ordinary share in Chesnara plc for every two ordinary shares held in Countrywide. On 25 May 2004, the existing ordinary shares of 2.5p in Chesnara plc were consolidated into ordinary shares of 5p each on the basis of one new share for every two old shares, so that, in effect, the Countrywide shareholders received one ordinary 5p share in Chesnara plc for every four ordinary shares held in Countrywide.

In substance the transactions described above represent a continuation of the business of CALH. Chesnara plc, a company with net assets of £2 prior to its acquisition of CALH, was used as a vehicle effectively to secure a listing for the business of CALH on the London Stock Exchange, and, prior to its acquisition of CALH, such net assets did not comprise an integrated set of activities and assets which were capable of generating revenue or of providing a return to investors. Chesnara plc, at the date of its acquisition of CALH, did not, therefore, comprise a business as defined in IFRS 3 Business Combinations. However the consolidated financial statements of Chesnara plc have been prepared based on the reverse acquisition method as set out in IFRS 3, as the Directors consider that this is the fairest way of presenting the financial position, results of operations and cash flows of the combined entities. Accordingly CALH is deemed to be the effective acquirer of Chesnara plc and the consolidated financial statements have been prepared as a continuation of the consolidated financial statements of CALH and its subsidiaries.

The fair value of the identifiable net assets and of the equity instruments of Chesnara plc before its deemed acquisition by CALH are negligible and the deemed consideration, based on the fair value of the equity instruments deemed to have been issued by CALH to the shareholders of Chesnara plc, is also negligible and is taken as £nil. Accordingly, the application of the purchase method of accounting for the deemed acquisition of Chesnara plc by CALH does not give rise to any goodwill or negative goodwill in the consolidated financial statements.

(c) Basis of consolidation

Subsidiaries

The consolidated financial statements incorporate the assets, liabilities and the results of the Company and of its subsidiary undertakings. Subsidiary undertakings are those entities in which the Group directly or indirectly has the power to govern the financial and operating policies in order to gain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

Intragroup balances, and any income and expenses or unrealised gains or losses arising from intragroup transactions, are eliminated in preparing the consolidated financial statements.

(d) Business combinations

The Group uses the purchase method of accounting to account for the acquisition of subsidiaries. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date.

(e) Product classification

The Group's products are classified as either insurance or investment contracts for accounting purposes. Insurance contracts are contracts, which transfer significant insurance risk. Contracts under which the transfer of insurance risk to the company from the policyholder is not significant are classified as investment contracts. Where contracts contain both insurance and investment components and the investment components can be measured reliably, the contracts are unbundled and the components are separately accounted for as insurance contracts and investment contracts respectively.

(f) Insurance contracts

(i) Premiums

Premiums are accounted for when due, or in the case of unit-linked insurance contracts when the liability is recognised, and exclude any taxes or duties based on premiums. Outward reinsurance premiums are accounted for when due.

(ii) Claims and benefits

Claims are accounted for in the accounting period in which they are due or notified. Surrenders are accounted for in the accounting period in which they are paid. Claims include policyholder bonuses allocated in anticipation of a bonus declaration. Reinsurance recoveries are accounted for in the same period as the related claim.

(iii) Acquisition costs

Acquisition costs comprise all direct and indirect costs arising from the conclusion of insurance contracts. An explicit deferred acquisition cost asset is established in the balance sheet to the extent that acquisition costs exceed initial fees deducted. Deferred acquisition costs are amortised at a rate based on the pattern of anticipated margins in respect of the related policies. Deferral of costs is limited to the extent that there are available future margins.

Renewal commission and other direct and indirect acquisition costs arising on enhancements to existing contracts are expensed as incurred.

(iv) Measurement of insurance contract provisions

Insurance contract provisions are measured using accounting policies having regard to the principles laid down in Council Directive 2002/83/EC.

Unit-linked provisions are measured by reference to the value of the underlying net asset value of the Group's unitised investment funds, determined on a bid value basis, at the balance sheet date. Deferred tax on unrealised capital gains is also reflected in the measurement of unit-linked provisions.

Insurance contract provisions are determined following an annual actuarial investigation of the long-term funds in accordance with regulatory requirements. The provisions are calculated on the basis of current information, using appropriate valuation methods.

For immediate annuities in payment the provision is calculated as the discounted value of the expected future annuity payments under the policies, allowing for mortality, interest rates and expenses.

For the other classes of non-linked business the provision is calculated on a net premium basis, being the level of premium consistent with a premium stream, the discounted value of which, at the outset of the policy, would be sufficient to cover exactly the discounted value of the original guaranteed benefits at maturity, or at death if earlier, on the valuation basis. The provision is then calculated by subtracting the present value of future net premiums from the present value of the benefits guaranteed at maturity, or death if earlier, as a result of events up to the balance sheet date. Negative provisions do not arise under the net premium method, which makes no allowances for voluntary discontinuances by policyholders, and which only implicitly allows for future policy maintenance costs.

2 Accounting policies (continued)

Insurance contract provisions are tested for adequacy by discounting current estimates of all contractual cash flows and comparing this amount to the carrying value of the provision and any related assets: this is known as the liability adequacy test. Where a shortfall is identified, an additional provision is made and the Group recognises the deficiency in income for the year.

For those classes of non-linked and unit-linked business where policyholders participate in profits the liability is wholly reassured to Guardian Assurance plc (“Guardian”). The liability is calculated on a net premium basis, but is then increased to the realistic liability as a result of the liability adequacy test.

Insurance contract provisions can never be definitive as to their timing nor the amount of claims and are therefore subject to subsequent reassessment on a regular basis.

(g) Investment contracts

(i) Amounts collected

Amounts collected on investment contracts, which primarily involve the transfer of financial risk such as long-term savings contracts, are accounted for using deposit accounting, under which the amounts collected, less any initial fees deducted, are credited directly to the balance sheet as an adjustment to the liability to the investor.

(ii) Amounts deposited with reinsurers

Amounts deposited with reinsurers under reinsurance arrangements, which primarily involve the transfer of financial risk, are entered directly to the balance sheet as amounts deposited with reinsurers. These assets are designated on initial recognition as at fair value through income.

(iii) Benefits

For investment contracts, benefits paid are not included in the income statement but are instead deducted from investment contract liabilities in the accounting period in which they are paid.

(iv) Acquisition costs

Acquisition costs relating to investment contracts comprise directly attributable incremental acquisition costs, which vary with and are related to securing new contracts, and are recognised as an asset to the extent that they represent the contractual right to benefit from the provision of investment management services. The asset is presented as a deferred acquisition cost asset and is amortised over the expected term of the contract, as the fees relating to the provision of the services are recognised. All other costs are recognised as expenses when incurred.

(v) Liabilities

All investment contract liabilities are designated on initial recognition as held at fair value through income. The financial liability in respect of unit-linked contracts is measured by reference to the value of the underlying net asset value of the Group’s unitised investment funds, determined on a bid value, at the balance sheet date. Deferred tax on unrealised capital gains is also reflected in the measurement of unit-linked provisions.

The Group has designated investment contract liabilities at fair value through Income as this more closely reflects the basis on which the business is managed. Guaranteed income and guaranteed growth bond liabilities and other investment contract liabilities are managed together with related investment assets on a fair value basis as part of the documented risk management strategy.

The fair value of other investment contracts is measured by discounting current estimates of all contractual cash flows that are expected to arise under contracts.

(h) Contracts with discretionary participation features (DPF)

A discretionary participation feature is a contractual right held by a policyholder to receive, as a supplement to guaranteed minimum payments, additional payments that are likely to be a significant portion of the total contractual payments. All such contracts are wholly reinsured with Guardian Assurance plc, a subsidiary of Aegon NV and the amount or timing of the additional payments are contractually at the discretion of the reinsurer and are contractually based on:

- (i) the performance of a specified pool of contracts or a specified type of contract;
- (ii) realised and/or unrealised investment returns on a specified pool of assets held by the reinsurer; or

(iii) the profit or loss of the reinsurer.

All contracts with discretionary participation features, whether classified as investment or insurance contracts, are accounted for as insurance contracts.

(i) Reinsurance

The Group cedes reinsurance in the normal course of business for the purpose of avoiding the retention of undue concentration of risk on any one life. Assets, liabilities and income and expense arising from ceded reinsurance contracts are presented separately from the related assets, liabilities, income and expenses from the related insurance contracts because the reinsurance arrangements do not relieve the Group from its direct obligations to its policyholders.

Only rights under contracts that give rise to a significant transfer of insurance risk are accounted for as reinsurance assets. Rights under contracts that do not transfer significant insurance risk are accounted for as financial instruments.

The net premiums payable to a reinsurer may be more or less than the reinsurance assets recognised by the Group in respect of the reinsurance cover purchased. Any gain or loss is recognised in the income statement in the period in which the reinsurance premiums are payable.

Rights under reinsurance contracts comprising the reinsurers' share of insurance contract provisions and accrued policyholder claims are estimated in a manner that is consistent with the measurement of the provisions held in respect of the related insurance contracts. Such assets are deemed impaired if there is objective evidence, as a result of an event that occurred after its initial recognition, that the Group may not recover all amounts due and the event has a reliably measurable impact on the amounts that the Group will receive from the reinsurer.

(j) Fee and commission income

Fees charged for investment management services provided in connection with investment contracts are recognised as revenue as the services are provided. Initial fees which exceed the level of recurring fees and relate to the future provision of services are deferred and amortised over the anticipated period in which services will be provided.

Initial fees charged for investment management services provided in connection with insurance contracts are recognised as revenue when earned.

For both insurance and investment contracts, initial fees on regular premiums, annual management charges and contract administration charges are recognised as revenue on an accruals basis. Surrender charges are recognised as a reduction to policyholder claims and benefits incurred when the surrender benefits are paid.

Benefit-based fees comprising charges made to unit-linked insurance and investment funds for mortality and morbidity benefits are recognised as revenue on an accruals basis.

Commissions received or receivable which do not require the Group to render further services are recognised as revenue by the Group on the effective commencement or renewal dates of the related contract. However, when it is probable that the Group will be required to render further services during the life of the contract, the commission, or part thereof, is deferred and recognised as revenue over the period in which services are rendered.

(k) Investment income

Investment income comprises income from financial assets and rental income from investment properties.

Income from financial assets comprises dividend and interest income, net fair value gains and losses (both unrealised and realised) in respect of financial assets classified as fair value through income, and realised gains on financial assets classified as loans and receivables.

Dividends are accrued on an ex-dividend basis. Interest received and receivable in respect of interest-bearing financial assets classified as fair value through income is included in net fair value gains and losses. For loans and receivables and cash and cash equivalents interest income is calculated using the effective interest method.

Rental income from investment properties under operating leases is recognised in the income statement on a straight-line basis over the term of each lease. Lease incentives are recognised in the income statement as an integral part of the total lease income.

Notes to the Consolidated Financial Statements (continued)

2 Accounting policies (continued)

(l) Expenses

(i) Operating lease payments

Leases where a significant proportion of the risks and rewards of ownership is retained by the lessor are classified as operating leases. Payments made under operating leases are recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives received are recognised in the income statement as an integral part of the total lease expense.

(ii) Financing costs

Financing costs comprise interest payable on borrowings calculated using the effective interest rate method.

(m) Income taxes

Income tax on the profit or loss for the year comprises current and deferred tax and is recognised in the income statement.

(i) Current tax

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

(ii) Deferred tax

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

(n) Acquired value of in-force business

Acquired in-force insurance and investment contracts arising from business combinations are measured at fair value at the time of acquisition.

The difference between the fair value of insurance contracts and the liability measured in accordance with the Group's accounting policies for the contracts is recorded as acquired present value of in-force business ("Acquired PVIF"). Acquired PVIF is carried gross of tax and is amortised against income on a time profile which, it is intended, will broadly match the profile of the underlying emergence of surplus as anticipated at the time of acquisition. It is tested for impairment if there are indications that recoverability of the full carrying value is in doubt.

Acquired PVIF in respect of in-force investment contracts is stated at cost less accumulated amortisation and impairment losses. The initial cost is deemed to be the fair value of the contractual customer relationships acquired. The acquired present value of the in-force investment contracts is carried gross of tax and is amortised against income on a time profile which, it is intended, will broadly match the profile of the underlying emergence of profit from the contracts. It is tested for impairment annually.

(o) Property and equipment

Items of property and equipment are stated at cost less accumulated depreciation and impairment losses.

Depreciation is charged to the income statement on a straight-line basis over the estimated useful lives of the property and equipment as follows:

Computers	5 years
Fixtures and fittings	5 years
Office equipment	5 years
Motor vehicles	4 years

(p) Investment property

Investment properties are properties which are held either to earn rental income or for capital appreciation or for both. On initial recognition investment properties are measured at cost including attributable transaction costs, and are subsequently measured at fair value. Independent external valuers, having an appropriate recognised professional qualification and recent experience in the location and category of property being valued, value the portfolio every twelve months.

The fair values reflect market values at the balance sheet date, being the estimated amount for which a property could be exchanged on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

Any gain or loss arising from a change in fair value is recognised in the income statement. Rental income from investment property is accounted for as described in accounting policy (k).

(q) Financial assets

Financial assets are classified into different categories depending on the type of asset and the purpose for which it is acquired. Currently two different categories of financial assets are used: "financial assets at fair value through income" and "loans and receivables". Financial assets classified as fair value through income comprise financial assets designated as such on initial recognition and derivative financial instruments.

All financial assets held for investment purposes other than derivative financial instruments are designated as fair value through income on initial recognition since they are managed, and their performance is evaluated, on a fair value basis in accordance with documented investment and risk management strategies. This designation is also applied to the Group's investment contracts, since the investment contract liabilities are managed together with the investment assets on a fair value basis as part of the documented risk management strategy.

Purchases and sales of "regular way" financial assets are recognised on the trade date, which is when the Group commits to purchase, or sell the assets.

All financial assets are initially measured at fair value plus, in the case of financial assets not classified as at fair value through income, transaction costs that are directly attributable to their acquisition.

Subsequent to initial recognition, financial assets classified as fair value through income are measured at their fair value without any deduction for transaction costs that may be incurred on their disposal.

The fair value of financial assets quoted in an active market is their bid prices at the balance sheet date.

Financial assets classified as loans and receivables are stated at amortised cost less impairment losses.

Financial assets are derecognised when contractual rights to receive cash flows from financial assets expire, or where the financial assets have been transferred together with substantially all the risks and rewards of ownership.

Investments in subsidiaries are carried at cost less impairment in the balance sheet.

(r) Derivative financial instruments

Derivative financial instruments are recognised at fair value. The gain or loss on remeasurement to fair value is recognised immediately in profit or loss. Hedge accounting has not been applied.

The fair value of interest rate swaps is the estimated amount that the Group would receive or pay to terminate the swap at the balance sheet date, taking into account current interest rates and the current creditworthiness of the swap counterparties. The fair value of forward exchange contracts is their quoted market price at the balance sheet date, being the present value of the quoted forward price.

(s) Cash and cash equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks and other short-term highly liquid investments. Highly liquid is defined as realisable into cash within 90 days.

(t) Impairment

The carrying amounts of the Group's assets other than reinsurance assets, acquired Insurance PVIF and assets which are carried at fair value are reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the assets' recoverable amount is estimated. An impairment loss is recognised whenever the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised in the income statement.

2 Accounting policies (continued)

Impairment losses are reversed through the income statement if there is a change in the estimates used to determine the recoverable amount. Such losses are reversed only to the extent that the assets' carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation where applicable, if no impairment loss had been recognised.

(u) Provisions

Provisions are recognised when the Group has a present, legal or constructive obligation as a result of past events such that it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate of the amount of the obligation can be made. Where the effect of the time value of money is material, the amount of the provision is the present value of the expenditures expected to be required to settle the obligation. The Group recognises provisions for onerous contracts when the expected benefits to be derived from a contract are less than the unavoidable costs of meeting the obligations under the contract.

(v) Borrowings

Borrowings are recognised initially at fair value, less transaction costs and are subsequently stated at amortised cost. The difference between the carrying value on initial recognition and the redemption value is recognised in the income statement over the borrowing period on an effective interest rate basis.

(w) Employee benefits

(i) Pension obligations

Group companies operate defined contribution pension schemes, which are funded through payments to insurance companies, to which Group companies pay fixed contributions. There are no legal or constructive obligations on Group companies to pay further contributions if the fund does not hold sufficient assets to pay employee benefits relating to service in current and prior periods. Accordingly, Group companies have no further payment obligations once the contributions have been paid.

Contributions to defined contribution pension schemes are recognised as employee benefit expense when they are due.

(ii) Bonus plans

The Group recognises a liability and an expense for bonuses based on a formula that takes into consideration the profit attributable to the Company's shareholders after certain adjustments. The expense is recognised in the income statement on an accruals basis.

(x) Share capital

Shares are classified as equity when there is no obligation to transfer cash or other assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax. Incremental costs directly attributable to the issue of equity instruments, as consideration for the acquisition of a business, are included in the cost of acquisition.

(y) Dividends

Dividend distributions to the Company's shareholders are recognised as liabilities in the period in which the dividends are paid, and, for the final dividend, when approved by the Company's shareholders at the annual general meeting.

(z) Foreign currency transactions

Foreign currency transactions are translated into pounds sterling at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into pounds sterling at the foreign exchange ruling at the balance sheet date. Foreign exchange differences arising on translation are recognised in the income statement.

(aa) Other payables and payables related to direct insurance and investment contracts

Insurance and investment contract payables and other payables are recognised when due and are measured on initial recognition at the fair value of the consideration paid. Subsequent to initial recognition, payables are measured at amortised cost using the effective interest rate method.

3 Accounting estimates and judgements

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities and also makes critical accounting judgements in applying the Group's accounting policies. Such estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable. The more critical areas where accounting estimates and judgements are made are described below.

(a) Classification of long-term contracts

The Group has exercised judgement in its classification of long-term business as between insurance and investment contracts, which fall to be accounted for differently in accordance with the policies set out in Note 2 Accounting Policies. Insurance contracts are those where significant risk is transferred to the Group under the contract and judgement is applied in assessing whether the risk so transferred is significant, especially with regard to pensions contracts, which are predominantly, but not exclusively, created for investment purposes.

(b) Estimates of future benefits payments arising from long-term insurance contracts

The Group makes estimates of the expected number of deaths for each of the years that it is exposed to risk. These estimates are based on either standard mortality tables or reinsurers' rate tables as appropriate, adjusted to reflect the Group's own experience. For contracts without fixed terms the Group has assumed that it will be able to increase charges to policyholders in future years, in line with emerging mortality experience.

The Group has offered guaranteed annuity options within certain contracts. Estimates have been made of the number of contract holders who will exercise these options, in order to measure their value. Changes in investment conditions could result in significantly more contract holders exercising their options than the Group has assumed in determining the liabilities arising from these contracts.

The Group makes estimates of future deaths, voluntary contract terminations, investment returns and administration expenses at the inception of long-term insurance contracts with fixed and guaranteed terms. These estimates, which are reconsidered annually, form the assumptions used to calculate the liabilities arising from these contracts.

The assumptions used to establish insurance contract liabilities and appropriate sensitivities relating to variations in critical assumptions are disclosed in Note 28 (on page 92).

(c) Fair value of investment contracts

Guaranteed income and guaranteed growth bonds

The fair value of investment contract liabilities, in respect of guaranteed income and guaranteed growth bonds, (which are fully described in Note 4(b) (on page 65) to these financial statements) is established using a valuation technique, which approximates the following methodology:

- (i) the fair value of the contract, measured at inception, is the purchase price paid for it. This price implies a retail market rate of interest prevailing at the inception of the contract, which is used to equate the contractual cash flows payable under the bond to the purchase price, including an allowance for expenses incurred in managing the contract; and
- (ii) subsequent measurement of the liability at fair value reflects the impact of changes in retail market interest rates for these products: this is accomplished in practice by tracking movements in the less-than-5-year gilt index as the bonds are predominantly less than 5 years in term.

This methodology has been adopted to reduce volatility in reported earnings in the income statement as the liabilities so determined are measured in a way which is consistent with the fair value of the underlying invested financial assets.

3 Accounting estimates and judgements (continued)

(d) *Liability for future redress in respect of mortgage endowment misselling complaints*

Included within insurance contract liabilities is a liability in respect of amounts anticipated to be payable as redress for upheld mortgage endowment misselling complaints. In establishing this liability the Group makes estimates about the number of future upheld complaints (taking into account the number of complaints received, the number of complaints time-barred and the number of complaints which are admitted) and about the average cost of redress per upheld complaint. These estimates are determined, taking into account historical experience and investment return projections. Variations in these estimates could result in higher or lower than expected numbers of upheld complaints and higher or lower than expected amounts of redress per upheld complaint. The impact of variations in these assumptions is disclosed in Note 28 (on page 94) to these financial statements.

(e) *Deferred acquisition costs and deferred income*

The Group applies judgement in deciding the amount of direct costs that are incurred in acquiring the rights to provide investment management services in connection with the issue of investment contracts. Judgement is also applied in establishing the amortisation of the assets representing these contractual rights and the recognition of initial fees received in respect of these contracts. The assets are amortised on a straight-line basis over the lifetime of the investment management service contracts and deferred income is amortised on a straight-line basis over the period in which it is earned. Estimates are applied in determining the lifetime of the investment management service contracts and in determining the recoverability of the contractual rights assets by reference to expected future income and expense levels. This test for recoverability is performed using best estimates of future cash flows, using a market consistent estimate of future investment returns.

(f) *Amortisation of acquired value of in-force business*

The Group applies accounting estimates and judgement in determining the fair value, amortisation and recoverability of acquired in-force business relating to insurance and investment contracts. The acquired value of in-force business has been amortised on a basis that reflects the expected profit stream arising from the business acquired at the date of acquisition. This profit stream is estimated from the experienced termination rates, expenses of management and age of the individual contract holders as well as global estimates of investment growth, based on recent experience at the date of acquisition. Acquired value of in-force business is tested for recoverability by reference to expected future income levels, if there are indications that recoverability of the full carrying value is in doubt.

4 Management of insurance and financial risk

The Group's management of insurance and financial risk is a critical aspect of the business. For a significant proportion of the Group's life insurance contracts, the cash flows are linked, directly or indirectly, to the performance of the financial assets which support those contracts. This gives rise to financial risk, which also arises on the Group's investment contracts in relation to financial assets which support these contracts. The Group has procedures for setting and monitoring the Group's assets and liability position with the objective of ensuring that the Group can always meet its obligations without undue cost and in accordance with the Group's internal and regulatory capital requirements.

The primary insurance activity carried out by the Group comprises the assumption of the risk of loss from persons that are directly subject to the risk. Such risks in general relate to life, accident, health and financial perils that may arise from an insurable event with the majority of the Group's exposure relating to mortality risk on individual lives, predominantly in the UK. As such the Group is exposed to the uncertainty surrounding the timing and severity of claims under the related contracts. The Group also has exposure to market risk through its insurance and investment activities.

(a) *Insurance risk management*

Introduction

The Group manages its insurance risk through underwriting limits, approval procedures for new products or for policies that exceed set limits, pricing guidelines, reinsurance and monitoring of emerging issues. The Group is substantially closed to new insurance business and, in practice, only sells a limited amount of new insurance business to existing policyholders: the assumption of new insurance risks is, accordingly, limited.

The principal risk is that the frequency and severity of claims is adverse to that expected. The theory of probability is applied to the pricing and provisioning for a portfolio of insurance contracts. Insured events are,

by their nature, random, and the actual number and size of events during any one year may vary from those estimated using established statistical techniques. The risk under assurance policies is partly naturally hedged by risks under annuity policies where the exposure is to the risk of longevity.

Underwriting strategy

The aim of the underwriting strategy is to avoid the assumption of undue concentration of risk on any one life and there are defined underwriting procedures embracing the limits on cover for individual policies.

Reinsurance strategy

The aim of the reinsurance strategy is to reinforce the underwriting strategy by avoiding the retention of undue concentration of risk on any one life. Accordingly, there is a policy on reinsurance, which limits the total exposure on any one policy. However, there are a small number of policies which breach these limits due to historical reasons.

The Group holds a wide range of reinsurance treaties, including wholly reinsured business and risk premium reinsurance which includes original terms reinsurance and facultative reinsurance.

Ceded reinsurance contains credit risk, and such reinsurance recoverables are reported after deductions for known insolvencies and uncollectable items. The Group monitors the financial condition of reinsurers on an ongoing basis and reviews its reinsurance arrangements periodically.

The Group has a policy in place of only entering into new reinsurance contracts with reinsurers rated A and above.

Terms and conditions of insurance contracts

The terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of future cash flows arising from insurance contracts are set out in the product analyses below, which give an assessment of the Group's main products and the ways in which it manages the associated risks.

	Sums assured – gross and net of reinsurance			
	31 December 2006		31 December 2005	
	Gross £000	Net £000	Gross £000	Net £000
Annuities-immediate (per annum)	3,844	3,740	3,553	3,449
Long-term with DPF	80,133	266	85,759	–
Long-term without DPF	6,041,116	4,131,883	7,093,121	4,695,350
Total	6,125,093	4,135,889	7,182,433	4,698,799

Long-term insurance contracts – immediate annuities

Product features

This type of annuity is purchased with a single premium at outset, and is paid to the policyholder for the remainder of his/her lifetime. Annuities may be level or escalate at a fixed rate.

There are two types of immediate annuities: retirement and voluntary. Voluntary annuities are made at the discretion of the policyholder. Policyholders of personal pensions may have to purchase an immediate annuity on retirement. Other variations (joint life annuities) are to continue the annuity (at the same level or lower) to the surviving spouse or partner.

Payments are often guaranteed to be paid for a minimum term regardless of survival (e.g. 5 or 10 years).

Profit on existing contracts arises when mortality and investment experience are better than expected. All risks and rewards associated with this type of product accrue to shareholders.

Management of risks

The main risks associated with this product are longevity and investment risks. Longevity risks arise as the annuities are paid for the lifetime of the policyholder, and this risk is managed through the initial pricing of the annuity. Investment risk depends on the extent to which the annuity payments under the contracts have been matched by suitable assets. The Group regularly monitors the asset matching for these contracts as discussed in "Market risk" below.

4 Management of insurance and financial risk (continued)

The key risks are managed through appropriate pricing and product design. Reinsurance is not generally used for this product, although there is a small number of reinsured policies. Underwriting is not used for this product.

In respect of mortality risk (longevity), the pricing assumption is based on both historic in-house and industry available information on mortality experience for the population of policyholders, including allowances for future mortality improvements.

In respect of investment risk, with this type of product the lump sum premium is available for the Group to invest at the start of the contract. The asset mix will consist of fixed interest securities, including gilts, with varying redemption dates. The income earned on the investment will not usually be sufficient to cover the annuity and the expense outgo, so each year part of the lump sum will be disinvested, which is taken account of in the asset mix, in order to balance the fund. If annuitants die as expected the assets referred to above would be appropriate. However, in most cases annuitants will not die as expected and, therefore, the Group will need to buy and sell assets as necessary throughout the term of the policies to minimise the risk of mismatch. This position is monitored on a regular basis. Details of default risk on the fixed interest securities are covered under the "Credit risk" section below.

Concentration of insurance risks

The tables for immediate annuity contracts set out below illustrate the concentration of risk based on two bands of contracts grouped by the annuity payable each year for each annuity policy insured.

Annuity payable each year for each life insured	Total annuities payable each year			
	Before reinsurance		After reinsurance	
	£000	%	£000	%
As at 31 December 2006				
£0 – £25,000	3,799	98.8	3,731	99.8
More than £25,000	45	1.2	9	0.2
	<u>3,844</u>	<u>100</u>	<u>3,740</u>	<u>100</u>

	Total annuities payable each year			
	Before reinsurance		After reinsurance	
	£000	%	£000	%
As at 31 December 2005				
£0 – £25,000	3,508	98.7	3,440	99.7
More than £25,000	45	1.3	9	0.3
	<u>3,553</u>	<u>100</u>	<u>3,449</u>	<u>100</u>

Long-term insurance contracts – with discretionary participation features

Product features

The Group historically wrote with-profits business in the UK, where the policyholder benefits comprise a discretionary annual bonus and a discretionary terminal bonus.

Management of risks

This business is wholly reassured to Guardian and hence the only risk retained by the Group for this business is the risk of default by the reinsurer. This risk is detailed under "Credit risk" below.

Long-term insurance contracts – without discretionary participation features

Product features

The Group has written both non-linked and unit-linked contracts, which include death and morbidity benefits on a whole life, endowment and term assurance basis.

For contracts where death is the insured risk, the most significant factors that could increase risk are epidemics (such as AIDS, SARS or a flu pandemic) or widespread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected.

Management of risks

Unit-linked insurance contracts are contracts where monthly reviewable charges are made for insurance risk and administration charges and consist mainly of regular unit-linked endowments where the primary purpose is to provide an investment return. In addition, the policyholder is insured against death and serious injury. Unit-linked contracts operate by investing the policyholders' premiums into pooled investment funds of the Group, the policyholders' share of the fund being represented by units. The benefit is payable on death, or maturity if earlier, the amount payable on death being subject to a guaranteed minimum amount. The maturity or surrender value depends on the investment performance of the underlying fund and on the level of charges levied by the Group for policy administration fees, mortality and other charges.

For contracts with fixed and guaranteed benefits and fixed future premiums, there are no mitigating terms and conditions that reduce the insurance risk accepted. This is the case for a small proportion (approximately 5% of total sums assured) of the life assurance business sold by the Group.

For the remainder of the business, operated on a quasi-linked basis, the Group charges for mortality risk on a monthly basis and has the right to alter these charges based on its mortality experience and hence minimise its exposure to mortality risk. The Group also reserves the right at regular intervals to change the premium payable in the light of charges made for insurance risk and administration services and the investment performance of the assets notionally backing these contracts. Delays in implementing increases in charges and market or regulatory restraints over the extent of the increases may reduce this mitigating effect.

A number of these contracts also include Permanent Health Insurance (PHI) benefits which have reviewable charges and the Group reserves the right to alter these charges based on its morbidity experience and hence to minimise its exposure to morbidity risk. Delays in implementing increases in charges and market or regulatory restraints over the extent of the increases may reduce this mitigating effect.

Reinsurance is used extensively on the business described above to mitigate concentrations of insurance risk.

For units held under unit-linked contracts all of the investment risk is borne by the policyholder, with the exception of a small number of contracts which provide for a minimum guaranteed rate of return, as investment performance directly affects the value of the unit fund and hence the benefits payable. Therefore, the Group is exposed only to insurance risk insofar as the value of the unit fund is lower than the guaranteed minimum death benefit. This insurance risk is managed primarily through pricing, product design and appropriate investment strategy.

Concentration of insurance risk

The tables for long term insurance contracts set out below illustrate the concentration of risk based on five bands of contracts grouped by benefits assured for each policy assured.

Benefits assured for each life assured	Total benefits assured			
	Before reinsurance		After reinsurance	
	£m	%	£m	%
In £000's bands				
As at 31 December 2006				
0 – 250	5,941	97.1	4,107	99.4
250 – 500	123	2.0	20	0.5
500 – 750	33	0.5	4	0.1
750 – 1,000	14	0.2	–	–
More than 1,000	10	0.2	1	–
	<u>6,121</u>	<u>100</u>	<u>4,132</u>	<u>100</u>

4 Management of insurance and financial risk (continued)

Benefits assured for each life assured In £000's bands	Total benefits assured			
	Before reinsurance		After reinsurance	
	£m	%	£m	%
As at 31 December 2005				
0 – 250	6,986	97.3	4,680	99.7
250 – 500	133	1.9	13	0.3
500 – 750	32	0.4	2	–
750 – 1,000	16	0.2	–	–
More than 1,000	12	0.2	–	–
	<u>7,179</u>	<u>100</u>	<u>4,695</u>	<u>100</u>

In addition to the above the Group has, at 31 December 2006, a total of approximately £18m per annum of retained PHI sums assured. The Group does not retain PHI sums assured on any one life greater than £25,000 per annum.

Long-term insurance contracts – guaranteed annuity options

Product features

There are a small number of unit-linked deferred annuity policies with guarantees regarding the rate at which the policyholder is able to convert the unit fund into an annuity at retirement, which creates an insurance liability. At retirement the fund available can either be transferred to another provider, used to purchase an annuity with a Group company at the current annuity rates then applying, or used to purchase an annuity from a Group company at guaranteed annuity rates written into the policy document. The guaranteed annuity rates are only available in certain circumstances. Policyholders gain the benefit of whichever of the then-current annuity rates and guaranteed annuity rates gives them the higher benefits.

Management of risks

The main risks associated with this product are longevity and market risks. These were controlled through product design and pricing. However, the guaranteed annuity rates were set during the 1960s and 1970s, when these products were sold. As these rates are no longer suitable in current conditions, appropriate technical provisions are held to reflect the risk arising from the guarantees.

The longevity assumptions underlying the technical provisions are based on both historic in-house and industry available information on mortality experience for the population of policyholders, including allowances for future mortality improvements.

Concentration of insurance risks

There are 380 such policies in force at 31 December 2006. The underlying contracts have total unit funds of £4.8m, with the largest fund being less than £0.2m.

Other risks on insurance contracts

Apart from financial risks relating to the financial assets, which support life assurance contracts, (described below), there are other significant types of risk pertaining to life insurance contracts, as follows:

Expense risk

The Group strategy is to outsource policy administration to third party administrators in order to reduce the significant expense inefficiencies that would arise with fixed and semi-fixed costs on a diminishing policy base. There are, however, risks associated with the use of outsourcing. In particular, there will be a need in future to renegotiate the terms of the outsourcing arrangements as the existing agreements expire. There is also a risk that at some point in the future third party administrators could default on their obligations. The Group monitors the financial soundness of third party administrators and it has retained step-in rights on the more significant of these agreements. There are also contractual arrangements in place which provide for financial penalties in the event of default by the administration service providers.

Mortgage endowment misselling complaints

The life businesses have experienced a significant level of complaints from mortgage endowment policyholders since their first regulatory mailing programme in 2000. In response to this, the life businesses hold mortgage endowment complaints redress provisions. The Group continues to monitor closely, among other factors, the volume of complaints and the value of compensation paid to policyholders in order to assess the continuing adequacy of the provisions.

There remains however a residual risk that at some point in future the levels of complaints received may prove to be higher than those anticipated within the provision.

(b) Investment contracts

The Group provides three types of investment contract which are predominantly written in the UK.

(i) Unit-linked savings

These are typically single premium contracts, with the premiums invested in a pooled investment fund (usually an internal fund of the life assurance company), where the policyholder's investment in the fund is represented by units. There is a small additional benefit payable on death which does not transfer significant insurance risk to the Group for these contracts. The benefits payable at maturity or surrender of the contract are the bid value of these units.

The key variables affecting the timing and uncertainty of future cash flows are investment performance, persistency and expense inflation.

(ii) Unit-linked pensions

The contractual features are similar to unit-linked savings, except they may be single or regular premium contracts. The benefits payable on retirement purchase an open market pension annuity.

The key variables affecting the timing and uncertainty of future cash flows are investment performance, interest risks, persistency and expense inflation.

(iii) Guaranteed Income and Growth Bonds

These are mainly single premium contracts for a fixed term offering either monthly or annually fixed payments together with a return of premium at the maturity date. A guaranteed growth bond variant has also been issued which offers no income but a higher guaranteed payment at the maturity date.

The key variables affecting the timing and uncertainty of cash flows are expense inflation, interest rates, persistency and mortality.

Risks associated with investment contracts

The risks associated with investment contracts are expense risk, persistency risk and market risk. Market risk is the risk of loss of fair value resulting from adverse fluctuations in interest and foreign currency exchange rates and in equity prices and the consequent effect that this has on the value of charges earned by the Group and on any guarantees in the contracts. Expense risk is of the same nature as described under other risks on insurance contracts above. Persistency risk is the risk that the investor cancels the contract or discontinues paying new premiums into the contract, thereby exposing the Group to a loss resulting from an adverse movement in the actual experience compared to that expected in the product pricing. Although changes in the levels of persistency would not adversely affect the result in the short term they would reduce future profits available from the contract.

(c) Financial risk management

The Group is exposed to financial risk through its life assurance contracts, financial assets, the financial liabilities which it issues, including investment contracts, and its reinsurance assets. These financial risks include market risk, credit risk (including risk of reinsurer default), and liquidity risk. Each of these financial risks is described below, together with a summary of the ways in which the Group manages them.

Market risk

Market risk is the risk that arises from exposure to adverse variations in the fair value of financial instruments and the value of insurance contract provisions due to changes in interest rates, asset prices (including equities) and foreign currency exchange rates.

4 Management of insurance and financial risk (continued)

(1) Interest rate risk in insurance contracts and financial instruments

The Group's exposure to market risk for changes in interest rates is concentrated in its investment portfolio, and to a lesser extent, its debt obligations. However, changes in investment values attributable to interest rate changes are mitigated by corresponding and partially offsetting changes in the economic value of insurance contract provisions, investment contract liabilities and debt obligations. The Group monitors this exposure through periodic reviews of its asset and liability positions. Estimates of cash flows, as well as the impact of interest rate fluctuations relating to the Group's investment portfolio and insurance contract provisions, are monitored periodically. The Group's objective is to match the timing of cash flows from insurance and investment contract liabilities with the timing of cash flows from assets subject to identical or similar risks. This policy ensures that the Group is able to meet its obligations under its contractual liabilities as they fall due. The overall objective of these strategies is to limit the net changes in the value of assets and liabilities arising from interest rate movements. The Group believes that interest rate movements will generate asset value changes that substantially offset changes in the value of the liabilities relating to the underlying products.

The Group specifically writes a number of contracts which expose it to interest rate risk. Primarily, these are annuities and non-linked investment contracts.

Assets held to meet regulatory capital requirements and surplus assets are mainly held in fixed interest securities and cash and cash equivalents. The Group's exposure to interest rate risk in respect of these assets is reduced by holding only short-term securities.

Annuities

The Group's immediate annuities expose it to interest rate risk. Deviations from expected mortality expose the Group to interest rate risk as the interest-bearing assets which back the annuities may not match the duration of the cash out-flows, with a consequential risk that the Group will not be able to invest in assets with suitable returns to support the annuity payments. There is also an exposure to interest rates arising as a result of the guaranteed annuity option described above, in respect of a small number of deferred annuities.

Non-linked investment contracts

The Group writes guaranteed income and guaranteed growth bonds which contain guaranteed payments. The Group is exposed to interest rate risk in these contracts as it holds interest-bearing securities which are expected to meet the cash flows from the bonds. This risk is managed through investing in fixed interest securities which mature at the guaranteed value, although there is some residual risk which arises from the effect of the uncertainty in timing of cash flows due to the variability inherent in deaths and surrenders before maturity.

The Group is also exposed to the risk of changes in future cash flows from fixed income securities arising from changes in market interest rates.

The table below summarises the effective interest rates at the balance sheet date for interest-bearing assets and liabilities, together with the contractual maturity dates of those assets and liabilities.

Interest bearing assets and liabilities

As at 31 December 2006	Effective interest rate %	Non-linked					Total non- linked £000	Linked £000	Total £000
		Less than one year £000	One to five years £000	Five to ten years £000	Over ten years £000				
Debt securities-fixed	5.97	67,325	81,304	20,395	65,317	234,341	113,966	348,307	
Debt securities-floating	5.22	2,217	–	–	–	2,217	–	2,217	
Cash and cash equivalents-cash	5.20	26,104	–	–	–	26,104	4,675	30,779	
Cash and cash equivalents- deposits	5.11	115,960	–	–	–	115,960	154,479	270,439	
Borrowings	7.04	(4,200)	(12,600)	–	–	(16,800)	–	(16,800)	
Interest-bearing investment contract liabilities	5.20	(70,428)	(73,207)	–	–	(143,635)	–	(143,635)	
Net assets and liabilities		136,978	(4,503)	20,395	65,317	218,187	273,120	491,307	

As at 31 December 2005	Effective interest rate %	Non-linked					Total non- linked £000	Linked £000	Total £000
		Less than one year £000	One to five years £000	Five to ten years £000	Over ten years £000				
Debt securities-fixed	4.36	66,971	119,954	23,443	66,759	277,127	105,187	382,314	
Debt securities-floating	4.84	1,503	–	–	–	1,503	–	1,503	
Cash and cash equivalents-cash	4.75	35,457	–	–	–	35,457	6,338	41,795	
Cash and cash equivalents- deposits	4.75	82,483	–	–	–	82,483	158,174	240,657	
Borrowings	6.88	(4,200)	(16,800)	–	–	(21,000)	–	(21,000)	
Interest-bearing investment contract liabilities	4.20	(47,803)	(113,953)	–	–	(161,756)	–	(161,756)	
Net assets and liabilities		134,411	(10,799)	23,443	66,759	213,814	269,699	483,513	

These tables disclose assets and liabilities which are held in linked funds separately from other assets and liabilities as the interest rate exposure in these liabilities is matched with a corresponding exposure in the assets held to match the liabilities.

Included within the less than one year category are instruments which do not have a maturity date.

The Group also has an indirect exposure to the average mortgage rate as follows:

Mortgage rate risk

Products which are invested in the Guaranteed Growth Fund provide a return to policyholders which is linked to the average mortgage rate. The risk arises due to a mismatch of assets and liabilities as there are no suitable assets available to back this guarantee and hence the assets are held in cash. This means that the return on assets held is lower than the return given to policyholders. Provisions are held to meet this shortfall, on appropriate assumptions as to future levels of return on assets and return given to policyholders. There is a risk that the return given to policyholders will increase by more than the return on assets due to inability to match the guarantee – that is, that the spread between mortgage rates and cash deposit rates will increase.

(2) Equity price risk

The Group's portfolio of marketable equity securities, which is carried on the balance sheet at fair value, has exposure to price risk. This risk is defined as the potential loss in market value resulting from an adverse change in prices. The Group has a policy of not having significant investments in equities within the shareholder funds. However shareholders are still exposed to movements within policyholder funds. In general the assets are matched by corresponding insurance contract provisions and investment contract liabilities.

The areas where there is a residual risk to shareholders are as follows:

(i) Surplus units

Market risk arises from the existence of surplus units (over and above requirements to match policyholder unit liabilities) in the insurance company funds. Such surplus units (which effectively back surplus carried forward in the long-term insurance funds) arise because the number of units in the funds are in decline.

(ii) Mortgage endowment misselling redress provision

Market risk arises in two ways in respect of the redress provisions for mortgage endowment misselling.

The first is that a fall in equity prices directly increases the cost of future redress payments. In addition it is also likely that a large fall in equity prices would increase the propensity for policyholders to make a complaint about their mortgage endowment policies.

(iii) Guarantees in Timed Investment Funds

Investment guarantees have been made in respect of policies invested in the Group's Timed Investment Funds whereby the price paid to policyholders for their units on death or maturity will always be the highest price that the units have reached during their period of investment in the funds. Although there is a charge paid by policyholders for this guarantee there is a risk to shareholders that this will be insufficient to meet the full cost of this guarantee: this risk is managed within the investment strategy of the fund (see Note 27(d) (on page 88) for more details).

4 Management of insurance and financial risk (continued)

(iv) Change in insurance contract provisions

When calculating insurance contract provisions for the non unit component of liabilities under linked contracts allowance is made for both future investment management charges and investment expenses as a proportion of unit funds. As investment charges are generally in excess of investment expenses this surplus is used to offset future administration expenses on the contracts. In a falling market the absolute amount of the surplus of investment charges over investment expenses would reduce and hence this might lead to an increase in insurance contract provisions.

(3) Foreign currency exchange risk

The Group is not materially exposed to foreign exchange risk as the only assets denominated in foreign currencies are matched by corresponding insurance contract provisions and financial liabilities.

Credit risk

Credit risk is the risk that a counterparty will be unable to pay amounts in full when due.

The Group is exposed to credit risk in the following areas:

- (i) reinsurers' share of insurance liabilities;
- (ii) amounts deposited with reinsurer in relation to investment contracts;
- (iii) amounts due from reinsurers in respect of claims already paid; and
- (iv) counterparty risk with respect to corporate bond, deposits and debt securities.

The Group structures the levels of credit risk it accepts by placing limits on its exposure to a single counterparty, or group of counterparties. Such risks are subject to at least an annual review.

By far the largest credit risk to the Group is in relation to its reinsurance assets. Although the Group holds a significant proportion of its financial assets in securities, the risk of default on these is mitigated to the extent that any losses arising in respect of unit linked funds backing the insurance and investment contracts the group issues, would effectively be passed on to policyholders and investors through the unit-linked funds backing the insurance and investment contracts the Group issues.

The Group retains some residual risks on assets which support annuities, guaranteed investment bonds and shareholder's equity. These risks are monitored: a key aspect of this is the Group's policy of investing only in high-quality corporate bonds and government-issued debts. The Group does not currently purchase assets rated below AA by Standard and Poors.

The Group's objective is to earn competitive relative returns by investing in a diversified portfolio of securities. Watch lists are maintained for exposures requiring additional review and all credit exposures are reviewed at least annually.

The Group's exposure to credit risk in relation to its debt securities and cash balances is summarised below:

As at 31 December 2006	Credit rating-debt securities				Cash balances £000	Total £000
	AAA £000	AA £000	A £000	Unrated £000		
Debt securities, deposits and cash balances with credit institutions						
Linked	2,560	70,477	64,810	–	27,320	165,167
Non-linked	61,422	92,291	32,564	310	101,675	288,262
Government or pseudo Government deposits						
Linked	110,601	–	–	–	–	110,601
Non-linked	87,712	–	–	–	–	87,712
Total debt, deposits and cash balances	262,295	162,768	97,374	310	128,995	651,742

As at 31 December 2005	Credit rating-debt securities				Cash balances £000	Total £000
	AAA £000	AA £000	A £000	Unrated £000		
Debt securities, deposits and cash balances with credit institutions						
Linked	2,514	217	12,368	–	152,322	167,421
Non-linked	82,128	80,603	12,841	327	130,130	306,029
Government or pseudo Government deposits						
Linked	–	–	–	102,278	–	102,278
Non-linked	–	–	–	90,541	–	90,541
Total debt, deposits and cash balances	84,642	80,820	25,209	193,146	282,452	666,269

Reinsurance credit risk

Reinsurance is used to manage insurance risk. This does not however discharge the Group's liability as primary insurer. If a reinsurer fails to pay a claim for any reason, the Group remains liable for the payment to the policyholder. The creditworthiness of major reinsurers is considered on an annual basis by reviewing their financial strength.

It should be noted that for historical reasons the Group has a significant exposure of £232.5m (of which £208.3m is in respect of currently guaranteed benefits) at 31 December 2006 (31 December 2005: £221.3m) to Guardian, which does not have a published credit rating. The exposure which relates to reinsured insurance contract liabilities, and which relates to amounts deposited with Guardian in respect of investment contract liabilities, was mitigated during the year when Guardian granted to CA a legal charge over related investment assets.

The Group also has significant exposure to Irish Life Assurance plc, which does not have a published credit rating, of £36.4m at 31 December 2006 (31 December 2005: £37.7m) in relation to reinsured insurance liabilities and amounts deposited in respect of investment contracts.

At 31 December 2005 the Group had similar exposure of £7.7m in respect of GE Frankona, but this exposure transferred to Swiss Re, which had a published credit rating (AA-, Source: S&P) during the year ended 31 December 2006.

In addition the Group also has an exposure on a number of its risk premium reinsurance contracts, although in general the premiums payable under these contracts in any period will be higher than the claims payments received.

Liquidity risk

The Group has to meet daily calls on its cash resources. There is therefore a risk that cash will not be available to settle liabilities when due at a reasonable cost. The Group manages this risk by regular monitoring of its cash flow position.

5 Acquisition and disposal of subsidiaries

Acquisition

On 2 June 2005, Chesnara plc acquired the whole of the issued ordinary share capital of CWA Life Holdings plc ("CWALH"), formerly Irish Life (UK) Holdings plc, from Irish Life and Permanent plc, of which City of Westminster Assurance Company Limited ("CWA") was a wholly-owned subsidiary. CWA was the principal operating subsidiary of CWALH and was a UK based business concentrating on the operation of a life assurance book which was closed to new business. The acquired business contributed revenues of £126,398,000 and net profit of £12,686,000 to the Chesnara plc Group for the period from 2 June 2005 to 31 December 2005. If the acquisition had occurred on 1 January 2005, Chesnara plc Group's revenue would have been £406,005,000 and net profit would have been £18,161,000 for the year ended 31 December 2005.

Details of net assets acquired and goodwill are as follows:

	£000
Purchase consideration:	
Cash paid	47,500
Direct costs relating to the acquisition	278
Total purchase consideration	47,778
Fair value of net assets acquired	(47,778)
Goodwill	–

No goodwill arose on the acquisition of CWALH. This is because the principal operating subsidiary of CWALH, CWA, was closed to new business and because the excess of the total purchase consideration paid over the fair value of the identifiable tangible net assets of the CWALH Group at the acquisition date was established as the fair value of the purchased value attributed to acquired in-force investment and insurance contracts at the acquisition date.

Due to the timing of the acquisition, the fair values of the assets and liabilities acquired, which were reported as at 30 June 2005 in the interim financial statements for the six months then ended were provisional and were subject to review up to twelve months after the acquisition date.

As at 31 December 2005 the provisional fair values were updated to reflect the latest information available and the following table, which sets out the assets and liabilities at acquisition, details the acquiree's carrying amount and the adjustments to the fair values of the net assets acquired which were reflected in the six months ended 31 December 2005.

The assets and liabilities arising from the acquisition were as follows:

	Provisional fair value at acquisition £000	Adjustments and reclassifications £000	Updated fair value at acquisition £000	Acquiree's carrying amount £000
Intangible assets				
Deferred acquisition costs	9,858	–	9,858	9,858
Acquired value of in-force business				
Insurance contracts	19,619	5,234	24,853	–
Investment contracts	12,502	2,752	15,254	–
Investment properties	20,986	–	20,986	20,986
Financial assets				
Equity securities at fair value through income	419,948	–	419,948	419,948
Debt securities at fair value through income	160,605	–	160,605	160,605
Loans and receivables including insurance receivables	16,101	448	16,549	16,101
Derivative financial instruments	678	–	678	678
Deferred tax assets	–	–	–	3,024
Reinsurers' share of insurance contract provisions	8,241	(448)	7,793	8,241
Amounts deposited with reinsurers	–	35,788	35,788	–
Cash and cash equivalents	172,275	–	172,275	172,275
Insurance contract provisions	(344,138)	(3,549)	(347,687)	(344,138)
Financial liabilities				
Investment contracts at fair value through income	(409,865)	(33,985)	(443,850)	(409,865)
Derivative financial instruments	(1,614)	1,408	(206)	(1,614)
Deferred tax liabilities	(7,136)	(7,876)	(15,012)	–
Payables related to direct insurance and investment contracts	(10,027)	–	(10,027)	(10,027)
Deferred income	(13,859)	–	(13,859)	(13,859)
Income taxes	(1,206)	228	(978)	(1,206)
Other payables	(5,190)	–	(5,190)	(5,190)
Net assets	47,778	–	47,778	25,817

The following adjustments were made to the fair value of the net assets at acquisition:

	Increase/ (decrease) in net assets £000
(a) Net increase in insurance and investment contract liabilities to recognise unit enhancements on pension contracts	
– Gross	(760)
– Current tax relief thereon	228
(b) Impact on deferred tax liabilities of reassessment of cumulative timing differences at acquisition date	(6,348)
(c) Consequential impact of adjustments (a) and (b) on acquired value of in-force business	
– Insurance contracts (gross)	5,234
– Investment contracts (gross)	2,752
– Deferred tax thereon	(1,106)
Net increase in net assets	–

There was no net increase in net assets as a result of the update of the fair values of assets and liabilities at acquisition, because, as stated above, the excess of the total purchase consideration paid over the fair value of the identifiable net assets at the acquisition date was established as the fair value of the acquired value of in-force business at the acquisition date.

Notes to the Consolidated Financial Statements (continued)

5 Acquisition and disposal of subsidiaries (continued)

All other restatements to the provisional fair values of assets and liabilities at acquisition, reflected reclassifications between assets and liabilities and had no impact on the fair value of net assets at acquisition.

Disposal

On 15 March 2006 the Group disposed of its interest in Premium Life International Limited to LCL International Life Assurance Company Limited for a consideration receivable in cash of £1, which, net of cash balances of £ 295,067 in the subsidiary at that date, gave rise to a net cash outflow of £295,066. This amount is reflected as a cash outflow from investing activities in the Consolidated Statement of Cash Flows.

The contribution of the subsidiary to the net profit for the year ended 31 December 2006 is not material and a loss of £248,000 arising on the disposal has been recognised in the Consolidated Income Statement for that period.

Following the disposal there was a reduction of £2,030,000 in the regulatory capital resource requirements of Countrywide Assured plc, which are disclosed in Note 27 (a) (on page 85) and there was a reduction in available capital resources of £248,000.

6 Insurance premium revenue

	Year ended 31 December 2006				Year ended 31 December 2005			
	Unit linked-without DPF £000	Other-without DPF £000	With DPF £000	Total £000	Unit linked-without DPF £000	Other-without DPF £000	With DPF £000	Total £000
Insurance premium revenue	84,755	24,711	3,334	112,800	89,023	23,225	3,425	115,673
Insurance premium ceded to reinsurers	(12,468)	(6,622)	(3,104)	(22,194)	(14,642)	(8,947)	(3,102)	(26,691)
Net insurance premium revenue	72,287	18,089	230	90,606	74,381	14,278	323	88,982

7 Fees and commission income

	Year ended 31 December 2006		Year ended 31 December 2005	
	Insurance contracts £000	Investment contracts £000	Insurance contracts £000	Investment contracts £000
Fee income				
Policy based fees	10,598	3,906	13,858	2,389
Fund management based fees	3,336	3,021	2,668	1,823
Benefit based fees	29,053	252	32,293	135
Change in deferred income – gross	–	1,964	–	1,702
Change in deferred income – reinsurer share	–	(58)	–	(78)
Total fee income	42,987	9,085	48,819	5,971
Commission income	532	–	586	–
Total fee and commission income	43,519	9,085	49,405	5,971

8 Investment income

	Year ended 31 December	
	2006 £000	2005 £000
Dividend income	34,271	17,901
Interest income	28,767	7,929
Rental income from investment properties	1,610	1,236
Net fair value gains and losses		
Equity securities designated as at fair value through income on initial recognition	97,780	121,690
Debt securities designated as at fair value through income on initial recognition	(13,733)	62,773
Derivative financial instruments	447	1,844
Investment properties	2,328	1,318
Total investment income	151,470	214,691

Net fair value gains and losses in respect of holdings in collective investment schemes are included in the line that is most appropriate taking into account the nature of the underlying investments.

No amounts included in net fair value gains and losses of financial instruments were estimated using a valuation technique (2005: £nil).

9 Other operating income

	Year ended 31 December	
	2006 £000	2005 £000
Release of unused provisions	8	281
Recharge of shared property services to tenants	453	401
Administration fees charged to reinsurers	248	341
Professional indemnity insurance recoveries	254	203
Other	232	–
Total other operating income	1,195	1,226

10 Policyholder claims and benefits

	Year ended 31 December 2006				Year ended 31 December 2005			
	Unit linked-without DPF £000	Other-without DPF £000	With DPF £000	Total £000	Unit linked-without DPF £000	Other-without DPF £000	With DPF £000	Total £000
Claims and benefits paid to policyholders	134,578	24,297	6,858	165,733	132,143	31,797	5,409	169,349
Net increase/(decrease) in insurance contract provisions	44,297	6,551	1,960	52,808	91,114	7,501	23,957	122,572
Total policyholder claims and benefits	178,875	30,848	8,818	218,541	223,257	39,298	29,366	291,921
Recoveries from reinsurers	(21,266)	(3,116)	(8,379)	(32,761)	(27,615)	(4,902)	(28,783)	(61,300)
Net policyholder claims and benefits incurred	157,609	27,732	439	185,780	195,642	34,396	583	230,621

Notes to the Consolidated Financial Statements (continued)

11 Change in investment contract liabilities

	Year ended 31 December	
	2006 £000	2005 £000
Net changes in the fair value of investment contracts designated on initial recognition as fair value through income	58,905	85,130
Reinsurer's share	(1,304)	(3,742)
Net change in investment contract liabilities	57,601	81,388

Investment contract benefits comprise benefits accruing to holders of investment contracts issued by the Group.

The total amount included in net changes in the fair value of investment contracts, which were estimated using a valuation technique was £58,905,000 (2005: £85,130,000).

12 Fees, commission and other acquisition costs

	Year ended 31 December	
	2006 £000	2005 £000
Directly expensed costs		
Insurance contracts		
Commission	65	171
New business and renewal costs	139	203
Investment contracts		
Commission	344	353
New business and renewal costs	53	18
Amortisation of deferred acquisition costs		
Insurance contracts	1,114	4,009
Investment contracts-gross	1,199	989
Investment contracts-reinsurance	(33)	(44)
Total	2,881	5,699

13 Administrative expenses

	Year ended 31 December	
	2006 £000	2005 £000
Depreciation	–	105
Personnel-related costs	2,450	2,486
Costs paid to third-party administrators	6,650	8,024
Other goods and services	8,084	8,060
Total	17,184	18,675

Included in Other Goods and Services above are the following amounts payable to the Auditor and its associates, exclusive of VAT.

	Year ended 31 December	
	2006 £000	2005 £000
Fees payable to the Company's Auditor for the audit of the company's annual accounts	17	76
Fees payable to the Company's Auditor and its associates for other services:		
The audit of the Company's subsidiaries pursuant to legislation	223	238
Other services pursuant to legislation	136	201
Tax services	49	55
Services related to information technology	21	–
Services relating to corporate finance activities	–	365
All other services	15	52
	461	987

14 Other operating expenses

	Year ended 31 December	
	2006 £000	2005 £000
Charge for amortisation of intangible assets		
Amortisation of acquired value of in-force business		
Insurance contracts	2,756	1,771
Investment contracts	1,017	593
Total	3,773	2,364
Reinsurance recapture premium	1,374	–
With effect from 31 December 2006 a reinsurance arrangement with Munich Re was terminated. This resulted in a recapture premium payable to them of the amount shown above.		
Other		
Increase in provisions	8	125
Direct operating expenses of investment properties		
Revenue-generating properties	680	116
Non revenue-generating properties	38	17
Other	55	9
Total	781	267

Notes to the Consolidated Financial Statements (continued)

15 Financing costs

	Year ended 31 December	
	2006 £000	2005 £000
Interest expense on bank borrowings	1,206	805

Interest expense on bank borrowings is calculated using the effective interest method and is the total interest expense for financial liabilities that are not designated at fair value through income.

16 Income tax expense

	Year ended 31 December	
	2006 £000	2005 £000
Current tax expense		
Current year	4,212	5,021
Adjustment to prior years	626	–
Overseas tax	334	253
	<u>5,172</u>	<u>5,274</u>
Deferred tax expense		
Origination and reversal of temporary differences	619	(3,433)
	<u>619</u>	<u>(3,433)</u>
Total income tax expense	5,791	1,841

Reconciliation of effective tax rate on profit before tax

	Year ended 31 December	
	2006 £000	2005 £000
Profit before tax	25,047	20,456
Income tax using the domestic corporation tax rate of 30% (2004: 30%)	7,514	6,137
Effect of tax rates in offshore jurisdictions	–	4
Permanent differences	163	–
Effect of UK taxing bases on insurance profits		
Offset of franked investment income	(3,463)	(3,790)
Other	951	(510)
Under provided in prior years	626	–
	<u>626</u>	<u>–</u>
Total income tax expense	5,791	1,841

17 Deferred acquisition costs

	Insurance contracts		Investment contracts		Total	
	2006 £000	2005 £000	2006 £000	2005 £000	2006 £000	2005 £000
Balance at 1 January	1,114	5,120	11,886	3,017	13,000	8,137
Additions-acquisition of subsidiary	–	–	–	9,858	–	9,858
Additions-other	–	3	–	–	–	3
Amortisation charged to income	(1,114)	(4,009)	(1,199)	(989)	(2,313)	(4,998)
Impairment losses	–	–	–	–	–	–
Balance at 31 December	–	1,114	10,687	11,886	10,687	13,000
Current	–	1,114	1,093	1,538	1,093	2,652
Non-current	–	–	9,594	10,348	9,594	10,348
Total	–	1,114	10,687	11,886	10,687	13,000

The amortisation charged to income is recognised in Fees, Commission and Other Acquisition Costs (see Note 12 on page 74).

18 Acquired value of in-force business (AVIF)

	AVIF on insurance contracts £000	AVIF on investment contracts £000	Total £000
Cost			
Balance at 1 January 2005	8,425	–	8,425
Additions-acquisition of subsidiary	24,853	15,254	40,107
Balance at 31 December 2005	33,278	15,254	48,532
Additions	–	–	–
Balance at 31 December 2006	33,278	15,254	48,532
Amortisation and impairment losses			
Balance at 1 January 2005	6,607	–	6,607
Amortisation for the year	1,771	593	2,364
Impairment charge	–	–	–
Balance at 31 December 2005	8,378	593	8,971
Amortisation for the year	2,756	1,017	3,773
Impairment charge	–	–	–
Balance at 31 December 2006	11,134	1,610	12,744
Carrying amounts			
At 31 December 2005	24,900	14,661	39,561
At 31 December 2006	22,144	13,644	35,788
31 December 2005			
Current	2,756	1,017	3,774
Non-current	22,144	13,644	35,787
Total	24,900	14,661	39,561
31 December 2006			
Current	2,716	1,017	3,733
Non-current	19,428	12,627	32,055
Total	22,144	13,644	35,788

Notes to the Consolidated Financial Statements (continued)

18 Acquired value of in-force business (AVIF) (continued)

The amortisation period of AVIF on insurance contracts is 13 years and the amortisation period for AVIF on investment contracts is 15 years.

The amortisation is charged to income and is recognised in Other Operating Expenses (see Note 14 on page 75).

The cost and accumulated amortisation on insurance contracts at 1 January 2005 relates to the acquisition of Premium Life Assurance Company Limited in 1996.

19 Property and equipment

	Motor vehicles £000	Computer equipment £000	Fixtures, fittings and office equipment £000	Total £000
Cost				
Balance at 1 January 2005	12	1,088	113	1,213
Additions	–	2	–	2
Disposals	(12)	(1,090)	(113)	(1,215)
Balance at 31 December 2005	–	–	–	–
Additions	–	–	–	–
Disposal	–	–	–	–
Balance at 31 December 2006	–	–	–	–
Depreciation and impairment losses				
Balance at 1 January 2005	12	741	57	810
Depreciation charge for the year	–	95	10	105
Disposals	(12)	(836)	(67)	(915)
Balance at 31 December 2005	–	–	–	–
Depreciation charge for the year	–	–	–	–
Disposals	–	–	–	–
Balance at 31 December 2006	–	–	–	–
Carrying amounts				
At 1 January 2005	–	347	56	403
At 31 December 2005	–	–	–	–
At 31 December 2006	–	–	–	–

20 Investment properties

	31 December	
	2006 £000	2005 £000
Balance at 1 January	25,422	3,092
Additions		
Acquisition of subsidiary company	–	20,986
New properties	–	675
Disposals	–	(649)
Fair value adjustments	2,328	1,318
Impairment losses	–	–
Balance at 31 December	27,750	25,422
Current	24,241	–
Non-current	3,509	25,422
Total	27,750	25,422

Investment properties have been bought for investment purposes in line with the investment strategy of the Group. The properties are independently valued in accordance with International Valuation Standards on the basis of determining the open market value of the investment properties on an annual basis. The latest valuations were conducted as at 31 December 2006.

Income arises from investment properties in two streams:

- (i) Fair value gains arising as a result of market appreciation in the value of the properties and
- (ii) Rental income arising from leases granted on the properties.

Both of these amounts are disclosed in Investment Income (see Note 8 on page 73). Expenses incurred in the operation and maintenance of investment properties are disclosed in Other Operating Expenses (see Note 14 on page 75).

Notes to the Consolidated Financial Statements (continued)

21 Financial assets

Group	31 December	
	2006 £000	2005 £000
Financial assets by measurement category		
Fair value through income		
Designated at fair-value through income on initial recognition	1,431,363	1,412,674
Derivative financial instruments	30,642	16,108
Loans and receivables	17,310	19,810
Total	1,479,315	1,448,592

	31 December	
	2006 £000	2005 £000
Financial assets at fair value through income		
Equities		
Listed	738,487	688,478
Debt securities-fixed rate		
Government Bonds	198,314	192,819
Listed	149,993	189,495
Debt securities-floating rate		
Listed	2,217	1,503
Total debt securities	350,524	383,817
Holdings in collective investment schemes	342,352	340,379
Derivative financial instruments	30,642	16,108
Total	1,462,005	1,428,782
Current	339,091	273,721
Non-current	1,122,914	1,155,061
Total	1,462,005	1,428,782

Company	31 December	
	2006 £000	2005 £000
Investments in subsidiaries	52,006	52,006
Current	–	–
Non-current	52,006	52,006
Total	52,006	52,006

22 Loans and receivables, including insurance receivables

Group	31 December	
	2006 £000	2005 £000
Receivables arising from insurance contracts		
Policyholders	2,258	2,651
Receivables arising from investment contracts		
Policyholders	13	20
Reinsurance receivables	716	3,250
Commission receivables	508	267
Debtor for professional indemnity insurance	80	122
Other receivables		
Accrued interest income	12,259	11,165
Accrued rental income	–	684
Related party receivables	77	130
Other	1,399	1,521
Total loans and receivables	17,310	19,810
Current	17,310	19,810
Non-current	–	–
Total	17,310	19,810

The fair value of loans and receivables is £17,310,000 (2005: £19,810,000).

Company	31 December	
	2006 £000	2005 £000
Amounts due from subsidiary companies	473	1,439
Other	78	33
Total loans and receivables	551	1,472
Current	551	1,472
Non-current	–	–
Total	551	1,472

The fair value of loans and receivables is £551,000 (2005: £1,472,000).

Notes to the Consolidated Financial Statements (continued)

23 Derivative financial instruments

The Group does not use derivatives as part of any hedging strategies to mitigate risk.

Non-hedge derivatives within unit-linked funds

As part of its Investment management strategy, the Group purchases derivative financial instruments comprising part of its investment portfolio for unit-linked investment funds, which match the liabilities arising on its unit-linked insurance and investment business.

A variety of equity futures are part of the portfolio matching the unit-linked investment and insurance liabilities. Derivatives are used to facilitate more efficient portfolio management allowing changes in Investment strategy to be reflected by futures transactions rather than a high volume of transactions in the underlying assets.

All the contracts are exchange-traded futures, with their fair value being the bid price at the balance sheet date.

	31 December 2006		31 December 2005	
	Asset £000	Liability £000	Asset £000	Liability £000
Exchange-traded futures (by geographical investment market)				
Australia	808	(108)	741	(59)
Switzerland	1,777	(85)	690	–
Europe	7,394	(85)	3,429	–
UK	1,067	(28)	1,352	–
Hong Kong	1,755	(203)	471	(12)
Japan	2,869	(809)	1,258	(345)
South Korea	3,208	(10)	3,389	–
Sweden	596	(3)	242	–
Singapore	568	(11)	419	–
USA	10,600	(79)	3,482	–
Total exchange traded futures	30,642	(1,421)	15,473	(416)
Fixed interest	–	–	635	–
Total	30,642	(1,421)	16,108	(416)
Current	30,642	(1,421)	16,108	(416)
Non-current	–	–	–	–
Total	30,642	(1,421)	16,108	(416)

24 Income tax assets

	31 December	
	2006 £000	2005 £000
Group		
Income tax assets, which are all current, comprise:		
Corporation tax recoverable	260	199
Company		
Corporation tax recoverable	153	150

25 Cash and cash equivalents

	31 December	
	2006 £000	2005 £000
Group		
Bank and cash balances	48,392	4,481
Call deposits due within 1 month	62,773	75,404
Call deposits due after 1 month	190,053	202,567
Total cash and cash equivalents	301,218	282,452
Bank overdrafts	–	–
Cash and cash equivalents in the statement of cash flows	301,218	282,452

The effective interest rate on short term bank deposits was 5.11% (2005: 4.75%), with an average maturity of 90 days. All deposits included in cash and cash equivalents are capable of being realised as cash within 90 days.

Included in cash and cash equivalents held by the Group are balances totalling £155,482,000 (2005: £152,322,000) held in unit-linked policyholders' funds.

	31 December	
	2006 £000	2005 £000
Company		
Bank and cash balances	297	180
Call deposits due within 1 month	11,258	1,031
Total	11,555	1,211

Notes to the Consolidated Financial Statements (continued)

26 Assets and related liabilities

	Shareholder funds		Policyholder funds				Total	
	31 December		Unit-linked 31 December		Non-linked 31 December		31 December	
	2006 £000	2005 £000	2006 £000	2005 £000	2006 £000	2005 £000	2006 £000	2005 £000
Assets								
Intangible assets								
Deferred acquisition costs	–	–	–	–	10,687	13,000	10,687	13,000
Acquired value of in-force business	35,788	39,561	–	–	–	–	35,788	39,561
Property and equipment	–	–	–	–	–	–	–	–
Investment properties	376	300	27,374	25,122	–	–	27,750	25,422
Financial assets	9,123	21,021	1,222,811	1,147,518	247,381	280,053	1,479,315	1,448,592
Reinsurers share of insurance contract provisions	–	–	118,588	187,048	88,691	12,515	207,279	199,563
Amounts deposited with reinsurer	–	–	63,229	62,697	492	–	63,721	62,697
Reinsurers share of accrued policyholder claims	–	–	4,191	4,810	–	–	4,191	4,810
Income taxes	260	199	–	–	–	–	260	199
Cash and cash equivalents	32,016	51,875	155,482	152,322	113,720	78,255	301,218	282,452
Interfund balances	76,652	40,609	594	(29,134)	(77,246)	(11,475)	–	–
Total assets	154,215	153,565	1,592,269	1,550,383	383,725	372,348	2,130,209	2,076,296
Liabilities								
Insurance contract provisions	–	–	932,496	920,856	182,701	151,208	1,115,197	1,072,064
Financial liabilities								
Investment contracts at fair value through income	–	–	658,352	629,111	154,627	174,035	812,979	803,146
Borrowings	16,574	20,638	–	–	–	–	16,574	20,638
Derivative financial instruments	–	–	1,421	416	–	–	1,421	416
Provisions	417	438	–	–	180	995	597	1,433
Deferred tax liabilities	13,946	13,327	–	–	–	–	13,946	13,327
Reinsurance payables	–	–	–	–	3,059	2,049	3,059	2,049
Payable related to direct Insurance and investment contracts	–	–	–	–	24,927	23,866	24,927	23,866
Deferred income	–	–	–	–	18,231	20,195	18,231	20,195
Income taxes	2,023	3,345	–	–	–	–	2,023	3,345
Other payables	7,000	7,550	–	–	–	–	7,000	7,550
Total liabilities	39,960	45,298	1,592,269	1,550,383	383,725	372,348	2,015,954	1,968,029
Net assets	114,255	108,267					114,255	108,267

This information is presented to illustrate the allocation and matching of assets and liabilities to shareholder funds and to internal policyholder funds.

The Group keeps linked investments separate from other investments and invests them separately, in accordance with the requests of the policyholders. Linked investments are held at the risk of policyholders. Therefore policyholders are entitled to all the gains on investments shown under this heading, but they also have to bear any losses.

27 Solvency and regulatory capital

This note provides information about the solvency and regulatory capital position of the Group. The Group's regulated life company falls outside the scope of the FSA's "realistic capital" regime. The life assurance business of the Group is mainly non-profit business, comprising both unit-linked and non-linked business. The with-profits liabilities of the life assurance business are wholly reassured to Guardian. Therefore, notwithstanding the existence of with-profits business, there is no with-profits fund and a Fund for Future Appropriations is not maintained. The relevant capital requirement for the long-term business fund is therefore the minimum solvency requirement determined in accordance with FSA regulations.

The Group's life assurance business, up to 30 June 2006, as determined for UK regulatory purposes, comprised Countrywide Assured plc ("CA") and City of Westminster Company Limited ("CWA"), which was acquired on 2 June 2005. On 30 June 2006, under the provisions of Part VII of the Financial Services and Markets Act 2000 (the "Part VII Transfer"), the long-term business of CWA was transferred to CA. As a result, the whole of the FSA regulated activity of the Group effectively subsists within CA from that date. CWA was de-authorised by the FSA as a regulated life company during September 2006. The transfer gives rise to a number of recognised and prospective benefits within the combined entity, including the determination of the capital resources and capital resource requirements, savings in operational expenses and relief of some accumulated tax losses in CA.

Notwithstanding these changes, the assumptions underlying the calculation of technical provisions are, where appropriate, determined separately for the ongoing portions of the long-term business conducted separately within CA and CWA prior to the Part VII Transfer. In the information which follows the designations "CA" and "CWA" relate to the separately regulated life companies, while the designations "CA business" and "CWA business" relate to the separate long-term businesses which were conducted within CA and CWA prior to the Part VII Transfer and which now continue within CA alone.

(a) Regulatory capital resources and requirements

The following summarises the capital resources and requirements of CA and CWA, as determined for UK regulatory purposes:

	31 December 2006	31 December 2005	
	CA	CA	CWA
Available capital resources (CR) (£m)	84.4	59.2	25.3
Long-term insurance capital requirement (LTICR) (£m)	28.8	25.7	8.4
Resilience capital requirements (RCR) (£m)	2.6	2.0	0.8
Total capital resource requirements (CRR) (£m)	31.4	27.7	9.2
Target capital requirement cover (£m)	45.8	40.5	14.2
Excess of CR over target requirement (£m)	38.6	18.7	11.1
Ratio of available CR to CRR	269%	214%	275%

Available capital resources are stated before provision for dividends which were approved by the respective CA and CWA Boards subsequent to 31 December 2005 and 31 December 2006, as the case may be, but prior to the date at which their respective financial statements are or were reported. Had adjustment been made to available capital resources for dividends approved by the respective Boards after 31 December 2005 to the date of the respective financial statements, CA's ratio of available CR to CRR would have been 185% and CWA's ratio of available CR to CRR would have been 158%. Similarly had adjustment been made to available capital resources for the final dividend of £20m approved by the CA Board after 31 December 2006, but prior to the date of these financial statements, CA's ratio of available CR to CRR would have been 205%.

CA's Board, as a matter of policy, will continue to target CR cover for total CRR at a minimum level of 150% of the LTICR plus 100% of the RCR. The CWA target capital requirement cover as at 31 December 2005 was expressed as a £5m excess over the total regulatory CRR, as a consequence of a long-standing agreement with the FSA.

Apart from this difference in treatment of target capital requirements prior to the Part VII Transfer referred to above, there are no significant inconsistencies in the bases used.

27 Solvency and regulatory capital (continued)

The CA solvency position benefited during 2006 from

- (1) A reduction of £6m in the Reinsurer Default Reserve held against the possible default by Guardian. This amount represented the whole of the reserve held against such default and followed the granting of a legal charge by Guardian over related investment assets. During 2005 the CA solvency position had benefited from a reduction of £3m to £6m in the same reserve, following a review of publicly available information relating to the financial position of Guardian; and
- (2) A reduction of £2.0m in the LTICR arising on the disposal of Premium Life International Limited, while CR reduced by £0.3m

(b) Group capital position statement

The following summarises the regulatory capital resources arising in both life and non-life entities, together with a statement of capital resources on a consolidated basis and with a reconciliation to shareholders' net equity established on the IFRS basis:

As at 31 December 2006:	Life business UK non- participating	Life business shareholder	Total life business £000	Other activities £000	Consolidation adjustments £000	Group total £000
	CA £000	CA £000				
Shareholder funds outside long-term insurance funds	–	91,274	91,274	46,635	(27,168)	110,741
Shareholder funds in long-term insurance funds	3,514	–	3,514	–	–	3,514
Total shareholder funds	3,514	91,274	94,788	46,635	(27,168)	114,255
Adjustment onto regulatory basis						
– Adjustments to assets	(1,094)	(9,304)	(10,398)	(52,085)	27,168	(35,315)
– Other	74	–	74	–	–	74
Total available capital resources	2,494	81,970	84,464	(5,450)	–	79,014

As at 31 December 2005:	Life business UK non-participating		Life business shareholder		Total life business £000	Other activities £000	Consolidation adjustments £000	Group total £000	IFRS adjustments £000	Group total – IFRS basis £000
	CA £000	CWA £000	CA £000	CWA £000						
Shareholder funds outside long-term insurance funds	–	–	57,995	14,073	72,068	36,120	(26,814)	81,374	6,155	87,529
Shareholder funds in long-term insurance funds	9,285	11,453	–	–	20,738	–	–	20,738	–	20,738
Total shareholder funds	9,285	11,453	57,995	14,073	92,806	36,120	(26,814)	102,112	6,155	108,267
Adjustment onto regulatory basis										
– Adjustments to assets	(2,450)	–	(278)	(273)	(3,001)	(54,478)	26,814	(30,665)	–	–
– Other	(5,329)	–	–	–	(5,329)	–	–	(5,329)	–	–
Total available capital resources	1,506	11,453	57,717	13,800	84,476	(18,358)	–	66,118	–	66,118

The tables presented above illustrate Group total capital resources as measured for the purposes of inclusion in the related regulatory returns. As at 31 December 2005, the life business shareholder funds were prepared on a UK GAAP basis and as they, therefore, excluded the effect of certain adjustments required to present net equity on an IFRS basis, the table as at that date has been extended to summarise the net effect of the measurement of assets and liabilities under IFRS, in order to illustrate the relationship with the total consolidated shareholder net equity included in the consolidated balance sheet. As at 31 December 2006, life business shareholder funds were prepared on an IFRS basis and no such extension is necessary to the table as at that date.

The following table summarises the movement in the available capital resources of the constituent funds of CA and CWA businesses for the year ended 31 December 2006:

	Life business UK non-participating		Life business shareholder		Total life business £000
	CA £000	CWA £000	CA £000	CWA £000	
At beginning of period	1,506	11,453	57,717	13,800	84,476
Reduction in reserve held against possible default by a reinsurer	6,000	–	–	–	6,000
Reinsurance recapture premium	(1,374)	–	–	–	(1,374)
Changes in maintenance expense assumptions	(3,292)	–	–	–	(3,292)
Surplus arising in the year, net of the effect of the items shown above	25,395	2,006	–	–	27,401
Net loss arising in shareholder fund	–	–	(1,947)	–	(1,947)
Transfer between funds under the provisions of Part VII FSMA 2000	13,459	(13,459)	–	–	–
Effective reduction of capital available to life business consequent on deauthorisation	–	–	–	(3,000)	(3,000)
Transfer from long-term business fund to shareholder fund	(39,200)	–	39,200	–	–
Dividends paid to shareholders	–	–	(13,000)	(10,800)	(23,800)
At end of period	2,494	–	81,970	–	84,460

There were no changes in available capital resources for the year ended 31 December 2006 due to change in management policy, regulatory changes or external factors. The effect of new business written in the period on available capital resources is not considered to be material.

Subject to the capital management policy of the Group as set out below, capital resources are available for use elsewhere in the Group.

The Group has no formal intragroup funding arrangements.

(c) *Technical provisions net of reinsurance*

(i) The technical provisions established to determine the regulatory capital resources as set out above are:

Technical provisions	31 December 2006		31 December 2005		
	CA £000	Total £000	CA £000	CWA £000	Total £000
Unit-linked					
Unit					
– Insurance contracts	774,023	774,023	443,819	298,741	742,560
– Investment contracts	604,380	604,380	119,497	453,573	573,070
Non-unit (sterling)					
– Insurance contracts	42,039	42,039	40,007	8,813	48,820
– Investment contracts	9,770	9,770	5,745	3,753	9,498
Non-participating					
– Insurance contracts	92,792	92,792	32,404	54,145	86,549
– Investment contracts	155,196	155,196	161,478	13,295	174,773
Total	1,678,200	1,678,200	802,950	832,320	1,635,270

27 Solvency and regulatory capital (continued)

(ii) The principal assumptions underlying the calculation of the technical provisions are:

Mortality

A base mortality table is selected which is most appropriate for each type of contract taking into account rates charged to the Group by reinsurers. The mortality rates reflected in these tables are periodically adjusted, allowing for emerging experience and changes in reinsurer rates.

Morbidity

Morbidity tables are derived based on reinsurer tables. These are periodically adjusted to take into account emerging experience where appropriate.

Persistency

In general, no allowance is made for lapses or surrenders within the valuation of insurance contract liabilities. This is a prudent assumption.

Discount rates

The Group has used the following rates of interest in discounting the projected liabilities:

Rate of interest	31 December 2006		31 December 2005	
	CA business	CWA business	CA business	CWA business
Assurances				
Without profit: non linked business	3.95%	2.40%	3.70%	1.85%
Without profit: annual premium	3.95%	2.40%	3.70%	1.85%
Without profit: guaranteed income bonds	5.20%	–	4.20%	–
Annuities				
Without profit: deferred	3.95%	3.20%	3.70%	3.20%
Without profit: vested	4.50%	4.70%	4.00%	4.00%

For many of the life insurance products the interest rate risk is managed through asset/liability management strategies that seek to match the interest rate sensitivity of the assets to that of the underlying liabilities. The overall objective of these strategies is to limit the net change in value of assets and liabilities arising from interest rate movements. While it is more difficult to measure the interest sensitivity of the Group's insurance liabilities than those of the related assets, to the extent that the Group can measure such sensitivities, it believes that interest rate movements will generate asset changes that substantially offset changes in value of the liabilities relating to the underlying products.

Under the gross premium method of valuation and to a lesser extent the net premium method of valuation, the long-term business provision is sensitive to the interest rate used when discounting. For annuities in payment and assurances, the provision is sensitive to the assumed future mortality experience of policyholders.

Renewal expenses and inflation

The renewal expenses assumed are based on the charges made to CA by its two third party insurance administration services providers, with appropriate margins. These are assumed to inflate at a mix of current inflation rates in the UK, being the Retail Price Index and the National Average Earnings Index. Explicit allowance is also made for those Governance expenses which are charged to the long-term funds.

Taxation

The Group has assumed that current tax legislation and tax rates will not change.

The sensitivities of technical provisions and of components of capital to changes in assumptions are materially the same as those detailed in Note 28(c) (iii) on page 93.

(d) Valuation of options and guarantees

(i) Stochastically-valued options and guarantees

The Group has a small number of guaranteed annuity options, considered in Note 4, which are valued stochastically.

(ii) Deterministically-valued options and guarantees

Timed Investment Funds

Certain investment funds, the “Timed Investment Funds”, carry a guarantee that the price at maturity date or death will not be less than the highest price attained between commencement and contract cessation. The cost of the guarantee can be managed by changing the investment policy adopted by each fund.

In respect of this guarantee:

- (i) A monthly charge of $\frac{1}{48}$ % of the fund value is made.
- (ii) Investment conditions were such as to require the establishment of a reserve of £100,000 as at 31 December 2006 (31 December 2005: £100,000).

The reserve for a given fund is derived as the discounted exposure at fund maturity date, the exposure being the difference between the guaranteed Timed Investment Fund value and the projected fund maturity value, with the latter projected value being derived assuming an immediate fall in value of equities within the fund of 20% and allowing for future investment returns, including presumed future equity investment return of 4.45% per annum.

Guaranteed Growth Fund

The Guaranteed Growth Fund (GGF) is a deposit-based contract which provides a return to policyholders that is linked to the average residential mortgage rate. However, the assets backing the contract are largely held as cash on deposit. There is, therefore, likely to be a shortfall between the return given to policyholders and the return earned on assets, and the value of this shortfall is reserved for.

Other reserves for this product are a “unit” reserve of the current value of the benefits held and a non-unit reserve for expenses.

The underlying fund at 31 December 2006 was £9.7m. 1,077 policies invested in the fund, of which 157 were paying premiums (for a total of approximately £53,000 per annum).

For the valuation of contract liabilities CWA projects for each future year:

- the benefit outgo from the fund;
- the investment return from the assets backing the fund; and
- the difference between these items.

These differences are then discounted and summed to establish the GGF loss reserve.

The following assumptions are used for calculating the loss reserve:

Rate of growth of liability:	5.35% pa
Rate of return on cash:	4.25% pa
Discount rate:	3.90% pa
Retirement age:	90% of business with policyholders retiring at age 65 10% of business with policyholders retiring at age 70
Terminations before retirement:	3% pa

The reserve for the guarantee at 31 December 2006 was £1.3m (31 December 2005: £1.3m).

(e) Capital management policy

The Group’s capital management policy is effected by adherence to the targets set by the CA Board regarding the ratio of available capital resources as measured on a regulatory basis to capital resource requirements, as measured on a regulatory basis. These targets are set out under the Regulatory Capital Resources and Requirements section above.

In addition to these constraints the Group would also be constrained should the level of its target capital requirements in the Life Assurance subsidiaries fall below the amount of issued share capital in those subsidiaries. This constraint could, however, be overcome by undertaking a formal capital reduction scheme subject to the sanction of the Courts.

(f) Management of risk

The Group’s approach to the management of risk which may have an impact on the measurement of capital resources and requirements, as measured on a regulatory basis, is set out in Note 4 to these financial statements.

Notes to the Consolidated Financial Statements (continued)

28 Insurance contract provisions

(a) Analysis of insurance contract provisions by type

	31 December 2006			31 December 2005		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Long-term business						
Unit-linked without DPF	932,496	118,588	813,908	896,110	113,565	782,545
Non-linked without DPF	91,995	1,512	90,483	87,208	589	86,619
With DPF	90,706	87,179	3,527	88,746	85,409	3,337
Total insurance contract provisions	1,115,197	207,279	907,918	1,072,064	199,563	872,501
Current	55,034	8,293	46,741	87,356	7,970	79,386
Non-current	1,060,163	198,986	861,177	984,708	191,593	793,115
Total	1,115,197	207,279	907,918	1,072,064	199,563	872,501

(b) Analysis of movement in insurance contract provisions

Unit-linked without DPF

	2006			2005		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Balance at 1 January	896,110	113,565	782,545	517,462	102,412	415,050
Addition-acquisition of subsidiary company	–	–	–	287,534	–	287,534
Premiums received	84,357	10,574	73,783	86,129	9,962	76,167
Fees deducted	(23,423)	(1,413)	(22,010)	(23,668)	(1,802)	(21,866)
Reserves released in respect of benefits paid	(98,080)	(12,486)	(85,594)	(87,356)	(14,485)	(72,871)
Investment return	77,251	8,499	68,752	114,622	16,923	97,699
Other movements	(3,719)	(151)	(3,568)	1,387	555	832
Balance at 31 December	932,496	118,588	813,908	896,110	113,565	782,545

Non-linked without DPF

	2006			2005		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Balance at 1 January	87,208	589	86,619	19,554	(9,754)	29,308
Addition-acquisition of subsidiary company	–	–	–	60,153	7,793	52,360
Premiums received	24,363	6,034	18,329	25,464	7,684	17,780
Fees deducted	(14,670)	(5,549)	(9,121)	(19,990)	(8,145)	(11,845)
Reserves released in respect of benefits paid	(5,374)	1,565	(6,939)	(3,210)	4,976	(8,186)
Investment return	4,348	587	3,761	5,417	331	5,086
Other movements	(3,880)	(1,714)	(2,166)	(180)	(2,296)	2,116
Balance at 31 December	91,995	1,512	90,483	87,208	589	86,619

With DPF

	2006			2005		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Balance at 1 January	88,746	85,409	3,337	64,789	61,939	2,850
Addition-acquisition of subsidiary company	–	–	–	–	–	–
Premiums received	3,334	3,203	131	3,425	3,319	106
Fees deducted	(1,009)	(994)	(15)	(882)	(882)	–
Reserves released in respect of benefits paid	(5,358)	(5,203)	(155)	(4,500)	(4,404)	(96)
Investment return	1,819	1,590	229	22,477	22,000	477
Other movements	3,174	3,174	–	3,437	3,437	–
Balance at 31 December	90,706	87,179	3,527	88,746	85,409	3,337

The residual net liability of £3,527,000 at 31 December 2006 relates to unit linked holdings within policies which have been classified as “With DPF”.

(c) Assumptions and sensitivities for insurance contract provisions

(i) Process used to determine the assumptions

The process used to determine the assumptions is intended to result in conservative estimates of the most likely, or expected, outcome. The assumptions are checked to ensure that they are consistent with observed market prices or other published information.

For insurance contracts the Group regularly considers whether the current liabilities are adequate. The assumptions that are considered include the expected number and timing of deaths, other claims and investment returns, over the period of risk exposure. A reasonable allowance is made for the level of uncertainty within the contracts.

For those classes of non-linked and unit-linked business where policyholders participate in profits, the liability is wholly reassured to Guardian. When performing the gross liability adequacy test allowance is made for expected future bonuses paid by Guardian. This is based on the realistic liabilities of the underlying policies reassured, as provided to the Group by Guardian.

For all the other classes of linked and quasi-linked business, the long-term business provision is calculated on a gross premium basis, by subtracting the present value of future premiums from the present value of future benefits payable under the policy, until it ceases at maturity, or death if earlier. The gross premium method makes explicit allowance for future policy maintenance costs. If the net present value of the future discounted cash flows is positive, no asset is recognised.

28 Insurance contract provisions (continued)

For immediate annuities in payment the provision is calculated as the discounted value of the expected future annuity payments under the policies, allowing for mortality, interest rates and expenses.

For the other classes of non-linked, business the provision is calculated on a net premium basis, being the level of premium consistent with a premium stream, the discounted value of which, at the outset of the policy, would be sufficient to cover exactly the discounted value of the original guaranteed benefits at maturity, or at death if earlier, on the valuation basis. The provision is then calculated by subtracting the present value of future net premiums from the present value of the benefits guaranteed at maturity, or death of earlier, as a result of events up to the balance sheet date. Negative provisions do not arise under the net premium method, which makes no allowances for voluntary discontinuances by policyholders, and which only implicitly allows for future policy maintenance costs.

(ii) Assumptions

The principal assumptions underlying the calculation of the insurance contract provisions are:

Mortality

A base mortality table is selected which is most appropriate for each type of contract taking into account rates charged to the Group by reinsurers. The mortality rates reflected in these tables are periodically adjusted, allowing for emerging experience and changes in reinsurer rates.

Morbidity

Morbidity tables are derived based on reinsurer tables. These are periodically adjusted to take into account emerging experience where appropriate.

Persistency

In general, no allowance is made for lapses or surrenders within the valuation of insurance contract liabilities.

Discount rates

The Group has used the following rates of interest in discounting the projected liabilities:

Rate of interest	31 December 2006		31 December 2005	
	CA business	CWA business	CA business	CWA business
Assurances				
– without profit: non linked business	3.95%	2.40%	3.70%	1.85%
– without profit: annual premium	3.95%	2.40%	3.70%	1.85%
Annuities				
– without profit: deferred	3.95%	3.20%	3.70%	3.20%
– without profit: vested	4.50%	4.70%	4.00%	4.00%

For many of the life insurance products the interest rate risk is managed through asset/liability management strategies that seek to match the interest rate sensitivity of the assets to that of the underlying liabilities. The overall objectives of these strategies is to limit the net change in value of assets and liabilities arising from interest rate movements. While it is more difficult to measure the interest sensitivity of the Group's insurance liabilities than those of the related assets, to the extent that the Group can measure such sensitivities, it believes that interest rate movements will generate asset changes that substantially offset changes in value of the liabilities relating to the underlying products.

Under the gross premium method and to a lesser extent the net premium method, the long-term business provision is sensitive to the interest rate used when discounting. For annuities in payment and assurances, the provision is sensitive to the assumed future mortality experience of policyholders.

Renewal expenses and inflation

The renewal expenses assumed are based on the charges made to the Group by its two third party insurance administration services providers, with appropriate margins. These are assumed to inflate at a mix of current inflation rates in the UK, being the Retail Price Index and the National Average Earnings Index. Explicit allowance is also made for Governance expenses incurred by the Group.

Taxation

The Group has assumed that current tax legislation and tax rates will not change.

(iii) Changes in assumptions and sensitivity to change in assumptions

Assumptions are adjusted for changes in mortality, investment return, policy maintenance expenses and expense inflation to reflect anticipated changes in market conditions and market experience and price inflation.

The major changes to the bases used for the calculation of the provisions were as follows.

As a consequence of the fact that the valuation basis makes no allowance for lapses, when lapses occur it is necessary to allocate fixed expenses across a small number of in-force policies. Consequently the per policy expense reserve has increased. In addition per policy expense assumptions have been increased to allow for changes to third party administration arrangements. This increased the reserves by £5.7m as at 31 December 2006.

The reserve held in respect of the CWA business for guaranteed annuity rates was reduced by £0.3m, making allowance principally for the vesting of policies with the guarantee, changes in unit values and interest rates, and changes to the assumptions made regarding the profile of retirement ages and take-up rates.

Annuitant mortality assumptions in respect of the CWA business were weakened as a result of a reappraisal of mortality experience leading to release of £0.2m of reserves.

The basis for the calculation of the reserve held for complaints, principally mortgage endowment complaints, is given below.

The Group re-runs its valuation models on various bases. An analysis of sensitivity around various scenarios provides an indication of the sensitivity of the estimates to changes in assumptions in respect of its life assurance contracts. The table presented below demonstrates the sensitivity of assets and insured liability estimates to particular movements in assumptions used in the estimation process. Certain variables can be expected to impact on life assurance liabilities more than others, and consequently a greater degree of sensitivity to these variables may be expected.

Impact on reported net of tax profits and equity to changes in key variables:

	Change in variable %	Change in net of tax profits and equity 2006 £m
Investment return	+1	2.2
Investment return	-1	(3.7)
Mortality/morbidity	+10	(0.7)
Policy maintenance expenses	+10	(3.8)

The above sensitivities are calculated as an expected impact on IFRS-based profits, net of reinsurance and tax and the analysis has been prepared for a change in the stated variable, with all other assumptions remaining constant.

The sensitivities to the changes in investment returns are calculated taking into account the consequential changes to valuation assumptions.

The sensitivities to mortality and morbidity (critical illness) rates shown above are calculated on the assumption that there would be no consequential change in rates to policyholders. In practice, Group policy is to pass costs on to policyholders where it considers that the impact of the change is significant (see Note 4 for further information).

An increase in mortality rates would have a negative impact on the CA business due to the preponderance of assurance business. In contrast, there would be a positive impact occurring in the CWA business due to its preponderance of annuity business. On a consolidated Group basis the impacts are closely balanced. A decrease in mortality rates would have the contrary effect in each business but the Group results would remain closely balanced.

28 Insurance contract provisions (continued)

Changes in mortality and morbidity rates are not correlated: one may increase whilst the other remains unchanged or reduces. The figure shown above assumes both rates increase by 10%. The effects of separate 10% increases would be an increase in consolidated net of tax profits and equity by £0.3m for increased mortality rates and a reduction in consolidated net of tax profits and equity by £1.0m for increased morbidity rates.

Increases in expenses due to inflation would predominantly be passed on to policyholders through higher policy fees.

The main expense risk is that of unforeseen changes to third party administration expenses, as discussed in Note 4. The impact shown above quantifies a 10% increase in those expenses.

(iv) Provisions for redress in respect of pension transfers and opt-outs and in respect of endowment misselling complaints

Pension transfers and opt-outs

The investment liabilities include an amount of £0.4m in respect of potential compensation payments and associated costs arising from a review of advice provided to customers who were sold personal pension policies by Group representatives between 25 May 1988 and 30 June 1994. This comprises £0.3m for CA policies (2005: £0.4m) and £0.1m for CWA policies (2005: £0.3m). The reviews, which were conducted in accordance with guidelines issued by the FSA and which are now complete, relate to small numbers of unsettled cases where the Group does not have primary responsibility for compensation under the regulatory rules. The Directors are of the opinion that suitable provision has been made for these cases at 31 December 2006.

Endowment misselling complaints

The insurance liabilities include an amount of £11.62m (2005: £18.99m) in respect of potential compensation payments arising from endowment misselling complaints. This comprises £9.7m for CA policies (2005: £15.09m) and £1.92m for CWA policies (2005: £3.9m). The provision for the costs of redress has been estimated on the basis of the Group's experience in respect of policyholders' propensity to complain, complaint uphold rates and average cost of settlement. It is also based on estimation of the in-force endowment policy population exposed to complaint, taking account of estimated future policy cessation, and of the rate at which policies are expected to become time-barred in accordance with FSA rules.

As the setting of the provision for the rate of redress of endowment misselling complaints relies on estimates of factors which may be materially affected by unanticipated or unforeseen events, it is not possible to determine precisely the level of redress. The Directors are of the opinion that suitable provision has been made taking account of known circumstances.

The liability for mortgage endowment misselling claims would increase if there were an increase in the number of complaints received, a decrease in the number of policies time-barred, an increase in the complaint uphold rate or an increase in the average amount of redress per settled complaint compared with current assumptions. A decrease in the fund value of the assumed unit growth rate would tend to increase the average redress amount per policy. A 10% increase in assumed propensity to complain would increase insurance contract provisions by £1.0m. A 10% increase in assumed cost of redress to settle each complaint would increase insurance contract provisions by £1.1m.

29 Investment contracts at fair value through income and amounts deposited with reinsurer

(a) Analysis by contract type

	31 December 2006			31 December 2005		
	Investment contract liability £000	Amount deposited with reinsurer £000	Net £000	Investment contract liability £000	Amount deposited with reinsurer £000	Net £000
Long-term business						
Unit-linked	658,352	63,229	595,123	629,111	62,184	566,927
Non-linked	10,992	–	10,992	12,258	–	12,258
Guaranteed income and guaranteed growth bonds	143,635	–	143,635	161,777	–	161,777
Other	–	492	(492)	–	513	(513)
Total	812,979	63,721	749,258	803,146	62,697	740,449
Current	46,887	1,612	45,275	101,120	3,975	97,145
Non-current	766,092	62,109	703,983	702,026	58,722	643,304
Total	812,979	63,721	749,258	803,146	62,697	740,449

(b) Movements in investment contract

	31 December 2006			31 December 2005		
	Investment contract liability £000	Amount deposited with reinsurer £000	Net £000	Investment contract liability £000	Amount deposited with reinsurer £000	Net £000
Unit-linked						
Balance at 1 January	629,111	62,184	566,927	125,403	20,864	104,539
Addition-acquisition of subsidiary company	–	–	–	430,868	35,788	395,080
Deposits received	20,922	2,969	17,953	13,214	1,541	11,673
Fees deducted from account balances	(4,569)	(21)	(4,548)	(1,951)	(39)	(1,912)
Account balances paid on terminations in the year	(66,291)	(8,777)	(57,514)	(21,768)	(3,693)	(18,075)
Investment yield	82,316	7,835	74,481	83,370	9,036	74,334
Other movements	(3,137)	(961)	(2,176)	(25)	(1,313)	1,288
Balance at 31 December	658,352	63,229	595,123	629,111	62,184	566,927

Notes to the Consolidated Financial Statements (continued)

29 Investment contracts at fair value through income and amounts deposited with reinsurer (continued)

	31 December 2006			31 December 2005		
	Investment contract liability £000	Amount deposited with reinsurer £000	Net £000	Investment contract liability £000	Amount deposited with reinsurer £000	Net £000
Non-linked						
Balance at 1 January	12,258	–	12,258	–	–	–
Addition-acquisition of subsidiary company	–	–	–	12,982	–	12,982
Deposits received	75	–	75	50	–	50
Account balances paid on terminations in the year	(1,799)	–	(1,799)	(1,119)	–	(1,119)
Investment yield	560	–	560	356	–	356
Other movements	(102)	–	(102)	(11)	–	(11)
Balance at 31 December	10,992	–	10,992	12,258	–	12,258

	31 December 2006			31 December 2005		
	Investment contract liability £000	Amount deposited with reinsurer £000	Net £000	Investment contract liability £000	Amount deposited with reinsurer £000	Net £000
Guaranteed income and guaranteed growth bonds						
Balance at 1 January	161,777	–	161,777	181,383	–	181,383
Deposits received	34,552	–	34,552	48,468	–	48,468
Account balances paid on terminations in the year	(57,395)	–	(57,395)	(75,785)	–	(75,785)
Investment yield	6,093	–	6,093	6,900	–	6,900
Other movements	(1,392)	–	(1,392)	811	–	811
Balance at 31 December	143,635	–	143,635	161,777	–	161,777

30 Borrowings

Group and Company

	31 December	
	2006 £000	2005 £000
Bank loan	16,574	20,638
Current	4,102	4,063
Non-current	12,472	16,575
Total	16,574	20,638

The bank loan which was drawn down on 2 June 2005 under a facility made available in 4 May 2005 is unsecured and is repayable in five equal annual instalments on the anniversary of the draw down date. Accordingly the current portion as at 31 December 2006, being that payable within one year, is £4,102,176 and the non-current portion is £12,471,943. The outstanding principal on the loan bears interest at a rate based on the London Inter-bank Offer Rate, payable in arrears over a period which varies between one and six months at the option of the borrower.

The fair value of the bank loan at 31 December 2006 was £16,800,000 (31 December 2005: £21,000,000).

31 Provisions

	MECR £000	Other complaints redress £000	Onerous contracts £000	ISAA £000	Other £000	Total £000
Balance at 1 January 2005	–	–	498	255	173	926
Transfers from other payables	1,000	500	–	–	–	1500
Provisions made during the year	–	–	125	–	–	125
Provisions used during the year	(282)	(223)	(78)	(255)	–	(838)
Provisions reversed during the year	–	–	(107)	–	(173)	(280)
Balance at 31 December 2005	718	277	438	–	–	1,433
Provisions made during the year	83	(2)	24	–	–	105
Provisions used during the year	(337)	(70)	(42)	–	–	(449)
Provisions reversed during the year	(338)	(151)	(3)	–	–	(492)
Balance at 31 December 2006	126	54	417	–	–	597
31 December 2005						
Current	475	183	44	–	–	702
Non-current	243	94	394	–	–	731
Total	718	277	438	–	–	1,433
31 December 2006						
Current	126	54	44	–	–	224
Non-current	–	–	373	–	–	373
Total	126	54	417	–	–	597

The initial provisions for MECR (see (a) below) and Other Complaints Redress (see (b) below) were established by way of a transfer from Other Balances within Other Payables as this was considered to more properly reflect the nature of the related liability.

Notes to the Consolidated Financial Statements (continued)

31 Provisions (continued)

(a) Mortgage endowment complaints redress (MECR)

As part of the mortgage endowment complaint redress process (refer to Note 28 Insurance Contract Provisions on page 90), if the complaint is upheld an offer of redress is made to the customer where a loss has occurred. These offers are classified as payables for the first 6 months after they are made, subsequent to which they are reclassified as provisions, as the customer loses the right of redress at the level offered, but continues to have a right to enforce a claim, which the Group has the right to reassess. The provision is established at the original offer level as a prudent estimate of future liabilities.

(b) Other complaints redress

Offers of redress on complaints other than mortgage endowment related are classified in a manner similar to that detailed for MECR above.

(c) Onerous contracts

The Group has a number of onerous operating lease contracts that had been entered into historically, whose activity and current status is described in Note 42 Operating Leases on page 106. Given the terms of the contracts the Group has created an onerous contract provision for anticipated future net costs. Over the terms of the contracts this provision takes account of the contract terms, future payments and future mitigating income from sublets, contract by contract, to create a view as to the Group's exposure.

This provision comprises three components: provision for vacant properties, provision for properties due to become empty at the end of their subleases, and provision for future under-recoveries of costs on subleases entered into.

Within the provision calculation two estimates or judgements are made:

- The provision model assumes that if the rent is reduced to 75% of the Group contract, the Group will have 82% sublet occupancy of the properties.
- Future cash flows are discounted within the provision model at 4.5%, this being the difference between a cost of capital of 8.5% and a presumed rent review and inflation increase of 4%.

Sensitivities

	Provision at 31 December 2006 £000	Post sensitivity provision £000	Change in provision £000	%
Discount rate – decreased by 1% to 3.5%	417	436	19	+4.6%
Sublease rent mitigation – from 75% to 65%	417	479	62	+14.9%
Occupancy mitigation – from 82% to 72%	417	471	54	+12.9%

(d) Insurance services administration agreement (ISAA)

At 1 January 2005 the Group provided for legal and professional fees associated with an agreement for the provision of third-party insurance administration services. The provision was fully utilised during 2005.

(e) Other

At 1 January 2005, the Group held a provision in respect of potential Value Added Tax liabilities, relating to arrangements with the Countrywide Assured Group plc of which its constituent companies were former members. In the event, the liabilities did not crystallise and the provision was released during the year ended 31 December 2005.

32 Deferred tax liabilities

(a) Recognised deferred tax assets and liabilities

As at December 2006	Assets £000	Liabilities £000	Net £000
Insurance contract provisions	–	6,147	(6,147)
Contingency reserves	120	–	120
Intangible assets	–	–	–
Deferred acquisition costs	–	3,357	(3,357)
Acquired value of in-force business	–	9,856	(9,856)
Deferred income	5,172	–	5,172
Property and equipment	122	–	122
Total	5,414	19,360	(13,946)
Current	–	–	–
Non-current	5,414	19,360	(13,946)
Total	5,414	19,360	(13,946)

As at December 2005	Assets £000	Liabilities £000	Net £000
Insurance contract provisions	–	(5,104)	(5,104)
Contingency reserves	120	–	120
Intangible assets	–	–	–
Deferred acquisition costs	–	(3,705)	(3,705)
Acquired value of in-force business	–	(10,860)	(10,860)
Deferred income	5,743	–	5,743
Realised losses on financial assets	4,349	–	4,349
Unrealised gains on financial assets	–	(3,992)	(3,992)
Property and equipment	122	–	122
Total	10,334	(23,661)	(13,327)
Current	–	–	–
Non-current	10,334	(23,661)	(13,327)
Total	10,334	(23,661)	(13,327)

(b) Unrecognised deferred tax assets

	31 December	
	2006 £000	2005 £000
Tax losses arising in pensions business	45,557	57,419
Unrelieved expenses	125,985	101,704
Total	171,542	159,123

- (i) A deferred tax asset has not been recognised in respect of tax losses arising on pension business, because it is uncertain whether future taxable profit arising on pensions business will be available against which the Group can utilise the benefits therefrom.
- (ii) A deferred tax asset has not been recognised in respect of unrelieved expenses, because it is not probable that there will be a sufficient level of taxable income arising from income and gains on financial assets, so that the Group can utilise the benefits therefrom.

Notes to the Consolidated Financial Statements (continued)

32 Deferred tax liabilities (continued)

(c) Movement in temporary differences during the year

	Year ended 31 December 2006			Year ended 31 December 2005			
	Balance at 1 January £000	Recognised in income £000	Balance at 31 December £000	Balance at 1 January £000	Acquisition of subsidiary £000	Recognised in income £000	Balance at 31 December £000
Insurance contract provisions	(5,104)	(1,043)	(6,147)	(1,601)	(3,730)	227	(5,104)
Contingency reserves	120	–	120	120	–	–	120
Intangible assets							
Deferred acquisition costs	(3,705)	349	(3,356)	(2,233)	(2,957)	1,485	(3,705)
Amortised value of in-force business	(10,860)	1,004	(9,856)	(193)	(11,266)	599	(10,860)
Deferred income	5,743	(572)	5,171	2,073	4,158	(488)	5,743
Property and equipment	122	–	122	86	–	36	122
Realised losses on financial assets	4,349	(4,349)	–	–	(434)	4,783	4,349
Unrealised gains on financial assets	(3,992)	3,992	–	–	(783)	(3,209)	(3,992)
Total	(13,327)	(619)	(13,946)	(1,748)	(15,012)	3,433	(13,327)

33 Reinsurance payables

Payable to reinsurers

	31 December	
	2006 £000	2005 £000
Payables in respect of insurance contracts	3,032	1,951
Payables in respect of investment contracts	27	98
Total	3,059	2,049
Current	3,059	2,049
Non-current	–	–
Total	3,059	2,049

34 Payables related to direct insurance and investment contracts

	31 December 2006			31 December 2005		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Accrued claims	22,721	4,191	18,530	21,169	4,810	16,359
Policyholder premium liabilities	2,206	–	2,206	2,697	–	2,697
Total	24,927	4,191	20,736	23,866	4,810	19,056
Current	24,927	4,191	20,736	23,866	4,810	19,056
Non-current	–	–	–	–	–	–
Total	24,927	4,191	20,736	23,866	4,810	19,056

The fair value of payables related to the direct insurance and investment contracts is not materially different from the carrying value.

35 Deferred income

	31 December	
	2006 £000	2005 £000
Balance at 1 January	20,195	8,038
Additions arising on acquisition of subsidiary company	–	13,859
Release to income	(1,964)	(1,702)
Balance at 31 December	18,231	20,195
Current	1,934	2,392
Non-current	16,297	17,803
Total	18,231	20,195

The release to income is included in Fee and Commission Income (see Note 7).

36 Income tax liabilities

	31 December	
	2006 £000	2005 £000
Income tax liabilities, which are all current, comprise:		
Corporation tax	2,023	3,345

37 Other payables

	31 December	
	2006 £000	2005 £000
Group		
Accrued expenses	4,141	3,937
Other	2,859	3,613
Total	7,000	7,550
Current	6,412	7,550
Non-current	588	–
Total	7,000	7,550
Company		
Accrued expenses	1,135	750
Other	388	190
Total	1,523	940
Current	935	940
Non-current	588	–
Total	1,523	940

The fair value of other payables is not materially different from the carrying value.

Notes to the Consolidated Financial Statements (continued)

38 Share capital and share premium

Group

	31 December 2006		31 December 2005	
	Number of shares	Share capital £000	Number of shares	Share capital £000
Share capital	104,588,785	41,501	104,588,785	41,501

There have been no changes in Group share capital and share premium during the year ended 31 December 2006.

Under the reverse acquisition basis of accounting referred to in Note 2, at the date of acquisition of Chesnara plc (the legal parent) the amount of issued share capital in the consolidated balance sheet represents the amount of issued share capital of Countrywide Assured Life Holdings Limited (the legal subsidiary) immediately before the acquisition and the deemed cost of acquisition, which as explained in Note 2 is taken as £nil. The number of shares, representing the equity structure, reflects the equity structure of Chesnara plc as set out below.

Company

The share capital of Chesnara plc comprises:

	31 December 2006 £	31 December 2005 £	
Authorised 201,000,000 Ordinary shares of 5p each	10,050,000	10,050,000	
	Number of Shares	Share Capital £	Share Capital £
Issued Ordinary shares of 5p each	104,588,785	5,229,439	5,229,439

There have been no changes in Company share capital and share premium during the year ended 31 December 2006.

39 Retained earnings

Group

Retained earnings attributable to equity holders of the parent company comprise:

	Year ended 31 December	
	2006 £000	2005 £000
Balance at 1 January	46,258	38,892
Profit for the year	19,256	18,615
Dividends		
Final approved and paid for 2004	–	(6,124)
Interim approved and paid for 2005	–	(5,125)
Final approved and paid for 2005	(7,986)	–
Interim approved and paid for 2006	(5,282)	–
Balance at 31 December	52,246	46,258

The retained earnings balance represents the amount available for dividend distribution to the equity shareholders of the parent company except for £2,504,000 (31 December 2005: £12,959,000) which is not

distributable and which must be retained in the regulated life subsidiary company in accordance with the solvency capital requirements pertaining to that subsidiary.

The interim dividend in respect of 2005, approved and paid in 2005, was paid at the rate of 4.9p per share. The final dividend in respect of 2005, approved and paid in 2006, was paid at the rate of 7.55p per share so that the total dividend paid to the equity shareholders of the Parent Company in respect of the year ended 31 December 2005 was made at the rate of 12.45p per share.

The interim dividend in respect of 2006, approved and paid in 2006, was paid at the rate of 5.05p per share to equity shareholders of the Parent Company registered at the close of business on 15 September 2006, the dividend record date.

A final dividend of 8.05p per share in respect of the year ended 31 December 2006 payable on 14 May 2007 to equity shareholders of the parent company registered at the date of business 10 April 2007, the dividend record date, was approved by the Directors after the balance sheet date. The resulting total dividend of £8.4m has not been provided for in these financial statements and there are no income tax consequences.

The following summarises dividends per share in respect of the year ended 31 December 2005 and 31 December 2006:

	2006 p	2005 p
Interim – approved and paid	5.05	4.90
Final – proposed	8.05	7.55
Total	13.10	12.45

Company

	Year ended 31 December	
	2006 £000	2005 £000
Balance at 31 January	7,524	–
Profit for the year	26,175	18,773
Dividends paid		
Final approved and paid for 2004	–	(6,124)
Interim approved and paid for 2005	–	(5,125)
Final approved and paid for 2005	(7,986)	–
Interim approved and paid for 2006	(5,282)	–
Balance at 31 December	20,431	7,524

Details of dividends approved and paid are set out in the “Group” section above.

40 Employee benefit expense

	Year ended 31 December	
	2006 £000	2005 £000
Wages and salaries	2,038	2,091
Social security costs	253	240
Pension costs-defined contribution plans	160	155
Total	2,451	2,486
Average number of employee		
Company	19	19
Subsidiaries	14	25
Total	33	44

Between 1 January 2004 and 31 May 2005 the Group offered membership of the Countrywide Assured Group plc (CAG) Pension Scheme to eligible employees. Under a Deed of Settlement dated 18 March 2004 CAG and the Scheme Trustees had given permission for the Company to participate in the CAG pension Scheme for a period of 12 months following the demerger described in Note 2 above. Accordingly employees of the Group became deferred members of the CAG Scheme at the end of May 2005. At that time the Group allowed eligible employees to enter the Chesnara plc Stakeholder Scheme, on a basis where employer contributions are made to the scheme at the same rate as would be payable had their membership of the Countrywide Assured Group pension scheme continued, provided that employee contributions also continue to be made at the same rate. The employee may opt to request the Company to pay employer contributions into a personal pension plan, in which instance, employer contributions will be made on the same terms as for the Chesnara plc Stakeholder Scheme.

Employees who joined the Group as a result of the acquisition of CWA Life Holdings plc either continue to be members of the pre-existing defined contribution Group Personal Pension scheme, to which employer and employee contributions are made, or they have opted to join the aforementioned Chesnara plc Stakeholder Scheme.

The Group has for the period covered by these financial statements only made contributions to defined contribution plans to provide pension benefits for employees upon retirement.

The Group has established frameworks for a sharesave plan and for discretionary share option plans which may, at the discretion of the Remuneration Committee, be utilised for granting options to Executive Directors and to other Group employees. No options have been granted in relation to these plans.

41 Earnings per share

Earnings per share is based on the following:

	Year ended 31 December	
	2006	2005
Profit for the year (£000)	19,256	18,615
Weighted average number of ordinary shares	104,588,785	96,637,227
Basic earnings per share	18.41p	19.26p
Diluted earnings per share	18.41p	19.26p

The weighted average number of shares in respect of the year ended 31 December 2005 is based on

- (i) 84,564,168 shares in issue at the beginning of the period.
- (ii) 1,691,284 shares issued on 10 February 2005 pursuant to exercise of a share option.
- (iii) 18,333,333 shares issued on 2 June 2005 pursuant to a placing and open offer.

The weighted average number of ordinary shares in respect of the year ended 31 December 2006 is based on 104,588,785 shares in issue at the beginning and end of the period.

The diluted weighted average number of shares in respect of the year ended 31 December 2005 was 96,673,130. The dilution reflects an adjustment for the equivalent number of shares that would have been issued for no consideration had the exercise of the share option, granted to Numis Securities limited for broking services, provided in connection with the admission of the company to the Official List of the UK Listing Authority, been exercised prior to its actual exercise date of 10 February 2005.

There were no further share options outstanding during the year ended 31 December 2005 or during the year ended 31 December 2006.

42 Operating leases

Leases as lessee

Non-cancellable operating lease rentals are payable as follows:

	31 December 2006				31 December 2005			
	Investment properties £000	Non-investment properties £000	Motor vehicles £000	Total £000	Investment properties £000	Non-investment properties £000	Motor vehicle £000	Total £000
Operating lease rentals								
Less than one year	470	200	32	702	58	647	25	730
Between one and two years	470	200	18	688	58	647	17	722
Between two and five years	1,410	600	8	2,018	44	1,940	–	1,984
More than five years	3,550	686	0	4,236	–	4,848	–	4,848
Expenses recognised in the year in respect of operating leases	470	177	31	678	58	603	25	686

The Group's investment property portfolio is typically freehold. However it has short-term leasehold interests in two properties, which will both have expired by 2008.

The Group leases a property under an operating lease which it occupies in the course of its day to day business. The lease expires on 22 July 2019, with an option to renew the lease after that date. Lease payments are reviewed every five years to reflect market rentals. The lease does not include any contingent rentals.

The Group leases a number of office premises which are no longer used for Group purposes. The leases typically run for approximately a further 10 years after the balance sheet date. Lease payments are reviewed every five years to reflect market rentals. None of the leases includes contingent rentals. These leased properties are sublet by the Group. Sublease payments as detailed below are expected to be received during the following years. The Group has recognised a provision of £417,000 at 31 December 2006 (31 December 2005: £438,000) in respect of these leases (see Note 31 Provisions on page 97).

Leases as lessor

The Group subleases out both its investment properties from its investment portfolio and the office premises which are no longer used for Group purposes. The future minimum lease payments under non-cancellable leases are as follows:

	31 December 2006			31 December 2005		
	Investment properties £000	Non-investment properties £000	Total £000	Investment properties £000	Non-investment properties £000	Total £000
Sub lease rentals						
Less than one year	204	257	461	1,551	427	1,978
Between one and two years	204	726	930	931	409	1,340
Between two and five years	612	788	1,400	2,465	1,223	3,688
More than five years	1,541	912	2,453	4,771	2,858	7,629
Rental income recognised in the year	204	82	286	1,236	311	1,547
Repairs and maintenance costs recognised in the year	117	1	118	133	80	213

43 Contingencies

The Group is subject to insurance solvency regulations and it has complied with all solvency regulations, either in accordance with the EU Directives or with UK regulations framed by the Financial Services Authority. There are no contingencies associated with the Group's compliance with these regulations.

There are otherwise no contingencies.

44 Capital commitments

There were no material capital commitments as at 31 December 2006.

45 Related party transactions

(a) Identity of related parties

The shares of the Company were widely held and no single shareholder exercised significant influence or control over the Company.

The Company has related party relationships with:

- (i) key management personnel who comprise only the directors of the company;
- (ii) its subsidiary companies;
- (iii) other companies over which its directors have significant influence; and
- (iv) a child of one of the directors

(b) Related party transactions

(i) Transactions with key management personnel

Key management personnel comprise of the Directors of the company. There are no executive officers other than certain of the Directors.

Key management compensation is as follows:

	Year ended 31 December	
	2006 £000	2005 £000
Short-term employee benefits	675	633
Post-employment benefits	55	51
Long-term employment benefits	274	177
Total	1,004	861

Fees of £25,000 payable to Terry Marris, Non-executive Director, which are included in short-term employment benefits, were paid with the addition of VAT to his employing company, Countrywide Property Services Limited, of which he is a Director and which is a subsidiary of Countrywide plc.

In addition to their salaries the Group also provides non-cash benefits to Directors, and contributes to a post employment defined contribution pension plan on their behalf.

A child of one of the Directors was paid £459 during the year ended 31 December 2005 for temporary employment, such payment being made at the legal minimum wage rate.

Notes to the Consolidated Financial Statements (continued)

45 Related party transactions (continued)

The following amounts were payable to Directors in respect of bonuses and incentives:

	31 December	
	2006 £000	2005 £000
Annual bonus scheme	166	160
Long-term incentive plan	658	309
Total	824	469

These amounts have been included in Group and Company Accrued Expenses as disclosed in Note 37 on page 101.

The amounts payable under the annual bonus scheme were payable within one year. No part of the amounts payable under the long-term incentive plan was payable within one year.

(ii) Transactions with subsidiaries

The Company undertakes centralised administration functions, the costs of which it charges back to its operating subsidiaries. The following amounts which effectively comprised a recovery of expenses at no mark up were credited to the income statement of the Company for the respective periods.

	Year ended 31 December	
	2006 £000	2005 £000
	2,489	1,947

(iii) Transactions with companies over which Chesnara directors have significant influence

The following transactions are disclosed for the periods covered by these financial statements because they were with companies within the Countrywide plc Group, which is controlled or significantly influenced by Directors of the Company.

	Year ended 31 December	
	2006 £000	2005 £000
Amounts payable/(receivable)		
Commission payable/(receivable) in respect of arrangement of the Groups' insurance and investment contracts (Included in Fees, Commission and Other Acquisition Costs: see Note 12 on page 74)	238	(460)
Administration services (Included in Other Operating Income: see Note 9 on page 73)	(107)	(144)
Property services	(15)	(15)
Total	116	(619)

Amounts outstanding in respect of the above transactions at each period end were:

	31 December	
	2006 £000	2005 £000
Payables (included in Other Payables: see Note 37 on page 101)	7	4
Receivables (included in Other Receivables see Note 22 on page 81)	5	13

46 Group entities

Control of the Group

The issued share capital of Chesnara plc the Group parent company is widely held, with no single party able to control 20% or more of such capital or of the rights which such ownership confers.

Group subsidiary companies

Name	Country of incorporation or registration	Ownership interest 31 December	
		2006	2005
Countrywide Assured plc	England & Wales	100% of all share capital ⁽⁴⁾	100% of all share capital ⁽⁴⁾
Countrywide Assured Life Holdings Limited	England & Wales	100% of all share capital	100% of all share capital
Countrywide Assured Services Limited	England & Wales	100% of all share capital ⁽⁴⁾	100% of all share capital ⁽⁴⁾
Countrywide Assured Trustee Company Limited	England & Wales	100% of all share capital ⁽⁴⁾	100% of all share capital ⁽⁴⁾
Premium Life Assurance Holdings Limited	England & Wales	100% of all share capital ⁽¹⁾	100% of all share capital ⁽¹⁾
Reefwise Limited	England & Wales	100% of all share capital ⁽²⁾	100% of all share capital ⁽²⁾
Premium Life International Limited	Guernsey	⁽⁶⁾	100% of all share capital ⁽³⁾
Countrywide Assured Commission Services Limited	England & Wales	100% of all share capital ⁽³⁾	100% of all share capital ⁽³⁾
The Greenways Management Company (Deepcar) Limited	England & Wales	100% of all share capital ⁽³⁾	100% of all share capital ⁽³⁾
Countrywide Assured Consultancy Limited	England & Wales	–	Dissolved 10/05/05
Countrywide Assured Care Limited	England & Wales	–	Dissolved 11/07/05
Premium Life Assurance Company Limited	England & Wales	–	Dissolved 10/05/05
Premium Life Finance Limited	England & Wales	–	Dissolved 10/05/05
Premium Life Investment Management Services Limited	England & Wales	–	Dissolved 10/05/05
Premium Life Unit Trust Managers Limited	England & Wales	–	Dissolved 10/05/05
CWA Life Holdings plc	England & Wales	100% of all share capital	100% of all share capital – Acquired 02/06/05
CWA Trustee Company Limited	England & Wales	100% of all share capital ⁽⁵⁾	100% of all share capital ⁽⁵⁾ – Acquired 02/06/05
City of Westminster Assurance Company Limited	England & Wales	100% of all share capital ⁽⁵⁾	100% of all share capital ⁽⁵⁾ – Acquired 02/06/05

- (1) Held indirectly through Countrywide Assured plc
(2) Held indirectly through Premium Life Assurance Holdings Limited
(3) Held indirectly through Reefwise Limited
(4) Held indirectly through Countrywide Assured Life Holdings Limited
(5) Held indirectly through CWA Life Holdings plc
(6) Disposal 15 March 2006 (see Note 5)

47. Post balance sheet event

On 10 January 2007 the Company's principal subsidiary company, Countrywide Assured plc, entered into an Insurance Related Policy Administration Services agreement with Capita Life and Pensions Regulated Services Limited ("Capita"), which takes effect from 1 April 2007 and which has a term of 15 years.

These arrangements were entered into in substitution for existing arrangements which are being terminated early. They provide for the continuation of the provision of insurance administration related services to the CWA business and include certain Actuarial and Accounting services performed directly by employees of the Chesnara plc Group up to 1 April 2007. Under the terms of the agreement the staff currently engaged on these functions will be transferred to Capita under arrangements which comply with the Transfer of Undertakings (Protecting Employment) Regulations 1981.

The longer-term expense assumptions underlying the establishment of insurance contracts provisions as disclosed in Note 28 on page 90 and of the statutory technical provisions as disclosed in Note 27 on page 85 as at 31 December 2006 materially anticipated the salient terms of these arrangements.

Statement of Directors' Responsibilities in respect of the EEV Basis Supplementary Information

The Directors have chosen to prepare supplementary information in accordance with the EEV Principles issued in May 2004 by the CFO Forum of European Insurance Companies and expanded by the Additional Guidance on European Embedded Value Disclosures issued in October 2005.

When compliance with the EEV Principles is stated, those principles require the Directors to prepare supplementary information in accordance with the Embedded Value Methodology ("EVM") contained in the EEV Principles and to disclose and explain any non-compliance with the EEV guidance included in the EEV Principles.

In preparing the EEV supplementary information, the Directors have:

- Prepared the supplementary information in accordance with the EEV Principles;
- Identified and described the business covered by the EVM;
- Applied the EVM consistently to the covered business;
- Determined assumptions on a realistic basis, having regard to past, current and expected future experience and to any relevant external data, and then applied them consistently;
- Made estimates that are reasonable and consistent; and
- Described the basis on which business that is not covered business has been included in the supplementary information, including any material departures from the accounting framework applicable to the Group's financial statements.

Independent Auditor's Report to Chesnara plc on the EEV Basis Supplementary Information

We have audited the EEV basis supplementary information (the supplementary information) on pages 113 to 124 in respect of the year ended 31 December 2006. The supplementary information has been prepared in accordance with the EEV Principles issued in May 2004 by the CFO Forum as supplemented by the Additional Guidance on European Embedded Value Disclosures issued in October 2005 (together "the EEV Principles") using the methodology and assumptions set out on pages 116 to 124. The EEV supplementary information should be read in conjunction with the Group's financial statements which are on pages 44 to 110.

This report is made solely to the Company in accordance with the terms of our engagement. Our audit work has been undertaken so that we might state to the Company those matters we have been engaged to state in this 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 for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As described in the statement of Directors' responsibilities on page 111, the Directors' responsibilities include preparing the supplementary information on the EEV basis in accordance with the EEV Principles. Our responsibilities, as Independent Auditor, in relation to the supplementary information are established in the UK by the Auditing Practices Board, by our profession's ethical guidance and the terms of our engagement.

Under the terms of engagement we are required to report to the Company our opinion as to whether the supplementary information has been properly prepared in accordance with the EEV Principles using the methodology and assumptions set out on pages 116 to 124. We also report if we have not received all the information and explanations we require for this audit.

Basis of audit opinion

We conducted our audit having regard to International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the supplementary information. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the supplementary information, and of whether the accounting policies applied in the preparation of the supplementary information are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the supplementary information is free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of the supplementary information.

Opinion

In our opinion, the EEV basis supplementary information for the year ended 31 December 2006 has been properly prepared in accordance with the EEV Principles using the methodology and assumptions set out on pages 116 to 124.

KPMG Audit Plc
Chartered Accountants and
Registered Auditor
St James' Square
Manchester M2 6DS

28 March 2007

Supplementary Information – European Embedded Value Basis

Summarised consolidated income statement

	Note	Year ended 31 December	
		2006 £000	2005 £000
Operating profit of covered business	6	15,684	11,353
Other operational result		(699)	(700)
Operating profit		14,985	10,653
Exceptional Item			
Profit on acquisition of subsidiary company		–	30,324
Variation from longer-term investment return		6,307	14,525
Effect of economic assumption changes		9,284	(3,598)
Profit before tax		30,576	51,904
Tax		(4,373)	(11,970)
Profit for the period		26,203	39,934
Earnings per share			
Based on profit for the period before exceptional item, net of attributable tax		25.05p	20.34p
Based on profit for the period		25.05p	41.32p
Diluted earnings per share			
Based on profit for the period before exceptional item, net of attributable tax		25.05p	8.42p
Based on profit for the period	25.05p	33.20p	

The notes and information on pages I 16 to I 24 form part of this supplementary information.

Supplementary Information – European Embedded Value Basis (continued)

Summarised consolidated balance sheet

	Note	31 December	
		2006 £000	2005 £000
Assets			
Value of in force business	5,8	109,941	109,961
Reinsurers' share of insurance contract provisions		183,033	174,154
Amounts deposited with reinsurers		62,794	60,979
Investment properties		27,750	25,422
Deferred tax assets		121	120
Financial assets			
Equity securities at fair value through income		738,487	688,478
Holdings in collective investment schemes at fair value through income		342,352	340,379
Debt securities at fair value through income		350,524	383,817
Loans and receivables including insurance receivables		17,310	19,810
Derivative financial instruments		30,642	16,108
Total financial assets		1,479,315	1,448,592
Reinsurers' share of accrued policy claims		4,191	4,810
Income taxes		260	199
Cash and cash equivalents		301,218	282,452
Total assets		2,168,623	2,106,689
Liabilities			
Insurance contract provisions		1,091,889	1,051,913
Financial liabilities			
Investment contracts at fair value through income		832,025	819,306
Borrowings		16,574	20,638
Derivative financial instruments		1,421	416
Total financial liabilities		850,020	840,360
Provisions		597	1,433
Reinsurance payables		3,059	2,049
Payables related to direct insurance and investment contracts		24,927	23,866
Income taxes		2,023	3,345
Other payables		7,000	7,550
Total liabilities		1,979,515	1,930,516
Net assets		189,108	176,173
Shareholders' equity			
Share capital		41,501	41,501
Share premium		20,458	20,458
Other reserves		50	50
Retained earnings		127,099	114,164
Total shareholders' equity	5,8	189,108	176,173

The notes and information on pages 116 to 124 form part of this supplementary information.

Approved by the Board of Directors on 28 March 2007 and signed on its behalf by:

Graham Kettleborough

Ken Romney

Summarised consolidated statement of changes in equity

	Year ended 31 December	
	2006 £000	2005 £000
Shareholders' equity at 1 January	176,173	126,029
Profit for the period representing total recognised income and expense	26,203	39,934
Dividends paid	(13,268)	(11,249)
Issue of ordinary shares pursuant to exercise of option	–	1,533
Issue of ordinary shares pursuant to placing and open offer	–	22,000
Expenses incurred in connection with issue of ordinary shares pursuant to placing and open offer	–	(2,074)
Shareholders' equity at 31 December	189,108	176,173

The notes and information on pages 116 to 124 form part of this supplementary information.

Notes to the Supplementary Information

1 Basis of preparation

This section sets out the detailed methodology followed for producing these Group financial statements which are supplementary to the Group's primary financial statements which have been prepared in accordance with International Financial Reporting Standards ("IFRS"). These financial statements have been prepared in accordance with the European Embedded Value ("EEV") principles issued in May 2004 by the European CFO Forum and supplemented by Additional Guidance on EEV Disclosures issued by the same body in October 2005. The principles provide a framework intended to improve comparability and transparency in embedded value reporting across Europe.

This first time adoption of EEV principles and associated disclosures represents a change from the Achieved Profit (AP) basis of reporting, which has previously been adopted by the Group as the basis for presenting supplementary financial information. The adoption of EEV principles does not affect the basis of reporting the statutory results, the regulatory capital position or the dividend paying capacity of Chesnara plc.

The Directors consider that the EEV methodology is a refinement of the AP basis previously adopted by the Group and represents a more meaningful basis of reporting the underlying value of the business and the underlying drivers of performance.

Information relating to the restatement of supplementary financial information, from reporting in accordance with the AP basis to reporting in accordance with EEV principles, is provided in the schedules and explanatory notes following these notes.

The Group acquired CWA Life Holdings plc on 2 June 2005, the principal operating subsidiary of which is City of Westminster Assurance Company Limited ("CWA") which was engaged in long-term insurance business. The summary consolidated income statement prepared on the EEV basis for the comparative year ended 31 December 2005 includes the profit arising within CWA from the date of acquisition to 31 December 2005. The excess of the embedded value of CWA, established on the EEV basis, over the total purchase consideration, has been treated as an exceptional credit to the profit of the Group for the year ended 31 December 2005.

No account has been taken of prospective tax changes announced by the Chancellor of the Exchequer on 21 March 2007.

2 Covered business

The Group uses EEV methodology to value its individual life assurance, pension and annuity business, which has been written, with only insignificant exceptions, in the UK ("covered business"). This business comprises the Group's long-term business operations, being those contracts falling under the definition of long-term insurance business for UK regulatory purposes.

The Group has no business activities other than those relating to the covered business. In particular, the operating activities of the holding company, Chesnara plc, are treated as an integral part of the covered business. Under EEV principles no distinction is made between insurance and investment contracts, as there is under IFRS, which accords these classes of contracts different accounting treatments.

On 30 June 2006, under the provisions of Part VII of the Financial Services and Markets Act 2000, the long-term business of CWA was transferred to Countrywide Assured plc ("CA"), the primary operating subsidiary company of the Group. As a result, the whole of the covered business of the Group effectively subsists within CA with effect from that date. The transfer gives rise to benefits which have been recognised within the covered business, including determination of the capital requirement of the covered business on a combined basis and reduced costs relating largely to audit and consultancy fees. The impact of these, together with the consequential relief of tax losses in CA, which had not hitherto been recognised in the cashflow projections relating to the value of business in force, has been recognised in these financial statements as at 31 December 2006 and for year then ended. In addition, the transfer affords the opportunity for synergistic savings in the resource required to manage the covered business. The effect of this has not been recognised in these financial statements, as related plans have neither been approved by the Directors nor implemented.

3 Methodology

(a) *Embedded Value*

Overview

Shareholders' equity comprises the embedded value of the covered business, together with the net equity of other Group companies, including that of the holding company which is stated after writing down fully the carrying value of the covered business.

The embedded value of the covered business is the aggregate of the shareholder net worth ("SNW") and the present value of future shareholder cash flows from in-force covered business (value of in-force business) less any deduction for the cost of required capital. It is stated after allowance has been made for aggregate risks in the business. SNW comprises those amounts in the long-term business, which are either regarded as required capital or which represent surplus assets within that business.

New business

Much of the covered business is in run-off and is, accordingly, substantially closed to new business. The Group does still sell guaranteed bonds but, overall, the contribution from new business to the results established using EEV methodology is not material. Accordingly, not all of those items related to new business values, which are recommended by the EEV guidelines, are reported in this supplementary financial information.

Value of in-force business

The cash flows attributable to shareholders arising from in-force business are projected using best estimate assumptions for each component of cashflow.

The present value of the projected cash flows is established by using a discount rate which reflects the time value of money and the risks associated with the cashflows which are not otherwise allowed for. There is a deduction for the cost of holding the required capital, as set out below.

Taxation

The present value of the projected cashflows arising from in-force business takes into account all tax which is expected to be paid under current legislation, including tax which would arise if surplus assets within the covered business were eventually to be distributed.

The value of the in-force business has been calculated on an after-tax basis and is grossed up to the pre-tax level for presentation in the income statement. The amount used for the grossing up is the amount of shareholder tax payable in the policyholder fund plus any direct tax charge within the shareholder fund.

Cost of capital

The cost of holding the required capital to support the covered business (see 3b below) is reflected as a deduction from the value of in-force business and is determined as the difference between the amount of the required capital and the projected release of capital and investment income.

Financial options and guarantees

The principal financial options and guarantees are (i) guaranteed annuity rates offered on some unit-linked pension contracts and (ii) a guarantee offered under Timed Investment Funds that the unit price available at the selected maturity date (or at death, if earlier) will be the highest price attained over the policy's life. The cost of these options and guarantees has been assessed, in principle, on a market-consistent basis, but, in practice, this has been carried out on approximate bases, which are appropriate to the level of materiality of the results.

Allowance for risk

Allowance for risk within the covered business is made by:

- (1) Setting required capital levels by reference to the Directors' assessment of capital needs;
- (2) Setting the risk discount rate, which is applied to the projected cash flows arising on the in-force business, at a level which includes an appropriate risk margin; and
- (3) Explicit allowance for the cost of financial options and guarantees and for reinsurer default.

3 Methodology (continued)

(b) Level of Required Capital

The level of required capital of the covered business reflects the amount of capital that the Directors consider necessary and appropriate to manage the business. In forming their policy the Directors have regard to the minimum statutory requirements and an internal assessment of the market, insurance and operational risks inherent in the underlying products and business operations. The capital requirement resulting from this assessment represents 150% of the long-term insurance capital requirement (“LTICR”) together with 100% of the resilience capital requirement (“RCR”), as set out in FSA regulations.

The required capital is provided by the retained surplus in the long-term business fund and the retained earnings and issued share capital in the shareholder fund.

(c) Risk Discount Rate

The risk discount rate (“RDR”) is a combination of the risk-free rate and a risk margin. The risk-free rate reflects the time value of money and the risk margin reflects any residual risks inherent in the covered business and makes allowance for the risk that future experience will differ from that assumed. In order to reduce the subjectivity when setting the RDR, the Board has decided to adopt a “bottom up” market-consistent approach to allow explicitly for market risk.

Using the market-consistent approach each cash flow is valued at a discount rate consistent with that used in the capital markets: in accordance with this, equity-based cash flows are discounted at an equity RDR and bond-based cash flows at a bond RDR. In practice a short-cut method known as the “certainty equivalent” approach has been adopted. This method assumes that all cash flows earn the risk-free rate of return and are discounted at the risk-free rate. In general, and consistent with the market’s approach to valuing financial instruments for hedging purposes, the risk-free rate is based on swap yields. Where, however, non-linked business is substantially backed by government bonds, the yields on these assets have been taken.

Within the risk margin allowance also needs to be made for non-market risks. For some of these risks e.g. mortality and expense risk it is assumed that the shareholder can diversify away any uncertainty where the impact of variations in experience on future cashflows is symmetrical. For those risks that are assumed to be diversifiable no adjustment to the risk margin has been made. For any remaining risks that are considered to be non-diversifiable risks there is no risk premium observable in the market and therefore a constant margin of 50 basis points has been added to the risk margin. The RDR is determined by equating the results from the traditional embedded value approach, including the assumed actual investment returns and traditional cost of capital, to that derived using the market-consistent method, this process being known as calibration of the RDR. The risk margin is then the difference between the derived RDR and the risk-free rate. The selection of the assumed actual investment returns and the reported cost of capital will have no impact on the reported result, as changes in these produce corresponding changes in the RDR.

A market-consistent valuation approach also generally requires consideration of “frictional” costs of holding shareholder capital: in particular, the cost of tax on investment returns and the impact of investment management fees can reduce the face value of shareholder funds. In the Group’s case, the expenses relating to corporate governance functions eliminate any taxable investment return in shareholder funds, while investment management fees are not material.

The risk margin established on the basis set above is normally calculated at each financial year end. In order to establish the opening position as at 1 January 2005 for the covered business of CA, at which time CWA was not yet a member of the Group, the risk margin employed is the risk margin of CA as a separate entity as at 31 December 2005. Further, in order to establish the acquisition date value of CWA as at 2 June 2005, the risk margin employed is the risk margin of CWA as a separate entity as at 31 December 2005.

(d) Analysis of Profit

The contribution to operating profit, which is identified at a level which reflects an assumed longer-term level of investment return, arises from three sources:

- (i) New business;
- (ii) Return from in-force business; and
- (iii) Return from shareholder net worth.

Additional contributions to profit arise from:

- (i) Variances between the actual investment return in the period and the assumed long-term investment return; and
- (ii) The effect of economic assumption changes.

The contribution from new business represents the value recognised at the end of each period in respect of new business written in that period, after allowing for the cost of acquiring the business, the cost of establishing the required technical provisions and after making allowance for the cost of capital.

The return from in-force business is calculated using closing assumptions and comprises:

- (i) The expected return, being the unwind of the discount rate over the period applied to establish the value of in-force business at the beginning of the period;
- (ii) Variances between the actual experience over the period and the assumptions made to establish the value of business in force at the beginning of the period; and
- (iii) The net effect of changes in future assumptions, made prospectively at the end of the period, from those used in establishing the value of business in force at the beginning of the period, other than changes in economic assumptions.

The contribution from shareholder net worth comprises the actual investment return on residual assets in excess of the required capital.

(e) Assumption Setting

The introduction of EEV reporting in lieu of reporting in accordance with the AP Basis does not alter the fundamental approach to determining the assumptions used to establish the present value of the future cash flows of the covered business. There is a requirement under EEV methodology to use best estimate demographic assumptions and to review these at least annually with the economic assumptions being determined at each reporting date. This approach is broadly that adopted for AP reporting and therefore the current practice will continue as detailed below.

Each year the demographic assumptions are reviewed as part of year-end processes and hence were reviewed in December 2006.

The detailed projection assumptions, including mortality, morbidity, persistency and expenses reflect recent operating experience. Allowance is made for future improvement in annuitant mortality based on experience and externally published data. Favourable changes in operating experience, particularly in relation to expenses and persistency, are not anticipated until the improvement in experience has been observed. Holding company expenses (for the Chesnara Group such expenses relate largely to listed company functions) are allocated to the covered business as the whole business of the Chesnara Group is the transaction of life assurance business through the subsidiary companies. Hence the expense assumptions used for the cash flow projections include the full cost of servicing this business.

The economic assumptions are reviewed and updated at each reporting date based on underlying investment conditions at the reporting date. The assumed discount rate and inflation rates are consistent with the investment return assumptions.

The assumptions required in the calculation of the value of the annuity rate guarantee on pension business have been set equal to best-estimate assumptions.

Notes to the Supplementary Information (continued)

4 Assumptions

(a) Investment Returns (pre-tax)

The assumed future pre-tax returns on fixed interest and RPI linked securities are set by reference to redemption yields available in the market at the end of the reporting period. The corresponding return on equities and property is equal to the fixed interest gilt assumptions plus an appropriate risk margin. For linked business the aggregate return has been determined by reference to the benchmark asset mix within the Managed Funds.

	2006	2005
Equity risk premium	2.7%	2.7%
Property risk premium	2.7%	2.7%
Investment return		
Fixed Interest	4.6%	4.1%
Equities	7.3%	6.8%
Property	7.3%	6.8%
Inflation		
Expenses	3.8%	3.4%

(b) Actuarial Assumptions

The demographic assumptions used to determine the value of the in-force business have been set at levels commensurate with the underlying operating experience identified in the periodic actuarial investigations.

(c) Taxation

Projected tax has been determined assuming current tax legislation and rates continue unaltered. No account has been taken of any prospective tax changes announced by the Chancellor of the Exchequer on 21 March 2007.

(d) Expenses

The expense levels are based on internal expense analysis investigations and are appropriately allocated to the new business and policy maintenance functions. These have been determined by reference to:

- (i) The outsourcing agreements in place with our third-party business process administrators;
- (ii) Anticipated revisions to the terms of such agreements as they fall due for renewal; and
- (iii) Corporate governance costs relating to the covered business.

The expense assumptions also include the expected future holding company expenses which will be recharged to the covered business.

No allowance has been made for future productivity improvements in the expense assumptions.

(e) Risk Discount Rate

The risk-free rate is set by reference to the sterling bid swap rates available in the market at the end of the reporting period. Where, however, non-linked business is substantially backed by government bonds, the yields on these assets have been used.

An explicit constant margin of 50 basis points is added to the risk-free rate to cover any remaining risks that are considered to be non-market, non-diversifiable risks, as there is no risk premium observable in the market. This margin gives due recognition to the fact that:

- (i) The covered business is substantially closed to new business;
- (ii) There is no significant exposure in the with profits business, which is wholly reassured;
- (iii) Expense risk is limited as a result of the outsourcing of substantially all policy administration functions to third-party business process administrators; and
- (iv) For much of the life business the Group has the ability to vary risk charges made to policyholders.

	31 December	
	2006	2005
Risk-free rate	4.8%	4.2%
Non-diversifiable risk	0.5%	0.5%
Risk margin	0.8%	0.9%
Risk discount rate	6.1%	5.6%

5 Analysis of shareholders' equity

	31 December	
	2006 £000	2005 £000
Covered business		
Required capital	45,792	54,749
Free surplus	38,668	29,727
Shareholder net worth	84,460	84,476
Value of in-force business	109,941	109,961
Embedded value of covered business	194,401	194,437
Less: amount financed by borrowings	(16,800)	(21,000)
Embedded value of covered business attributable to shareholders	177,601	173,437
Net equity of other Group companies	11,507	2,736
Total shareholders' equity	189,108	176,173
The movement in the value of in-force business comprises:		
Value at beginning of period	109,961	61,437
Acquired in-force value arising on the acquisition of CWA Life Holdings plc	–	53,804
Amount charged to operating profit	(20)	(5,280)
Value at end of period	109,941	109,961

On 2 June 2005, the Group drew down £21m on a bank loan facility, in order to part fund the acquisition of CWA Life Holdings plc, referred to in Note 1 above. This effectively represented a purchase of part of the underlying value in force of CWA by way of debt finance and it follows that the embedded value of the covered business is not attributable to equity shareholders of the Group to the extent of the outstanding balance on the loan account at each balance sheet date. The loan is repayable in five equal annual instalments on the anniversary of the draw down date, the funds for the repayment effectively being provided by way of the realisation of the underlying value of in-force business of the covered business. In accordance with this, £4.2m of the loan was repaid on 2 June 2006, leaving principal outstanding at that date of £16.8m.

6 Analysis of profit of covered business

	Year ended 31 December	
	2006 £000	2005 £000
New business contribution	1,599	1,147
Return from in-force business		
Expected return	10,386	9,087
Experience variances	7,459	(563)
Operating assumption changes	(5,072)	542
Return on shareholder net worth	1,312	1,140
Operating profit	15,684	11,353
Variation from longer-term investment return	6,307	14,525
Effect of economic assumption changes	9,284	(3,598)
Profit on covered business before tax	31,275	22,280
Tax	(4,496)	(2,068)
Profit on covered business after tax	26,779	20,212

The profit of covered business varies from amounts presented in the summarised consolidated income statement in respect of the pre-tax result of the holding company presented as “other operational result”, any tax pertaining thereto, which is included in “other tax”, and profit on acquisition of subsidiary company and related tax, which are exceptional items. The variation from longer-term investment return for the year ended 31 December 2006 is stated net of a loss of £248,000 arising on the sale of a subsidiary company.

7 Sensitivities to alternative assumptions

The following table shows the sensitivity of the embedded value of the covered business as reported at 31 December 2006 to variations in the assumptions adopted in the calculation of the embedded value. Sensitivity analysis is not provided in respect of the new business contribution for the year ended 31 December 2006 as the reported level of new business contribution is not considered to be material (see Note 3(a) above). It largely relates to guaranteed bond business, where a close asset/liability matching approach leaves values largely insensitive to changes in experience.

Embedded Value (“EV”) of covered business as at 31 December 2006	£194.4m
	Change in EV (£m)
Economic sensitivities	
100 basis point increase in risk discount rate	(5.8)
100 basis point reduction in yield curve	(2.5)
10% decrease in equity and property values	(3.1)
Operating sensitivities	
10% decrease in maintenance expenses	2.4
10% decrease in lapse rates	3.6
5% decrease in mortality/morbidity rates	
Assurances	2.0
Annuities	(0.5)
Reduction in the required capital to statutory minimum	0.9

The key assumption changes represented by each of these sensitivities are as follows:

Economic sensitivities

- (i) 100 basis point increase in the risk discount rate. The 6.1% RDR increases to 7.1%;
- (ii) 100 basis point reduction in the yield curve. The fixed interest return is reduced by 1% and the equity/property returns are also reduced by 1%, thus maintaining constant equity/property risk premiums. The

rate of future inflation has also been reduced by 1% so that real yields remain constant. In addition the risk discount rate has also reduced by 1%; and

- (iii) 10% decrease in the equity and property values. This gives rise to a situation where, for example, a Managed Fund unit liability with a 60% equity holding would reduce by 6% in value.

Operating sensitivities

- (i) 10% decrease in maintenance expenses, giving rise to, for example, a base assumption of £20 per policy pa reducing to £18 per policy pa;
- (ii) 10% decrease in persistency rates giving rise to, for example, a base assumption of 10% of policy base lapsing pa reducing to 9% pa;
- (iii) 5% decrease in mortality/morbidity rates giving rise to, for example, a base assumption of 100% of the parameters in a selected mortality/morbidity table reducing to 95% of the parameters in the same table; and
- (iv) the sensitivity to the reduction in the required capital to the statutory minimum shows the effect of reducing the required capital from 150% of the LTICR plus 100% RCR to the amounts of 100% LTICR plus 100% RCR, being the minimum requirement prescribed by FSA regulation.

In each sensitivity calculation all other assumptions remain unchanged except where they are directly affected by the revised economic conditions: for example, as stated, changes in interest rates will directly affect the risk discount rate.

The sensitivities to changes in the assumptions in the opposite direction will result in changes of similar magnitude to those shown in the above table but in the opposite direction.

8 Reconciliation of shareholders' equity on the IFRS basis to shareholders' equity on the EEV basis

	31 December	
	2006 £000	2005 £000
Shareholders' equity on the IFRS basis	114,255	108,267
Adjustments		
Deferred acquisition costs		
Insurance contracts	–	(1,114)
Investment contracts	(10,074)	(11,239)
Deferred income	17,239	19,145
Adjustment to provisions on investment contracts, net of amounts deposited with reinsurers	(19,596)	(16,700)
Adjustments to provisions on insurance contracts, net of reinsurers' share	(936)	(34)
Acquired in-force value	(25,933)	(28,703)
Deferred tax	4,212	2,590
Reinsurer default reserve	–	(6,000)
Group shareholder net worth	79,167	66,212
Value of inforce business	109,941	109,961
Shareholders' equity on the EEV basis	189,108	176,173
Group shareholder net worth comprises:		
Shareholder net worth in covered business	84,460	84,476
Shareholder's equity in other Group companies	11,507	2,736
Debt finance	(16,800)	(21,000)
Total	79,167	66,212

8 Reconciliation of shareholders' equity on the IFRS basis to shareholders' equity on the EEV basis (continued)

The reinsurer default reserve adjustment at 31 December 2005 related to a reserve which was established for FSA prudential reporting and which was recognised for reporting on the EEV basis, but not for reporting on the IFRS basis. The reserve was not recognised for reporting in accordance with IFRS as the events to which it relates were, in the opinion of the Directors, considered to be remote or uncertain. However, the reserve was charged to the shareholder net worth component of the embedded value of the covered business, as this was held to be consistent with the market-consistent valuation approach adopted in accordance with EEV principles. The reserve was maintained against the effect of possible default by a major reinsurer, Guardian Assurance plc, which is a subsidiary of Aegon NV. As a result of mitigating action that was taken during 2006 the reserve is no longer required at 31 December 2006.

Restatement of Supplementary Information from AP to EEV Basis

Introduction

The first-time adoption of EEV principles and associated disclosures represents a change from the AP basis of reporting, which has previously been adopted by the Group as the basis for presenting supplementary financial information.

The following tables and notes set out and explain the reconciliations between amounts previously reported under AP methodology for the comparative period presented in these supplementary financial statements and the amounts as they are now restated in accordance with EEV principles. The reconciliations set out the impact on the components of shareholder equity as at 31 December 2005 and on the changes in shareholder equity for the year then ended.

Reference should also be made to Note 3(e) to the Supplementary Information, which sets out the relationship between assumptions used to establish the present value of the future cashflows of the covered business on an AP basis with those used in accordance with EEV principles.

Reconciliation of the components of shareholder equity at 31 December 2005

	Note	AP as reported £000	Cost of capital £000 (a)	Indexation increases on business in force £000 (b)	Holding company expenses £000 (c)	Reinsurer default reserve £000 (d)	Risk discount rate £000 (e)	Tax £000 (f)	EEV as restated £000
Covered business									
Shareholder net worth		84,476	–	–	–	–	–	–	84,476
Value of in force business		119,476	(2,201)	2,676	(22,124)	(3,123)	19,742	(4,485)	109,961
Embedded value of covered business		203,952	(2,201)	2,676	(22,124)	(3,123)	19,742	(4,485)	194,437
Net equity of non-covered business		(18,264)	–	–	–	–	–	–	(18,264)
Total shareholder equity		185,688	(2,201)	2,676	(22,124)	(3,123)	19,742	(4,485)	176,173

Reconciliation of consolidated statement of changes in equity for the year ended 31 December 2005

	AP as reported £000	Net adjustments £000	EEV as restated £000
Shareholders' equity at 1 January	149,187	(23,158)	126,029
Profit for the period representing total recognised income and expense	26,291	13,643	39,934
Dividends paid	(11,249)	–	(11,249)
Issue of ordinary shares pursuant to exercise of option	1,533	–	1,533
Issue of ordinary shares pursuant to placing and open offer	22,000	–	22,000
Expenses incurred in connection with issue of ordinary shares pursuant to placing and open offer	(2,074)	–	(2,074)
Shareholders' equity at 31 December	185,688	(9,515)	176,173

Notes to the restatement of supplementary financial information from the AP to the EEV basis

(a) Cost of capital

For AP reporting the cost of capital was determined as the face value of the statutory minimum capital required to be maintained in accordance with FSA Pillar I regulations less the discounted value of future releases of that capital, after allowing for net investment returns. Accordingly, the level of capital was taken as 100% of the Long Term Insurance Capital Requirement (“LTICR”) plus 100% of the Resilience Capital Requirement (“RCR”) as set out in FSA Regulations.

As a result of the restatement in accordance with EEV principles, the level of required capital has increased so that it is determined to be 150% of the LTICR plus 100% of the RCR. Prior to the transfer, referred to in Note 2, the capital requirement for CWA covered business was determined to be £5m over the minimum statutory requirement.

The amount shown in the restatement table is the cost of holding the additional capital, such cost being determined using the same method as that used under AP methodology.

(b) Indexation increases on business in force

Within the value of in-force business for CA, as determined for AP reporting, credit was taken for indexation increases on policies where the policy contained contractual automatic increase options. However, for CWA business, the value of any such options was included in the value of new business when they were exercised and no benefit was taken for prospective increases within the in-force value.

EEV principles permit the continuance of the method of recognising the value of such options when they are written rather than when they are exercised. The amount shown in the restatement table is the effect of allowing for such options within the in-force value of CWA covered business.

No credit is taken within the in-force value under either AP or EEV methodologies for future DWP rebates and pension annuity vesting. These will continue to be treated as new business in the period of receipt.

(c) Holding company expenses

For AP reporting no allowance was made within the in-force value for future holding company expenses. In accordance with EEV principles, the in-force value is determined after making allowance for all Chesnara Group function expenses, which it is anticipated will be allocated to the covered business over the life of that business.

The holding company expenses are charged against the shareholder fund and there is a consequential effect on the amount of tax payable within the shareholder fund. This gives rise to a second order effect on the cost of holding the required capital, as frictional costs are reduced.

The amount shown in the restatement table reflects the effect of including the additional holding company expenses within the in-force value together with the associated impact on the cost of required capital.

(d) Reinsurer default reserve

For AP reporting credit was taken in the in-force value for the release of a reinsurer default reserve, which had been charged against shareholder net assets. This method was used effectively to recognise the cost of capital of maintaining the reserve.

In accordance with EEV principles a market-consistent embedded value methodology is used. The Directors consider that the release of the reserve within the in-force value is inconsistent with this methodology. Accordingly, the amount in the restatement table reflects the reversal of the release of the reserve within the in-force value.

(e) Risk discount rate

All of the preceding restatement items have been quantified by applying the risk discount rate determined under AP reporting to the cash flows related to the restatement items. The amount shown in the restatement table as the risk discount rate adjustment is the result of the application of the difference between (i) the risk discount rate determined for AP reporting and (ii) the risk discount rate established on a calibrated traditional embedded value basis, to the cashflows arising on the business in force, as adjusted for all of the other restatement items, including the associated impact on the cost of required capital.

This difference arises from the fact that the AP risk margin within the risk discount rate was intentionally determined by the Directors on a conservative basis, to recognise uncertainty surrounding lapse and expense

assumptions and the adequacy of provisions for mis-selling redress. In accordance with EEV principles, this subjectivity is removed from the assessment of the risk discount rate, as assumptions are explicitly determined on a best-estimate basis. The Directors consider that the acquisition of CWA and the subsequent transfer of its long-term business to CA diversify the risks inherent in each separate entity, thus requiring a lower overall risk margin. In addition, operational experience and strengthening of expense assumptions have removed some of the operational uncertainty referred to above, contributing to the reduction in the required risk margin.

(f) Tax

All of the effects shown in the restatement table are gross of tax. The amount shown as the tax adjustment in the restatement table is the aggregate effect on future tax payable of all of the preceding restatement items.

Notice of Annual General Meeting

Chesnara plc

Notice is hereby given that the Annual General Meeting of the Company will be held at the offices of Panmure Gordon (UK) Limited, Moorgate Hall, Moorgate, London, EC2M 6XB on 10 May 2007 at 11am for the following purposes:

Ordinary Business

To consider and if thought fit, to pass the following resolutions which will be proposed as ordinary resolutions:

Resolution 1

To receive and adopt the Financial Statements for the financial year ended 31 December 2006 together with the Reports of the Directors and Auditor thereon.

Resolution 2

To declare a final dividend for the financial year ended 31 December 2006.

Resolution 3

To approve the Directors' Remuneration Report set out in the Financial Statements for the financial year ended 31 December 2006.

Resolution 4

To re-elect Christopher Sporborg who retires by rotation.

Resolution 5

To re-elect Ken Romney who retires by rotation.

Resolution 6

To re-elect Frank Hughes who retires by rotation.

Resolution 7

To reappoint KPMG Audit Plc as Auditor of the Company to hold office from the conclusion of this meeting until the conclusion of the next General Meeting at which the Financial Statements are laid before the Company at a remuneration to be determined by the Directors.

Special Business

To consider and, if thought fit, pass the following resolutions of which Resolution 8 will be proposed as an ordinary resolution and resolutions 9, 10, 11 and 12 will be proposed as special resolutions.

Resolution 8

That the Directors be and they are generally and unconditionally authorised, pursuant to Section 80 of the Companies Act 1985 ("the Act") to exercise all the powers of the Company to allot relevant securities (as defined in Section 80 of the Act) provided that:

- (i) The aggregate nominal value of relevant securities allotted pursuant to this authority shall not exceed £1,742,972 representing 33.33% of the issued ordinary shares of 5p each;
- (ii) This authority shall expire on the date of the Annual General Meeting to be held in 2008 or fifteen months after the passing of this resolution whichever occurs first; and
- (iii) The company may make an offer or agreement before the expiry of this authority which would or might require relevant securities to be allotted after this authority has expired and the Directors may allot relevant securities in pursuance of any such offer or agreements as if this authority has not expired.

This authority is to replace the existing like authority which is hereby revoked with immediate effect.

Resolution 9

That, subject to the passing of Resolution 8, the Directors be and they are empowered, pursuant to Section 95 of the Act, to allot equity securities (as defined in Section 94 of the Act) pursuant to the authority contained in the foregoing Resolution numbered 8 as if Section 89(1) of the Act did not apply to such allotment, provided that this power shall be limited to:

- (i) The allotment of equity securities in connection with a rights issue or other pre-emptive offer in favour of holders of ordinary shares where the equity securities respectively attributable to the interests of all holders of ordinary shares are proportionate (as nearly as may be) to the respective numbers of ordinary shares held by them subject to such exclusions or arrangements as the Directors may deem necessary or desirable to deal with fractional entitlements otherwise arising or legal or practical problems under the laws or regulations of any regulatory authority in any territory;
- (ii) The allotment of equity securities pursuant to the terms of any share scheme for employees approved by the members in General Meetings; and
- (iii) The allotment of equity securities for cash (otherwise than as mentioned in sub-paragraphs (i) and (ii) above) provided that the maximum aggregate nominal value of equity securities allotted does not exceed £261,471 representing approximately 5% of the issued share capital of the Company; and shall expire on the date of the Annual General Meeting of the Company to be held in 2008 or fifteen months after the passing of this resolution whichever occurs first except to the extent that the same is renewed or extended prior to or at such Meeting save that the Company may make an offer or agreement before the expiry of this power which would or might require securities to be allotted after it has expired and the Directors may allot equity securities in pursuance of any such offer or agreement as if the power conferred hereby had not expired.

Resolution 10

That the Company be and is generally and unconditionally authorised for the purposes of Section 166 of the Act to make one or more market purchases (within the meaning of Section 163(3) of the Companies Act 1985) on the London Stock Exchange of ordinary shares of 5p each in the capital of the Company provided that:

- (i) The maximum aggregate number of ordinary shares hereby authorised to be purchased is 10,458,878 (representing 10% of the Company's issued share capital);
- (ii) The minimum price which may be paid for such ordinary shares is 5p per share;
- (iii) The maximum price (exclusive of expenses) which may be paid for such ordinary shares is not more than 5% above the average of the middle market quotations for the ordinary shares derived from the Daily Official List of the London Stock Exchange for the five business days before the purchase is made;
- (iv) The authority hereby conferred shall expire at the conclusion of the next Annual General Meeting of the Company held in 2008 or, if earlier, the date 15 months after the date on which the resolution is passed; and
- (v) The Company may make a contract or contracts to purchase ordinary shares under the authority hereby conferred prior to the expiry of such authority which will or may be executed wholly or partly after the expiry of such authority, and may make a purchase of ordinary shares in pursuance of any such contract or contracts.

Resolution 11

That the Company may send or supply documents, notices or information to its members by making such documents, notices or information available to its members on a website or by other electronic means or in other electronic form.

Resolution 12

That the Articles of Association set out in the document produced to the meeting (and signed by the Chairman for the purpose of identification) be adopted as the Articles of Association of the Company in substitution for, and to the exclusion of, all existing Articles of Association.

Notes

1. Any Member entitled to attend and vote at this Meeting may appoint a proxy or proxies to attend and on a poll, vote instead of him. A proxy need not be a Member of the Company. A form of proxy for this Meeting is enclosed, and if used should be lodged with the Company's Registrars, Capita Registrars at Proxy Processing Centre, Telford Road, Bicester OX26 4LD not less than 48 hours before the time appointed for the holding of the meeting. The appointment of a proxy will not preclude a shareholder from attending and voting at the meeting.
2. There is no Directors' service contract of more than one year's duration with any Director.
3. The Register of Directors' shareholdings and transactions and copies of Directors' service contracts will be available for inspection at the registered office of the Company during normal business hours each business day and at the place of the Annual General Meeting for at least 15 minutes prior to and during the Meeting.
4. Pursuant to Regulation 41 of the Uncertificated Securities Regulations 2001, the time by which a person must be entered on the register of members in order to have the right to attend and vote at the Annual General Meeting is 11am on 8 May 2007 or, if the Meeting is adjourned, such time being not more than 48 hours prior to the time fixed for the adjourned meeting. Changes to entries on the register of members after that time will be disregarded in determining the right of any person to attend or vote at the meeting.

Additional Information

Approval of the Directors' Remuneration Report set out in the Financial Statements (Resolution 3)

The Directors' Remuneration Report Regulations 2002, which came into force on 1 August 2002, stipulates the form of the Report. The Report is set out on pages 36 to 40 of the Financial Statements. Shareholders will be asked to approve this Remuneration Report under Resolution 3.

Authority to Allot Relevant Securities (Resolution 8)

The Company will be asking shareholders to renew the existing authority which the Directors have to allot shares in respect of the authorised but unissued ordinary share capital. Resolution 8 seeks to renew this authority to issue shares up to an aggregate nominal amount of £1,742,972 representing approximately 33.33% of the issued share capital of the Company.

Disapplication of Pre-emption Rights (Resolution 9)

Resolution 9 will be proposed as a Special Resolution, renewing the Directors' authority to allot shares for cash other than to existing shareholders in proportion to their shareholding up to an aggregate nominal value of £261,471, representing 5% of the Company's issued share capital.

Both these authorities (Resolutions 8 and 9), if given, will expire at the conclusion of the next Annual General Meeting or 15 months after the passing of the resolution, whichever occurs first.

Power to purchase own shares (Resolution 10)

The Companies Act 1985 permits a public company to purchase its own shares in accordance with powers contained in its Articles of Association with the authority of a resolution of shareholders. Such a power would expire at the conclusion of the next Annual General Meeting. With effect from 1 December 2003, listed companies are able to buy their own shares and, instead of cancelling them, hold them in treasury and either sell them for cash or use them for cash or use them for an employee share scheme under the Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003. The aggregate nominal value of shares of any class held as treasury shares must not at any time exceed 10% of the nominal value of the issued share capital of the shares in that class at that time. Your Directors believe that the Company should continue to have the authority to purchase its own shares. However, this authority will only be exercised when the result would be an increase in earnings per share and in the best interests of the Company. Your Directors have no present intention to make use of this authority. Resolution 10 will be proposed as a special resolution at the Annual General Meeting to give the necessary authority.

Electronic Communications (Resolution 11)

The Disclosure and Transparency Rules issued by the Financial Services Authority require that a decision for a company to use electronic means to convey information to shareholders must be taken in general meeting. The Company wishes to seek the approval of members in general meeting to the communication by the Company with its members by electronic means, including by way of a website or in any other electronic form (subject to the requirements of any enactment). This Resolution simply enables the Company to use these forms of communication: the Company is required to seek the individual agreement of each shareholder to such means of communication (please see the notes to Resolution 12).

Adoption of New Articles of Association (Resolution 12)

With effect from 20 January 2007 the electronic communications provisions of the Companies Act 1985 are repealed and are replaced by the electronic communications provisions of the Companies Act 2006 and, to the extent relevant, in the Disclosure and Transparency Rules of the Financial Services Authority. The changes shown in the draft Articles of Association to be adopted in place of the Company's existing Articles of Association bring into effect all such changes. The Company is required to seek the individual agreement of each shareholder to such means of communication in accordance with the terms of the Articles as to be amended by this Resolution. The proposed changes to effect these requirements affect the following:

- Article 2 (Definitions) (together with consequential changes in the text of the Articles)
- Article 49 (Untraceable Shareholders)
- New Articles 61, 62 and 63 (Notice of General Meetings)
- Articles 86-90 (Proxies)
- Articles 161 and 168, and New Articles 162, 163, 164 and 170 (Notices)

With effect from 20 January 2007 the provisions of sections 212 to 220 of the Companies Act 1985 are repealed and replaced with the provisions of Part 22 of the Companies Act 2006, save that where the Company has outstanding section 212 notices then Schedule 5 Part 2 Paragraph 2(2) of the Companies Act 2006 (Commencement No. 1 Transitional Provisions and Savings) Order 2006 provides that the obligations arising pursuant to such a section 212 notice continue notwithstanding its repeal. The changes which effect these provisions are made to Article 51 (Disclosure of Interests).

These changes put into effect the above proposals and, other than consequential changes in defined terms or cross referencing between Articles, make no other changes to the Articles of Association.

By Order of the Board

Ken Romney
Company Secretary

Date 28 March 2007

Registered Office and Group Head Office

Harbour House
Portway
Preston
PR2 2PR

AGM Location

Panmure Gordon (UK) Limited's Office
Moorgate Hall
Moorgate
London
EC2M 6XB

