

The logo for Chesnara, featuring the word "Chesnara" in a white, sans-serif font. The letters "e", "s", and "n" are highlighted with a green-to-blue gradient. The logo is set against a dark blue rectangular background.

Chesnara

Chesnara plc

Financial Statements
for the Year Ended
31 December 2008

Financial Calendar

31 March 2009	Results for the year ended 31 December 2008 announced
8 April 2009	Ex dividend date
14 April 2009	Dividend record date
14 April 2009	Published Financial Statements issued to shareholders
14 May 2009	Annual General Meeting
19 May 2009	Interim Management Statement
20 May 2009	Dividend payment date
August 2009	Interim results for the six months ending 30 June 2009 announced
November 2009	Interim Management Statement

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

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Note on terminology

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, in which the whole of the Life operations of the Group now subsist. However, within this document reference is made to ‘CWA’ and to ‘CA’ to continue to identify respectively the long-term business which had been conducted within the respective companies prior to this transfer.

Financial Highlights

	Year ended 31 December	
	2008	2007
IFRS basis		
Operating profit	23.5	28.8
Financing costs	(0.8)	(1.1)
Profit before income taxes	£22.7m	£27.7m
Basic earnings per share	19.24p	24.32p
Dividend per share	15.55p	15.10p
Shareholders' net equity	£126.4m	£125.8m
European Embedded Value basis (EEV)		
Operating profit	25.9	13.5
Investment variances and economic assumption changes	(9.9)	(7.1)
Profit before tax	16.0	6.4
Tax	(1.2)	5.7
Profit for the period	£14.8m	£12.1m
Shareholders' equity on EEV basis		
Covered business		
Shareholder net worth	69.4	77.6
Value of in-force business	84.9	94.0
Embedded value of covered business	154.3	171.6
Acquired embedded value financed by debt	(8.4)	(12.4)
Shareholders' equity in other Group companies	36.8	28.1
	£182.7m	£187.3m
EEV per share	180.0p	179.1p
Life annual premium income (AP)	£92.6m	£102.3m
Life single premium income (SP)	£23.9m	£32.0m
Life annualised premium income (AP + 1/10 SP)	£95.0m	£105.5m

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.

I am pleased to present the fifth annual financial statements of Chesnara plc ('Chesnara') and my first since I took over the chairmanship of the Company from Christopher Sporborg who retired at the end of 2008. It is a time when the economy is facing its greatest challenges for decades and when the Company has been presented with its most difficult trading conditions since its launch in May 2004. With this in mind, it is particularly pleasing that the Group's results for 2008 show a high degree of resilience, enabling us to continue to maintain a reliable and progressive dividend policy, whilst being in a good position to pursue value-enhancing acquisitions as they arise.

Review of the Business

A key influence on Group performance in 2008 has clearly been the decline in global equity markets, with the leading UK indices, for example, showing a 32% decline over the year. However, positive influences have significantly mitigated the overall adverse impact of investment market falls.

On the IFRS basis, the pre-tax profit has progressed from £10.0m at the half-year to £22.7m for the full year ended 31 December 2008. This compares with £27.7m for 2007, the year on year decrease being primarily driven by the expected reduction in the level of surplus arising in a declining book of business and by a £5m adverse impact from investment markets. Furthermore the 2007 result benefited from a one-off release of £1.1m from the mortgage endowment complaints provision.

On the EEV basis we have recognised a pre-tax profit of £16.0m compared with £6.4m for 2007. The impact of investment markets and associated policyholder CGT effects has led to a reduction at the pre-tax level, of £20.3m. This was offset by the sharp fall in short-term interest rates in the last quarter which led to a significant capital appreciation in our non-linked fixed interest portfolio. This benefited the EEV (and IFRS) pre-tax result to the extent of £3.5m, so that the net adverse impact arising from investment market influences is some £16.8m. In addition to the expected return of £10.4m arising from the unwind of the risk discount rate, this was further offset by:

- (i) favourable persistency experience of £5.5m;
- (ii) some £6.5m arising from a re-setting of the longer-term expense assumptions, which follows principally from a careful re-assessment of the expense conditions that will prevail as the policy base in the Life business diminishes; and
- (iii) economic assumption change effects adding some £7m to embedded value: this reflects an expected lower interest rate/lower inflation rate environment.

As stated in our Interim Management Statement issued in November 2008, following the entry of Kaupthing Singer and Friedlander into administration, we have fully written down a cash deposit with them and this has adversely impacted both the EEV and IFRS pre-tax result by £1.1m.

We have continued to maintain tight control over expenses, while the provisions we previously established for mortgage endowments misselling and unit pricing remedial redress exposures are considered to be adequate. The number of mortgage endowment misselling complaints received during the year at 1,200 shows a significant decline over the 2007 level of 2,234, while over 80% of all in-force mortgage endowment policies are now time-barred from complaint.

We have decided not to reflect the improvement in lapses experienced in 2008 in future EEV assumptions to allow for some future deterioration as a possible consequence of current economic conditions.

Shareholder Value and Returns to Shareholders

Total shareholder equity on the EEV basis, pre the final dividend appropriation, is £182.7m (180.0p per share) as at 31 December 2008, compared with £187.3m (179.1p per share) as at 31 December 2007. This movement includes the effect of dividends paid during the year of £16.1m and of £3.4m expended on a share buyback programme and is somewhat less than may be expected from the reducing underlying policy base. This results from the positive influences on EEV, which have more than outweighed the impact of adverse investment market conditions.

The capacity of the Company to continue to pursue its dividend policy relies on the continuing emergence of surplus in the Life business and on the ability to distribute this surplus, which in turn depends on the regulatory and solvency position of the Life business. While current economic and investment market conditions have challenged the strength of the Life business, I am pleased to report that the Life business's solvency ratio at 177% (179% at 31 December 2007) remains in excess of the target set by the Board of 150% and that the Group's

post-dividend solvency ratio continues to strengthen significantly from 312% at 31 December 2007 to 358% at 31 December 2008.

It is particularly worthy of note that market turmoil in 2008 has led to a significant widening of spreads in corporate bonds, through a changed assessment of default and liquidity risk, and this has led to general concern within the Life industry. The existing prudent approach in our Life business has not necessitated any additional strengthening in this area.

Based on the strength of our results, and of our capital solvency ratios, the Board has decided to recommend a final dividend of 10.05p per share (2007 final dividend: 9.85p per share), giving rise to total dividends of 15.55p per share for 2008 which represents a 2.98% increase over total dividends of 15.1p per share for 2007. At the recent trading range of between 120p and 130p per share, this represents a yield to shareholders of between 12% and 13%.

Despite having consistently fulfilled our undertaking to pursue a reliable and progressive dividend policy, between the end of June 2008 and the end of November 2008, the share price suffered from the wider investment market turbulence and traded at a significant discount to embedded value. The lowest closing price in this period was 100.25p, a 42% discount to the embedded value reported as at 30 June 2008.

In the light of this, the Board re-examined the opportunities for enhancing shareholder value. Through the year we examined a number of acquisition opportunities in the life assurance and related sectors. As none of the opportunities examined by us proved compelling, we decided to undertake a share buyback programme as an alternative and focussed way of delivering value to shareholders. The details of the programme which involved the utilisation of some £3.4m of funds are set out in the Directors' Report on page 8 and in Note 37 to the financial statements on page 104.

Outlook

The global investment market volatility experienced in 2008 continues into 2009. While we remain optimistic that our financial position will continue to demonstrate resilience, these circumstances clearly present a heightened level of risk. Accordingly, we have taken additional steps to protect shareholder value. We regularly monitor our fixed interest and treasury fund portfolio to ensure that we are not unduly exposed to particular counterparties or to particular sectors. Further, as our underlying bond obligations to policyholders mature, so our exposure to possible default of matching corporate bonds progressively reduces through 2009. We also closely monitor the financial position of a significant financial reassurer, Guardian Assurance plc, and are satisfied that we do not currently carry an undue level of default risk in this regard. The impact of adverse circumstances to the Group continues to be appraised through a risk-based assessment of capital requirements in the Life business which tests the ability of the Life business to withstand various scenarios, including the stresses presented by sharply adverse investment market and economic conditions.

We believe that attractively priced target acquisitions are starting to become available as a result of the current turbulence in the market. We will continue to examine such opportunities as they arise and believe that we have a strong financial and operational platform from which to pursue them, although, given the current climate, we will continue to apply strict financial and risk criteria to any prospective acquisitions.

I believe we are well placed to fulfil our stated objective of continuing to deliver a reliable and progressive dividend flow and I wish to thank all our employees for their contribution to the Group in realising this aim.

In addition, I would particularly like to thank Christopher Sporborg who, as Chairman, has guided the Company skilfully, wisely and prudently in the years since its launch. I also welcome Peter Wright to the Board. Peter's skills and experience will, I'm sure, prove invaluable to the Company in the challenges ahead.

Peter Mason
Chairman
30 March 2009

Peter Mason was the Senior Independent Non-executive Director of Chesnara plc and Chairman of the Audit Committee during 2008. He was appointed as Chairman of Chesnara plc and Chairman of the Chesnara Nomination Committee on 1 January 2009. He also served on the Remuneration and Nomination Committees during 2008 but retired from those Committees on 31 December 2008 on his appointment as Chairman of the Company. He is currently a Non-executive Director of 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.

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 in the financial services 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 25 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 24 years' experience in the life assurance industry gained with Royal Life, Norwich Union and CMG.

Mike Gordon is an Independent Non-executive Director of Chesnara plc and is Chairman of the Remuneration Committee. He was appointed as Senior Independent Non-executive Director of Chesnara plc on 1 January 2009. 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 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. Previous roles included senior management positions at Lloyds Bank and General Accident.

Peter Wright (appointed 1 January 2009) is an Independent Non-executive Director who was appointed to the Chesnara plc Board on 1 January 2009. At the same date he was appointed as Chairman of the Audit Committee and as a member of the Remuneration Committee. He retired as a Principal of Towers Perrin on 1 January 2008. He is a former Vice President of the Institute of Actuaries, having been admitted as a Fellow in 1979.

Directors' Report

The Directors present their report and the audited consolidated accounts of Chesnara plc ('Chesnara') for the year ended 31 December 2008.

Results and Dividends

The Group consolidated income statement for the year ended 31 December 2008, prepared in accordance with International Financial Reporting Standards and set out on page 43, shows:

	2008 £000	2007 £000
Profit for the year	20,017	25,439

An interim dividend of 5.5p per ordinary share was paid by Chesnara on 12 October 2008. The Board recommends payment of a final dividend of 10.05p per ordinary share on 20 May 2009 to shareholders on the register at the close of business on 14 April 2009.

Purchase of Own Shares

The Company was granted authority at the Annual General Meeting on 19 May 2008 to purchase its own shares up to a total aggregate number of 10,458,878, representing 10% of the Company's issued share capital at that date subject to certain conditions. In accordance with that authority and with the specified conditions and in order to enhance shareholder value, the Company purchased a total of 3,096,194 shares between 24 September 2008 and 20 November 2008 with a nominal value of £154,809, representing 2.96% of the Company's issued share capital on 24 September 2008, at a total cost of £3,379,000. These shares are held in Treasury. The existing authority to purchase own shares expires on the date of the 2009 Annual General Meeting, at which a resolution will be proposed for its renewal.

Business Review

Strategic aims

Chesnara seeks to participate in the consolidation of the closed life business sector in the UK. In 2004, at the same time that the Company was listed on the London Stock Exchange, we acquired Countrywide Assured plc ('CA') on CA's effective demerger from Countrywide plc. In 2005 we acquired City of Westminster Assurance Company Limited ('CWA') from Irish Life and Permanent plc. In 2006 we merged the long-term business of the two companies in order to release significant financial and operational synergies.

As the life company is substantially closed to new business its primary focus is on the efficient run-off of its 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.

Following a spate of activity, consolidation in the UK closed life sector slowed in the last two years as valuations reached levels which meant that potential returns were unattractive. Valuations have since reduced as a consequence of changes in the wider financial market environment and of concerns relating to capital adequacy and risk. Whilst the environment is now more challenging, it is apparent that further consolidation is likely to occur.

Consolidation is driven by the opportunity to rationalise operations and to achieve financial and operational synergies from the closed books. These may in turn be enhanced by merging them into one legal entity, which also provides the opportunity for more efficient use, and potential release, of capital from the combined businesses. Returns are underpinned by the prospect of a reasonably predictable emergence of surplus.

To prolong the yield delivery afforded by this emergence of surplus we continue to search for opportunities to acquire similar businesses in the small to medium sector of the life assurance market. In the absence of suitable acquisitions we continue to examine other opportunities in the wider financial services sector that could leverage value from our existing capabilities.

Chesnara, by virtue of its market capitalisation, primarily targets acquisitions with a value of between £50m and £200m, although other opportunities are considered. All opportunities are assessed against a number of key criteria including size, risk (including actual or potential product and financial liabilities), discount to embedded value, and the pattern and quality of predicted profit emergence. Our strategic approach, however, remains that

such potential acquisitions should not detract significantly from the key aim of delivering a steady and attractive dividend yield.

In the absence of any compelling acquisition opportunities and with the share price trading at a significant discount to embedded value the Board decided, in late September 2008, that the most efficient way to create shareholder value was to undertake a share buyback programme. This ended on 20 November 2008 at which point we had purchased 3,096,194 shares at an average price of 108.05p which compares favourably to the closing price on 27 March 2009 of 138.75p and to the embedded value per share of 180.02p as at 31 December 2008. The shares are currently held in Treasury.

How we achieve our strategic aims

The operating model of our life business 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 broadly 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;
- management of risk, including management of financial exposures;
- maintaining regulatory compliance;
- pursuing value-enhancing initiatives on the existing business; 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.

As well as maintaining systems and controls which satisfy the regulatory requirements we maintain a strong internal risk management culture and regime. Further detail on the processes we utilise for identifying, evaluating and managing risks to the Group can be found on page 33.

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 focussed on 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 Company performance. Accordingly, we maintain an annual bonus scheme where half of the potential payment is guaranteed provided that the individuals remain in Company employment on a specified date, while the remaining half 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 34. The training and competence needs of individuals are regularly assessed as an integral part of our risk management regime as 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 or that they should form any significant element of remuneration or reward.

Developments during 2008

The emergence of new acquisition opportunities in the UK closed life sector slowed considerably for the major part of 2008, particularly within our £50m to £200m value target range. There are signs that more closed life and pensions books will become available as a consequence of the current difficulties in the financial markets. Nevertheless we have continued to investigate other opportunities which could leverage value from our existing capabilities.

During the course of the year we examined a number of such opportunities. In general, whilst there was value to be had, difficulties in pricing, exacerbated by the never-ending stream of disturbing financial news, meant that the potential risks involved outweighed the possible rewards. This, together with the dearth of capital available in the markets and difficulties in accurately assessing pricing in volatile markets, has meant that we have kept our powder dry in 2008.

As to the existing life and pensions portfolios, we have continued to seek to maintain shareholder value through 2008, particularly in the following areas:

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 exposure to market falls by way of policyholder's linked funds (from which surplus is partially generated) and to the misselling of policies sold in connection with an endowment mortgage. As regards the latter, 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. Such exposure to redress payments has declined as policyholders have become time-barred from making a successful complaint. Over 80% of our in-force mortgage endowment policies are now time-barred and this proportion is expected to increase slightly as time progresses. 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 assuming reasonable long-term market performance. We are pleased to report that during 2008 the number of complaints we have received has continued to reduce to below the levels assumed. However, due to the fall in investment values the average amount of compensation we are required to pay, where misselling has occurred, has risen. We therefore consider that it is appropriate to maintain the current provision.

The Board continues to have a conservative approach to the investment of shareholder funds, which underpins our strong solvency position and future dividend capability. The benchmark of 70% cash and 30% fixed interest has been maintained and this approach has generally proved beneficial in the recent investment market volatility. However, we are not totally immune from market failures and despite our disciplined risk and counterparty strategy we fell foul of the entry into administration of Kaupthing Singer and Friedlander and, as a result, have fully written down the £1.1m deposit we had with them. The identification of secure institutions offering reasonable rates of return has been a significant growth area in our workload during the course of the year.

Managing the Expense Base

We continue to manage the business with a core team of 15 FTE's. A key part of their role is the management of our outsourcing partners. During 2008 significant developments occurred in both our key outsourcers.

In July it was announced that Liberata Financial Services Ltd ('Liberata'), who manage the administration and financial aspects of the CA book of business were to be sold to HCL Technologies ('HCL') – one of India's foremost global technology companies. The financial strength of HCL and its stated aspirations in the UK financial services outsourcing market are welcome.

Also in July, Capita Life and Pensions Regulated Services Ltd ('Capita'), who manage the administration and financial aspects of the CWA book, transferred the business to their systems and relocated the administration from Luton to their centre in Cheltenham. The Luton office has since been closed. Looking forward we have the option on this contract to extend it to an 'evergreen' basis, on agreed terms. This would have the advantage of fixing the financial terms of the book until the last policy ends.

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, in some cases as a consequence of economic conditions, and their need for, or capability to fund, 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. To date, despite the challenging economic environment, we have yet to see any significant deterioration in retention rates. We have not, however, fully reflected the favourable effect of this experience in setting our long-term embedded value assumptions, bearing in mind current economic conditions.

An important element of our customer retention strategy is the pursuit of good relative investment performance in the unit-linked funds. These underpin our unit-linked products, which account for a significant proportion of our overall policy portfolio. 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

As ever, there have been developments on the regulatory front which we continue to manage proactively. These include:

On business conduct and practice – through the year we continued the development of the FSA's Treating Customers Fairly ('TCF') initiative. We met the target of having developed suitable management information by the end of March 2008, albeit we have developed this further since, and we have also continued to embed TCF in the business. We believe we have the systems and culture in place which enable us to meet the FSA's second target of being able to demonstrate full TCF compliance by the end of 2008.

In previous reports we stated that we had identified a data error whilst migrating from an aged unit pricing system to a modern system. The project to rectify the consequences of this data error, which were capped in December 2007, continues and the established provision of £2.5m (£1.8m net of tax) is considered to be adequate.

We have not been the subject of any formal FSA review as our next Arrow assessment is not due until 2010. We have, however, maintained good relations with our FSA supervisory team and discussed regulatory matters with them. We have also submitted an updated Individual Capital Assessment to the FSA, as is required on an annual basis, and we believe our current regulatory capital resources requirement (as set out on Page 86) will continue to be adequate. We will continue our strong risk management culture and processes which complement our regulatory compliance ethos. The current financial market turbulence has given rise to a number of industry-wide requests for information from the FSA regarding capital strength and related issues which we have completed as required.

We continue to receive and review Good Practice Guides as issued by the Association of British Insurers and, where we believe it appropriate to our business, amend our practice to comply with the guidance.

On financial reporting – in contrast with the recent past there has been little requirement for changes in financial reporting. We provide financial information supplementary to our primary financial statements which are prepared in accordance with International Financial Reporting Standards. As previously, we utilise EEV principles as the basis for providing this supplementary information, as these principles 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. The continued strong underlying emergence of surplus results in a healthy excess of regulatory capital over the 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 focussed 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 Audit Committee. Our risk processes have regard to the significance of risks, the likelihood of their occurrence, taking account of existing controls, and the cost 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. Accordingly, the identification, assessment and control of risk is firmly embedded within the organisation and the procedures for the monitoring and updating of risk are robust. As part of this we have established a Risk Committee, in the Life subsidiary, 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 Life subsidiary's 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 Notes 4 and 5 to the Financial Statements on pages 59 to 74.

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 retention 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 19 to 27.

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 123 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 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 at the same rate, as not all expenses vary in line 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 2007	Variation due to			As at 31 December 2008
		Expected variation	Policy volume projection	Expenses projection	
EEV projected expense per policy per year (£'s)	73.56	3.35	(3.95)	(0.88)	72.08

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

Continued 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 been enhanced by revised expense projections following, principally, from a reassessment of costs which may be incurred in the longer-term.

Policy Attrition Rate

Generally, 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 Resources and Requirements' below. It is important therefore that CA maximises policy retention through providing an advice service to customers. 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)

	2008	2007
Beginning of year	210	235
End of year	192	210
Rate of attrition over the year	8.6%	10.6%

The improvement in the year-on-year attrition rate reflects both our endeavours to maximise policy retention and the tendency for attrition rates to reduce, up to a point, in closed Life businesses.

Unit-linked Fund Performance

Relative outperformance in the unit-linked funds helps promote policy retention and, when positive, increases the embedded value of the Group as future management charges received will be of a higher magnitude. The CA Managed Fund, which represents a significant proportion of CA policyholder funds under management, returned (16.96%) over the year ended 31 December 2008 (31 December 2007: 4.1%), while the CWA Global Managed Fund, which represents a significant proportion of CWA policyholder funds under management, returned (16.0%) over the same period (31 December 2007: 4.8%). These returns compare favourably with the average of (20.78%) 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

	2008	2007
Number of complaints received during the year	1,206	2,234
% upheld of complaints assessed during the year	28%	16%
% time-barred at end of year	81%	69%

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 the ABI. It 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 increase only marginally during 2009.

Whilst the number of complaints we have received has continued to reduce, the percentage of claims upheld has increased. This is as a consequence of a reduction in the number of complaints received from customers who are already time-barred. Where misselling has occurred, the average amount of compensation we are required to pay has risen due to investment market falls. Having taken these factors into account, we have decided to maintain the current provision. (See comments on the IFRS result in the Operating and Financial Review on pages 19 to 27).

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 25 to 27. 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 position after making allowance for dividend payments from CA to Chesnara after the respective period ends:

	31 December	
	2008 £m	2007 £m
Available capital resources (CR) represented by:		
– Share capital	40.0	40.0
– Retained earnings	1.0	5.2
– Surplus in long-term business fund	2.0	2.4
	<u>43.0</u>	<u>47.6</u>
Regulatory capital resource requirement (CRR)	24.3	26.6
Target requirement	35.6	39.1
Ratio of CR to CRR	177%	179%
Excess of CR over target requirements	<u>£7.4m</u>	<u>£8.5m</u>

The CA Board sets a minimum target of 150% of the long-term insurance capital requirement and of 100% of the resilience capital requirement components of the CRR. At each reported period end, it can be seen that CA is significantly over this target.

The target requirement as at 31 December 2008 continues to fall below the amount of share capital in CA and it follows that £4.4 m (being the difference between the target requirement and the amount of share capital) of the reported excess of £7.4m cannot be distributed to Chesnara other than by way of a capital reduction in CA. This constraint is now expected to increase over the next few years and the ratio of CR to CRR is, accordingly, expected to rise significantly.

It is our intention that, in the medium-term, and provided that there are, otherwise, no unforeseen demands on CRR, that it will be reduced by way of a formal capital reduction through the courts, thus making funds available for transfer to the parent company.

Further details relating to regulatory capital resources and requirements are provided in the Operating and Financial Review on page 25.

Future trends and developments

In line with our primary aim of delivering an attractive long-term dividend yield we remain focussed 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 will eventually diminish and 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. As there was little opportunity to acquire in the closed life book sector through most of 2008 we also assessed other financial services propositions that would utilise the skill sets of the corporate team whilst offering value to shareholders. As the year progressed, and the financial effects of the credit crisis took hold, we saw an increase in the number of such opportunities in the marketplace. However, it has proved difficult to evaluate, with any certainty, the worth of such businesses with the financial and economic climate as it is. Whilst we will, on an opportunistic basis, continue to consider such businesses, we remain committed to assessing any opportunities that present in the closed life sector. We believe that the current turmoil in the financial marketplace is likely to give rise to opportunities in this sector as capital constrained owners look to realise such assets to alleviate their current difficulties.

The measures we have taken to de-risk the life business and to make the operational structure more efficient mean we can 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 volatility of investment markets: Whilst shareholders have no direct exposure to sub-prime market issues, the volatility in equity markets since the middle of 2007 has affected fund performance, policyholder sentiment and, as fund values have fluctuated, the embedded value of the Group. The sensitivity of the embedded value to investment market movements, is detailed on page 122;
- (ii) exposure to corporate debt, bank deposit security and interest rate fluctuations. Exposure to corporate debt is reducing significantly as our book of guaranteed bond business runs down and we continue to actively manage these and our bank deposits through a number of controls. Interest rates can fall only a little further but the reductions already in place do affect the returns we receive on the significant cash balances we hold;
- (iii) the effect of the economic downturn on policy continuation rates. Whilst reductions in interest rates and low inflation will help affordability, the likely increase in unemployment will have an inevitable effect and we have factored in these considerations in setting our discontinuance rates;
- (iv) ongoing domestic- or European-driven regulatory change, e.g. the ongoing review of insurance companies under the European Solvency II initiative; and
- (v) changes to industry solvency and capital requirements as may be required by the FSA in response to market events or changes in the application or interpretation of other regulatory-based rules e.g. mortgage endowment mis-selling 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 5 to the Financial Statements.

Directors

The present Directors of the Company and their biographical details are set out on page 7. With the exception of Peter Wright, who was appointed as a Non-executive Director on 1 January 2009, all of those Directors served for the period from 1 January 2007 to 31 December 2008. In addition, Christopher Sporborg served as

Chairman from 1 January 2007 to 31 December 2008, at which date he retired from the Board. There have been no other changes in the Directorate between 31 December 2008 and 30 March 2009.

On 17 October 2008 Peter Mason, whose existing term of appointment expired on 31 October 2008, was re-appointed for a further three years, so that his term of appointment now expires on 31 October 2011. On 22 December 2008 he was appointed as Chairman with effect from 1 January 2009 and Mike Gordon was designated as Senior Independent Director with effect from the same date, the position having previously been occupied by Peter Mason.

The Non-executive Directors who served as Chairmen and members of the Nomination and Audit Committees of the Board are set out in the Corporate Governance Report on pages 28 to 33. Information in respect of the Chairmen and members of the Remuneration Committee and in respect of Directors' service contracts is included in the Directors Remuneration Report on pages 34 to 39, which also includes details of Directors' interests in shares and share options.

Pursuant to the Articles of Association, Peter Mason, Peter Wright and Graham Kettleborough 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. In addition, 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 years ended 31 December 2007 and 31 December 2008 and at 30 March 2009.

The Group also provided qualifying third party indemnity provisions to certain directors of associated companies during the years ended 31 December 2007 and 31 December 2008.

Substantial shareholdings

The following substantial interests in the Company's ordinary share capital at 31 December 2008 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 2008
Allianz AG (including Veer Palthe Voute)	11,195,648	11.03%
New Star Asset Management	10,454,665	10.30%
Amerprise Financial, Inc. (Threadneedle Asset Management)	10,163,397	10.01%
AXA SA	4,994,951	4.92%
Lloyds Banking Group plc	4,310,619	4.25%

Subsequent to 31 December 2008, the following revised 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
Allianz AG (including Veer Palthe Voute)	9 January 2009	10,090,655	9.94%
Allianz AG (following sale of Veer Palthe Voute to Commerzbank)	14 January 2009	–	–
Commerzbank (including Veer Palthe Voute)	15 January 2009	10,042,328	9.90%
New Star Asset Management	22 January 2009	5,055,694	4.98%
Standard Life Investments Ltd	16 March 2009	4,548,586	4.48%

The other substantial shareholder interests remained unchanged at 25 March 2009 and no other person holds a notifiable interest in 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 2008 were £nil (2007: £nil). No political contributions were made during the year ended 31 December 2008 (2007: £nil).

Employees

The average number of employees during the year was 24 (2007: 28).

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, sexual orientation 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 business 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 endeavours to protect and preserve the environment where it operates. To support this we allow each of our employees two days release on full pay each year where they can support a local charity project of their choice.

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 2008, based on the consolidated financial statements, was 4 for the Group (2007: 3) and 13 for the Company (2007: 5).

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 as stated in Note 2(b) to the financial statements on page 50. Detailed analysis of relevant risks and other factors is included within the sections headed 'Going Concern', 'Capital Structure, Treasury policy and Liquidity' and 'Cash Flows' in the Operating and Financial Review and within Note 5 to these financial statements.

Disclosure of information to 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 30 March 2009 and signed on its behalf by:

Ken Romney

Director

The Business Review, presented in the Directors' Report on pages 8 to 18, 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 2008 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 also substantially closed to new business. The funding for the purchase, which was settled in cash, was made by the raising of further equity of £22m from shareholders, and by the provision of a bank loan of £21m, of which £8.4m remains outstanding as at 31 December 2008, with the balance being sourced from internal retained funds.

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 has helped to improve the overall mix of Chesnara's business by spreading the risk subsisting within the different policy types. 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 have resulted.

Overall CA now manages a portfolio of some 192,000 life assurance and pension 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 sells a small amount of guaranteed bond and protection business to existing customers while it also benefits from additional inward flows on its existing life and pension contracts by way of inflation-linked increases and rebates received from the government in respect of contracted-out pension policies.

As a substantially closed book it is expected that the embedded value of the Life business will decline over time as the number of policies in force reduces and as the surplus emerging in the business is distributed by way of dividends. As the portfolio runs off, the regulatory capital supporting it may also be reduced and returned to shareholders.

Chesnara continues to seek to acquire similar businesses in order to meet our primary objective of delivering an attractive dividend yield.

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. In July it was announced that Liberata was to be sold to HCL Technologies ('HCL') – one of India's foremost global technology companies. The financial strength of HCL, and its stated aspirations in this market, are welcome.

In January 2007, we entered into an outsourcing agreement with Capita Life and Pension Regulated Services Limited ('Capita') for them to provide back office functions for the CWA book of business from 1 April 2007 for a period of 15 years. This replaced an existing agreement with Computer Sciences Corporation that was due to

expire early in 2009. The project to facilitate migration of CWA's policy administration to Capita's systems completed in July 2008 and the business now operates from Capita's service centre in Cheltenham.

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 centred in Preston, Lancashire. The Luton office, inherited as part of the CWA acquisition, closed mid-2008 following the completion of the migration of the book to Capita's systems. On completion of the transition just one of the nine roles that existed on acquisition was transferred to the revised corporate governance team. Chesnara has 15 FTE employees in its corporate governance team. The team are engaged on the management of the outsourcing contracts, corporate governance, the fulfilment of regulatory responsibilities and identification and development of business opportunities.

Chesnara is 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. The agreement with Liberata also includes management of the systems, including provision for business continuity, necessary to support the operation of the Preston-based governance team. Similar business continuity and governance systems support arrangements exist with Capita in respect of their operations.

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.

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 adopted European Embedded Value ('EEV') principles as the basis for providing this supplementary information. EEV methodology aims to measure the underlying embedded value of the Group's life assurance, pensions and annuity businesses and provides a framework which is intended to improve the comparability and transparency of embedded value reporting across Europe. As stated in the 'International Reporting Developments' section of the Financial Review on page 26, we intend to comply with the European Insurance CFO Forum Market Consistent Embedded Value (MCEV) Principles (copyright © Stichting CFO Forum Foundation 2008) with effect from our interim financial statements for the six months ending 30 June 2009.

IFRS Result

The following summarises pre-tax earnings information reflected in the IFRS Consolidated Income Statement, showing, separately, the contribution from the Life business and from the parent company. .

	Life business £000	Parent company £000	Amortisation of AVIF £000	Total £000
Year ended 31 December 2008				
Operating profit	27,116	(135)	(3,502)	23,479
Financing costs	–	(752)	–	(752)
Profit before income taxes	27,116	(887)	(3,502)	22,727
Year ended 31 December 2007				
Operating profit	31,240	1,071	(3,502)	28,809
Financing costs	–	(1,089)	–	(1,089)
Profit before income taxes	31,240	(18)	(3,502)	27,720

Notes

- (1) Financing costs are in respect of a bank loan raised to part finance the acquisition of CWA.
- (2) 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.

The IFRS result before tax has progressed from £10.0m at the half-year to £22.7m as reflected above. Global investment market conditions continued to have a significant adverse impact (of some £5m over the year) on the core Life business, while, following the entry into administration of Kaupthing Singer and Friedlander, we considered it appropriate to fully write-down a cash deposit of £1.1m with them. However, these adverse effects were more than offset by the impact of the very sharp falls in short-term interest rates in the last quarter of 2008, which led to a significant capital appreciation in our fixed-interest portfolio. Overall, these investment market influences, in fact, gave rise to a £1.5m net favourable effect. This was reinforced by continuing tight control over expenses (£0.5m less than planned), but was offset by £3.2m following from the impact of statutory reserve releases in the Life company not being as high as anticipated – this, in turn, follows principally from favourable policy lapse experience, which, although overall beneficial to EEV, gives rise to an adverse short-term impact on the IFRS basis. Taken together, these factors contributed some £1.2m of the shortfall of £5.0m in the pre-tax result compared with the year-ended 31 December 2007. Other factors were:

- (i) the 2007 result benefited from a release of £1.1m from the mortgage endowment complaints provision, which has not been replicated in 2008; and
- (ii) the level of surplus arising in the life business abates naturally as the policy base diminishes over time.

EEV Result

Supplementary information prepared in accordance with EEV principles and set out in the financial statements on pages 111 to 123 is presented to provide alternative information to that presented under IFRS. EEV principles assist in identifying the value being generated by the Life business. The result determined under this method represents principally the movement in the Life business 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 result:

	Year ended 31 December	
	2008 £000	2007 £000
Operating profit before tax	25,906	13,506
Variation from longer term investment return	(16,831)	(3,020)
Economic assumption changes	6,951	(4,043)
Profit before tax	16,026	6,443
Tax		
– current	(3,759)	(4,379)
– deferred	2,559	10,053
Profit for the year after tax	14,826	12,117

A key determinant of the Group performance over the year, as measured on the EEV basis, has been the decline in global equity markets. The leading UK market indices show a 32% decline over 2008 and this, together with associated policyholder CGT effects, has given rise to a significant diminution of £20.3m in embedded value. However, as referred to in 'IFRS Result' above, the impact of this has been mitigated, to a degree, by the effect of the capital appreciation of the fixed-interest portfolio, following from the significant reduction in short-term interest rates so that, overall, the net adverse impact at the pre-tax operating level, arising from investment market influences is some £16.8m, as reflected in the variation in longer-term investment return above.

The following factors have also contributed to the strong operating profit before tax:

- (i) unwind of the risk discount rate giving rise to a £10.4m contribution to pre-tax operating profit;
- (ii) favourable lapse experience of £5.5m;
- (iii) new business of £0.7m;
- (iv) an expenses underrun of £2.1m; and
- (v) a re-setting of long-term expense assumptions giving rise to a favourable effect of £6.5m.

This last item follows principally from a careful re-assessment of the expense conditions that will prevail as the policy base diminishes. It is clear that, as significant diseconomies of scale arise, steps will be taken to avoid them in practice. In particular, it is evident that the allocation of Parent Company expense to the Life business at the level previously assumed is untenable.

While investment market conditions have served to depress the EEV at the profit before tax level, it is also clear that, within the gloom of global recession, wider economic factors can serve to have a positive impact. The lower interest rate/lower inflation rate environment, together with some favourable policyholder tax effects has given rise to favourable economic assumption change effects of some £7m as reflected in the table above.

Overall, the embedded value has proved resilient in the face of a difficult trading environment. As this is likely to be subject to continuing volatility, attention is drawn to the sensitivity of the EEV to various factors as set out on page 122.

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	
	2008 £000	2007 £000
Value of in-force business	84,940	94,007
Other net assets	97,768	93,308
	182,708	187,315
Represented by:		
Embedded value ('EV') of covered business	154,329	171,639
Less: amount financed by borrowings	(8,358)	(12,469)
EV of covered business attributable to shareholders	145,971	159,170
Net equity of other Group companies	36,737	28,145
Shareholders' equity	182,708	187,315

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

Number of policies	31 December	
	2008 000	2007 000
Endowment	62	68
Protection	64	73
Annuities	5	4
Pensions	53	56
Other	8	9
Total	192	210

Value in-force	31 December	
	2008 £m	2007 £m
Endowment	53.8	58.3
Protection	51.2	63.0
Annuities	4.5	2.0
Pensions	33.5	38.1
Other	–	1.4
Total at product level	143.0	162.8
Valuation adjustments		
Holding company expenses	(8.7)	(20.7)
Other	(26.3)	(21.4)
Cost of capital	(5.1)	(5.5)
Value in-force pre-tax	102.9	115.2
Taxation	(18.0)	(21.2)
Value in-force post-tax	84.9	94.0

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.

'Other' valuation adjustments principally comprise expenses of managing policies which are not attributed at product level. Certain expenses, previously classified as holding company expenses, have, as at 31 December 2008, been included within these other valuation adjustments. The comparative figures as at 31 December 2007 have not been restated to reflect this reclassification and this explains part of the year-on-year increase in other valuation adjustments and part of the year-on-year decrease in holding company expenses reflected above. The balance of the year-on-year decrease in holding company expenses arises principally from the reassessment of the expense conditions that will prevail as the policy base diminishes, as referred to under 'EEV Result' above.

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 -16.96% over the year ended 31 December 2008. 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 -16.0% over the same period. The performance of both funds compares favourably with the average of -20.78% achieved by the ABI Life Balanced Managed Fund sector.

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 28 to the 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 2008 this rate was reset to 6.3% (31 December 2007: 7.7%), following the methodology described in the Supplementary Information – European Embedded Value Basis on page 117. 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.

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, while the Group's embedded value supports this dividend flow and, in the absence of further acquisitions, holds out the prospect of a return of capital to shareholders. For the first half of 2008 the shares generally traded in a range from 145p to 165p. With total proposed dividends in respect of the year ended 31 December 2008 at 15.55p per share, this implied a yield of between 9.4% and 10.7%. The shares may also be characterised as having traded at a discount to Group embedded value, as reported on the EEV basis as at 31 December 2007, within a range of 8% to 19%.

Between the end of June 2008 and the end of November 2008, the share price suffered from the wider investment market turbulence and traded at a significantly deeper discount to embedded value. The lowest closing price recorded in this period was 100.25p, representing a 42% discount to the embedded value reported as at 30 June 2008. In the light of this, and in order to maximise shareholder value, the opportunity was taken to undertake a share buyback operation, the details of which are set out in the Directors' Report on page 8.

Subsequent to the end of November 2008, the share price has recovered to trade, generally, in a range of 120p to 130p. This implies a yield, based on total 2008 proposed dividends, of between 12% and 13%, with the shares trading at a discount of between 28% and 33% to embedded value, as now reported as at 31 December 2008. Notwithstanding this, the share price performance in the early part of 2009 has significantly outperformed that for the Life sector as a whole as illustrated by the performance graph set out in the Directors' Remuneration Report on page 37.

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 CA, and on the full distribution of reserves from CA to Chesnara.

The regulations include minimum standards for assessing the value of liabilities, including making an appropriate allowance for default risk on corporate bonds held to match liabilities when assessing the valuation discount rates used for valuing these liabilities. Market turmoil in 2008 has led to significant widening of spreads on corporate bonds above gilts, through changed assessment of default risk and liquidity issues, and therefore, with the widening spreads, this issue has been of concern to the industry. The life company continues to maintain a prudent approach of limiting the assumed liquidity premium in corporate bonds to a maximum of 50bps as at 31 December 2008 (31 December 2007: 30bps).

Additionally, the CA Board continues to maintain their stance that permissive changes to regulations introduced in 2006, in FSA policy statement PS06/14, that would allow a reduction in liabilities, are not appropriate for CA at this time.

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

	31 December	
	2008 £m	2007 £m
Available capital resources ('CR')	43.0	47.6
Long-term insurance capital requirement ('LTICR')	22.5	25.1
Resilience capital requirement ('RCR')	1.8	1.5
Total capital resources requirement ('CRR')	24.3	26.6
Target capital requirement cover	35.6	39.1
Ratio of available CR to CRR	177%	179%
Excess of CR over target requirement	£7.4m	£8.5m

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. To the extent that the target capital requirement cover of £35.6m as at 31 December 2008 falls short of the £40m share capital component of CR, so it follows that £4.4m of the reported excess of CR over target requirement is not available for distribution to shareholders except by way of a capital reduction.

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 Groups Directive

In accordance with the EU Insurance Groups 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 after the recognition of final dividends for the respective financial year, but approved by the Board and paid to Group shareholders after the respective dates:

	31 December	
	2008 £m	2007 £m
Available group capital resources	86.9	82.9
Group regulatory capital requirement	(24.3)	(26.6)
Excess	62.6	56.3
Cover	358%	312%

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

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 on the statutory mathematical reserves, and involves stress testing the resultant realistic balance sheet for the impact of adverse events, including such market effects as significant falls in equity values, interest rate increases and decreases, bond defaults and further widening of bond spreads.

CA completed a further full annual assessment during 2008 as a result of which it was 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. This assessment is subject to quarterly high-level update until the next full annual assessment.

International Reporting Developments

Over the year, we have continued to monitor developments in the EU Solvency II framework which, when introduced, will replace the current framework, developed in the 1970s, with a risk-based approach. Following publication by the FSA of DP08/4 'Insurance Risk Management: The Path to Solvency II' in September 2008, we have initiated a gap analysis, which is being undertaken by a firm of external consultants, and have commenced internal quantitative analysis. The final regulations are not expected to take effect until October 2012.

In May 2007, the IASB released for comment a discussion paper on accounting for insurance and reinsurance contracts, entitled 'Preliminary Views on Insurance contracts', as part of the second phase of their insurance contracts project, which we reviewed and responded on. We will continue to monitor developments in this area.

In June 2008 the European Insurance CFO forum issued the European Insurance CFO Forum Market Consistent Embedded Value (MCEV) Principles. These principles, with which we intend to comply with effect from interim financial statements for the six months ended 30 June 2009, represent a development of the existing European Embedded Value (EEV) principles, issued by the same Forum, which form the current basis of preparation of our Supplementary Information – European Embedded Value Basis as set out in Note I to the Supplementary Information on page I 16. It is not expected that our adoption of the MCEV Principles will materially impact our operating profit, profit before tax, value of in-force business or total shareholder equity as reported in the Supplementary Information.

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 business. It normally does not make use of financial reinsurance or similar arrangements.

There is no significant trading in any currencies other than sterling. Cash available for more than twelve months is normally transferred to fund managers for longer-term investment.

The Board continues to have a conservative approach to the investment of shareholder funds in the Life business, which underpins our strong solvency position. This approach targets the investment of 100% of available funds in cash and fixed interest securities. In the light of current volatility in financial markets, particular attention is given to the mix and spread of these investments to ensure that we are not unduly exposed to particular sectors and that our counterparty limits are strictly adhered to. Notwithstanding these safeguards, we had one specific exposure in respect of a cash deposit of £1.1m with Kaupthing Singer and Friedlander, which we have fully written down following its entry into administration. Current economic conditions also heighten the risk of corporate bond default and observations on this are made in the 'Going Concern' section below.

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. To the extent that ongoing administration of the Life business is performed within the terms of its third party outsourcing agreements, the Group is sheltered, to a degree, from these development costs as they are likely to be on a shared basis.

To the extent that the Group proposes to acquire 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 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 and to repay our debt obligations as set out in Note 28 of these financial statements on page 97.

Going concern

The Group's cash flow position described above, together with the return on financial assets in the Parent Company, supports the ability to trade in the short-term. Accordingly, the underlying solvency position of the Life business and its ongoing ability to generate surpluses which support cash transfers to shareholder funds is critical to the ongoing ability of the Group to continue trading and to meet its obligations as they fall due.

The information set out in 'Solvency and Regulatory Capital' above indicates a strong solvency position as at 31 December 2008 as measured at both the individual Life Company and at the Group level. In addition, a Financial Condition Report and a detailed annual Individual Capital Assessment, as also set out above, have continued to be produced for the Life business. These include assessments of the ability of the business to withstand key events, including those which may now become more significantly adverse in the current financial and economic environment, being an increased rate of policy lapse, expense overruns and unfavourable investment market conditions. The assessments indicate that the Group is able to withstand the impact of these adverse scenarios, including the effect of continuing significant investment market falls, while the Group's outsourcing arrangements protect it from significant expense overruns.

Notwithstanding that the Group is well capitalised, the current financial and economic environment does present some specific threats to its short-term cash flow position and it is appropriate to assess these. In the first instance, the Group does not rely on the renewal or extension of bank facilities to continue trading – indeed, as indicated, its normal operations are cash generative. The Group does, however, rely on cash flow from the maturity or sale of fixed interest securities which match its obligations to its Guaranteed bond policyholders: in the current economic environment there is clearly a higher risk of bond default, particularly in respect of financial institutions. In order to manage this risk we ensure that our bond portfolio is actively monitored and well diversified. Further, this risk abates through 2009 as our underlying bond obligations to policyholders mature. Other significant counterparty default risk relates to our principal reinsurer Guardian Assurance ('Guardian'). We monitor Guardian's financial position and are satisfied that any associated credit default risk is low.

Our expectation is that, notwithstanding the risks set out above, the Group will continue to generate surplus in its long-term business sufficient to meet its debt obligations as they fall due and to continue 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 June 2007 and as appended to the Listing Rules.

The following statement, together with the Directors' Remuneration Report on pages 34 to 39, 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 2008.

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, except for Peter Wright who was appointed with effect from 1 January 2009 and whose appointment maintained the balance between Non-executive and Executive Directors. This followed from the retirement of Christopher Sporborg as Chairman on 31 December 2008 and his replacement, in that position, by Peter Mason.

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; and
- 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 (being Christopher Sporborg up to 31 December 2008 and Peter Mason with effect from 1 January 2009) 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 designated Mike Gordon as Senior Independent Director with effect from 1 January 2009 following the appointment as Chairman of the Company of the previous Senior Independent Director, Peter Mason. 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 was independent on his appointment as Chairman on 1 January 2009. In making this determination, the Board has carefully considered the fact that he 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 Countrywide Assured Life Holdings Limited ('CALHL'), the parent company of Countrywide Assured plc, a position he has held since 18 November 1991.

The Board considers that Mike Gordon, Terry Marris and Peter Wright are independent Non-executive Directors. In making this determination, the Board has carefully considered the following matters.

Terry Marris had, within five years of his appointment, been an employee of a subsidiary company within the CALHL Group, 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 Wright has, within the last three years prior to his appointment, served as Head of Actuarial Function of Countrywide Assured plc and has otherwise provided actuarially-based consultancy advice, the relevant services being provided under an agreement with his employer at the time, Tillinghast Towers Perrin.

There were no comparable matters to consider in respect of Mike Gordon.

With regard to Peter Mason and Terry Marris, the Board considers that the characteristics, aims and mode of operation of the relevant activities of the Company are sufficiently different from those prevailing when they held the relevant positions, that the judgement and independence of mind exercised on behalf of the Company are not adversely affected or circumscribed. The Board is of the view that their considerable specific experience and knowledge in the business of the Group outweighs any residual risk in the historic relationships described above. With regard to Peter Wright, the nature of the services he provided, being subject either to FSA regulation or to professional standards and guidance prescribed or issued variously by the Institute of Actuaries or by the Financial Reporting Council Board of Actuarial Standards, was such that he was required to maintain a vigorous independence of mind and to prepare recommendations in accordance with the highest professional standards.

The Board is satisfied that the overall balance of the Board continues to provide significant independence of mind and judgement and further considers that, taking the Board as a whole, the Independent Directors are of sufficient calibre and number that their views carry significant weight in the Company's decision making. The appointment of Peter Mason as Chairman, of Peter Wright as Non-executive Director and the associated designation of Mike Gordon as Senior Independent Director, were discussed with the Company's major shareholders who shared the Board's view that the appropriate course of action was being taken.

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. 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.

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 the Actuarial Function Holders and With-profits Actuary;
- Compliance report;
- Investment report; and
- Outsourcing reports.

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 incumbent Chairman, Christopher Sporborg, 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
Christopher Sporborg – Non-executive Chairman (to 31 December 2008)	7(7)	2(2)	n/a	n/a
Peter Mason – Non-executive Director (to 31 December 2008) and Non-executive Chairman (from 1 January 2009)	7(8)	1(2)	1(2)	4(4)
Terry Marris – Non-executive Director	8(8)	2(2)	2(2)	4(5)
Mike Gordon – Non-executive Director	6(8)	2(2)	2(2)	4(5)
Peter Wright – Non-executive Director (from 1 January 2009)	1(1)	n/a	–(–)	1(1)
Graham Kettleborough – Executive Director	8(8)	n/a	n/a	n/a
Ken Romney – Executive Director	8(8)	n/a	n/a	n/a
Frank Hughes – Executive Director	6(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 or Committee member. The information above relates to the period from 1 February 2008 to 31 January 2009.

Nomination Committee

During the period under review, the Nomination Committee comprised Christopher Sporborg who resigned on 31 December 2008 and who also served as Chairman of the Committee to that date, Peter Mason who also served as Chairman of the Committee from 1 January 2009, 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. Except for the resignation of Christopher Sporborg, there were no other changes to the Committee membership during the period under review.

Remuneration Committee

Full details of the composition and work of the Remuneration Committee are provided in the Directors' Remuneration Report on pages 34 to 39.

Audit Committee

During the period under review, the Audit Committee comprised Peter Mason to 31 December 2008 (who also acted as Chairman to that date), Mike Gordon and Terry Marris, as independent Non-executive Directors. Following Peter Mason's resignation from the Committee on his appointment as Chairman of the Company, Peter Wright was appointed as a member on 1 January 2009 and acted as Chairman of the Committee from that date. The Board is satisfied that both Peter Mason and Peter Wright had and have recent and relevant financial experience. On invitation, the Chief Executive, the Finance Director, the Chairman, the Head of Internal Audit and the external Auditor attend meetings to assist the Committee in the 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 2008 and the year ended 31 December 2008;

- reviewing the appropriateness of the Group's accounting policies;
- reviewing 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 and reviewing and approving the audit and non-audit fees;
- 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; and
- reviewing the Group's anti-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 both audit and non-audit services during the year are provided in Note 13 to the financial statements (on page 77).

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, the Senior Independent Director 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 14 May 2009 can be found in the notice of the meeting on pages 124 to 134.

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 significance 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 might prevent the Company meeting its objectives and, accordingly, only provides reasonable, but 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 organisation 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 significant 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 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 2008 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 Chairman of the Audit Committee.

Going Concern

The Directors' Statement on Going Concern is included in the Directors' Report on page 17.

Directors' Remuneration Report

The Remuneration Committee

The Remuneration Committee (the 'Committee') determines the overall pay policy and the remuneration packages and the 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.

During the period under review the Committee comprised solely of Non-executive Directors: Mike Gordon (who also acted as Chairman), Peter Mason (to 31 December 2008), Peter Wright (from 1 January 2009) 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 to 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 29.

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. Neither the Annual Bonus Scheme nor the Long-term Incentive Plan is pensionable. Awards made under the Annual Bonus Scheme were pensionable up to 31 December 2007 but were made non-pensionable from that date to reflect best practice in this area. The Committee may award other discretionary bonuses to the Executive Directors where they consider extraordinary value has been created or significant achievement has occurred.

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

The Company notes the recent publications by the Financial Services Authority regarding the reward structures for Executive Directors of financial institutions and, as a result, the Remuneration Committee will be undertaking a review of the suitability of current remuneration practice.

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 fully-expensed company car, life assurance and private medical insurance.

Bonus Schemes

The 2008 Annual Bonus Scheme was designed to incentivise the Executive Directors. The scheme consists of two elements and the overall maximum award is 50% of basic salary.

The first element is a retention measure and this becomes payable 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 which requires particular skill sets and does, inherently, offer limited career opportunities.

The second element is based on Group performance and is designed to ensure that Executive Directors' awards are closely aligned to shareholders' interests on this element of the scheme. It is, therefore, based upon the level of achievement of budgeted IFRS pre-tax profit.

These arrangements can be summarised as follows:

Element	Award
Retention	25% of basic salary on completion of service to year-end.
Group performance IFRS pre-tax profit:	
– less than 90% of budget	Nil
– at 90% of budget	12.5% of basic salary and then increasing pro rata to:
– at or greater than 100% of budget	25% of basic salary

The table below sets out the details of the awards made to the Executive Directors under the scheme in 2008.

Annual Bonus Scheme – awards made in respect of year ended 31 December 2008

Graham Kettleborough	£61,628
Ken Romney	£47,407
Frank Hughes	£42,666

The Long-term Incentive Plan was designed as a long-term cash based incentive for Executive Directors. As the business is a run-off proposition in its current form, the Remuneration Committee believes that a share based plan would be inappropriate and, therefore, the scheme continues on a cash basis. The scheme consists of two elements and there is no overall maximum award.

The first element is a retention measure and this becomes payable on completion of three years service after it is earned. This is designed to reflect the specific nature of the business as explained in the Annual Bonus section above.

The second element is based on Group performance and is designed to ensure that Executive Directors' awards are closely aligned to shareholders' interests on this element of the scheme. It is, therefore, also based upon the level of achievement of budgeted IFRS pre-tax profit.

This scheme differs from the Annual Bonus Scheme in that awards are made on a rolling half-year basis rather than on an annual basis. As an additional retention measure, payment of awards is deferred for three years.

These arrangements can be summarised as follows:

Element	Award
Retention	16.66% of basic salary on completion of service to mid-year 16.66% of basic salary on completion of service to year-end
Group performance IFRS pre-tax profit:	
– at or less than 75% of budget in first half-year	Nil
– at 100% of budget in first half-year	And then increasing pro rata to 16.66% of basic salary
– at or less than 75% of budget in second half-year	Nil
– at 100% of budget in second half-year	And then increasing pro rata to 16.66% of basic salary

Where pre-tax IFRS profit exceeds 100% of budget, the award increases on a straight-line basis.

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.

Long-term Incentive Plan – awards made in 2007 and 2008

	Amount awarded in respect of the half-year ended			
	31 December 2008	30 June 2008	31 December 2007	30 June 2007
Graham Kettleborough	£47,268	£37,656	£76,785	£55,364
Ken Romney	£36,360	£28,966	£59,066	£42,588
Frank Hughes	£32,724	£26,070	£53,159	£38,329

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 2008 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

The Executive Directors are members of the Chesnara plc Stakeholder Scheme to which employer contributions are made at rates agreed by the Remuneration Committee. Employer contribution rates were increased during 2008 to compensate for the removal of pension contributions linked to the Annual Bonus Scheme. Employer contributions to the respective schemes are detailed on page 39.

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 Sporborg (Chairman to 31 December 2008)	31 December 2008
Peter Mason (Chairman from 1 January 2009)	31 October 2011
Mike Gordon	30 April 2011
Terry Marris	1 March 2010
Peter Wright	1 January 2012

On 17 October 2008 the Board agreed to re-appoint Peter Mason for a period of three years further to the date of expiry of his current appointment, being 31 October 2008.

Peter Mason, Peter Wright and Graham Kettleborough retire by rotation at the end of the forthcoming AGM, at which a resolution proposing their re-election will be tabled.

Directorate

The Directors who served during the period were:

Chairman

Christopher Sporborg (retired 31 December 2008)

Peter Mason (Non-executive Director to 31 December 2008 and Chairman from 1 January 2009)

Non-executive Directors

Terry Marris

Mike Gordon

Peter Wright (appointed 1 January 2009)

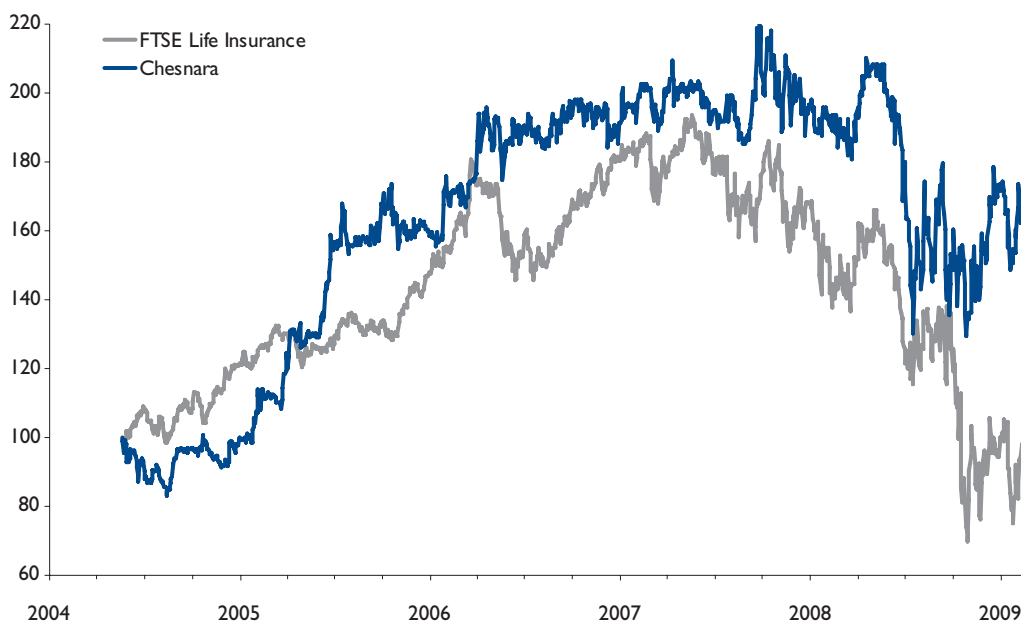
Executive Directors

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 Insurance sector index. The Company considers this to be the most appropriate index, given that its activities are centred on life insurance. 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 24 February 2009. 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 2008		31 December 2007	
	Beneficial	Non-beneficial	Beneficial	Non-beneficial
Christopher Sporborg	75,000	–	75,000	–
Peter Mason	17,500	–	2,500	–
Terry Marris	52,708	–	52,708	–
Mike Gordon	–	–	–	–
Peter Wright	20,000	–	–	–
Graham Kettleborough	42,600	–	26,000	–
Ken Romney	15,476	–	15,476	–
Frank Hughes	5,163	–	5,163	–

Ken Romney purchased an additional 35,000 shares in January 2009 bringing his total holding to 50,476 at 30 March 2009. There were no other changes in the Directors' shareholdings in Chesnara plc between 31 December 2008 and 30 March 2009.

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 2008 is shown below with comparative figures for the year ended 31 December 2007.

	Year ended 31 December	
	2008 £000	2007 £000
Aggregate emoluments:		
Fees to Non-executive Directors	140	140
Compensation to a Non-executive Director for loss of office (ex gratia)	30	–
Emoluments to Executive Directors	723	865
Company contributions to pension schemes	160	84
Total	1,053	1,089

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 2008:

	Salaries and fees £000	Bonuses £000	Deferred bonuses £000	Benefits £000	Compensation for loss of office £000	Total 2008 £000	Total 2007 £000
Executive Directors							
Graham Kettleborough	134	62	85	15	–	296	351
Ken Romney	108	47	65	17	–	237	278
Frank Hughes	77	43	59	11	–	190	236
	<u>319</u>	<u>152</u>	<u>209</u>	<u>43</u>	<u>–</u>	<u>723</u>	<u>865</u>
Non-executive Directors							
Christopher Sporborg	50	–	–	–	30	80	50
Peter Mason	40	–	–	–	–	40	40
Terry Marris	25	–	–	–	–	25	25
Mike Gordon	25	–	–	–	–	25	25
	<u>140</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>30</u>	<u>170</u>	<u>140</u>
Total	<u>459</u>	<u>152</u>	<u>209</u>	<u>43</u>	<u>30</u>	<u>893</u>	<u>1,005</u>

Peter Wright, who was appointed to the Chesnara plc Board on 1 January 2009, was paid fees of £20,000 for the year ended 31 December 2008 in respect of his services as Non-executive Director of Countrywide Assured plc, a subsidiary company. He was appointed to this latter position on 2 January 2008.

The following table sets out each Executive Director's pension benefits for the years ended 31 December 2008 and 31 December 2007.

	Company contributions to money purchase scheme	
	2008 £000	2007 £000
Graham Kettleborough	49	25
Ken Romney	52	33
Frank Hughes	59	26
	<u>160</u>	<u>84</u>

A Salary Sacrifice scheme was introduced in July 2007. As a result, contributions formerly made by Executive Directors are now made by the Group and deducted from Directors' salaries.

The pension arrangements for the Executive Directors are set out on page 34.

No pension contributions were made by companies within the Chesnara plc Group from 1 January 2007 to 31 December 2008 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 2008 and 30 March 2009, nor were there any options outstanding as at 31 December 2007, 31 December 2008 or 30 March 2009.

Approved by the Board of Directors on 30 March 2009 and signed on its behalf by:

Peter Mason

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.

We confirm that, to the best of our knowledge:

- the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company and the undertakings included in the consolidation taken as a whole; and
- the Directors' Report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

Peter Mason
Chairman

Graham Kettleborough
Chief Executive

Independent Auditor's Report to the Members of Chesnara plc

We have audited the Consolidated and Parent Company financial statements (the "financial statements") of Chesnara plc for the year ended 31 December 2008 which comprise the 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 40.

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 2006 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 2008 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 2008;
- 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

30 March 2009

Consolidated Income Statement for the year ended 31 December 2008

	Note	Year ended 31 December	
		2008 £000	2007 £000
Insurance premium revenue		94,274	103,554
Insurance premium ceded to reinsurers		(17,193)	(18,716)
Net insurance premium revenue	6	77,081	84,838
Fee and commission income			
Insurance contracts	7	35,289	38,032
Investment contracts	7	9,305	9,149
Net investment return	8	(222,742)	90,210
Total revenue (net of reinsurance payable)		(101,067)	222,229
Other operating income	9	1,314	1,298
		(99,753)	223,527
Insurance contract claims and benefits incurred			
Claims and benefits paid to insurance contract holders	10	(131,829)	(154,657)
Net decrease/(increase) in insurance contract provisions	10	180,265	(2,457)
Reinsurers' share of claims and benefits	10	(8,736)	26,518
Net insurance contract claims and benefits incurred		39,700	(130,596)
Change in investment contract liabilities	11	108,516	(50,697)
Reinsurers' share of investment contract liabilities	11	(4,743)	11,534
Net change in investment contract liabilities		103,773	(39,163)
Fees, commission and other acquisition costs	12	(1,377)	(1,546)
Administrative expenses	13	(13,633)	(15,955)
Other operating expenses			
Charge for amortisation of acquired value of in-force business	14	(3,578)	(3,734)
Other	14	(1,653)	(3,724)
		123,232	(194,718)
Operating profit		23,479	28,809
Financing costs	15	(752)	(1,089)
Profit before income taxes		22,727	27,720
Income tax expense	16	(2,710)	(2,281)
Profit for the year		20,017	25,439
Basic earnings per share	40	19.24p	24.32p
Diluted earnings per share	40	19.24p	24.32p

The notes and information on pages 50 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 2008

	Note	31 December	
		2008 £000	2007 £000
Assets			
Intangible assets			
Deferred acquisition costs	17	8,590	9,542
Acquired value of in-force business			
Insurance contracts	18	16,866	19,427
Investment contracts	18	11,610	12,627
Reinsurers' share of insurance contract provisions	26	182,693	212,353
Amounts deposited with reinsurers	27	22,181	27,558
Investment properties	19	3,432	4,983
Financial assets			
Equity securities at fair value through income	20	363,879	743,670
Holdings in collective investment schemes at fair value through income	20	576,502	508,857
Debt securities at fair value through income	20	279,104	247,152
Insurance and other receivables	20/21	11,056	15,131
Prepayments	20/21	1,600	284
Derivative financial instruments	20/22	5,570	9,525
Total financial assets		<u>1,237,711</u>	<u>1,524,619</u>
Reinsurers' share of accrued policyholder claims	32	4,100	4,661
Cash and cash equivalents	24	192,381	225,127
Total assets		<u>1,679,564</u>	<u>2,040,897</u>
Liabilities			
Bank overdrafts	24	1,094	1,229
Insurance contract provisions	26	923,506	1,110,848
Financial liabilities			
Investment contracts	27	558,542	726,503
Borrowings	28	8,358	12,469
Derivative financial instruments	22	70	265
Total financial liabilities		<u>566,970</u>	<u>739,237</u>
Provisions	29	3,397	3,575
Deferred tax liabilities	30	10,798	11,847
Reinsurance payables	31	1,397	1,622
Payables related to direct insurance and investment contracts	32	23,891	22,859
Deferred income	33	14,575	16,362
Income taxes	34	1,074	743
Other payables	35	6,494	6,791
Total liabilities		<u>1,553,196</u>	<u>1,915,113</u>
Net assets		<u>126,368</u>	<u>125,784</u>
Shareholders' equity			
Share capital	36	41,501	41,501
Share premium	36	20,458	20,458
Treasury shares	37	(3,379)	–
Other reserves		50	50
Retained earnings	38	67,738	63,775
Total shareholders' equity		<u>126,368</u>	<u>125,784</u>

The notes and information on pages 50 to 110 form part of these financial statements.

Approved by the Board of Directors on 30 March 2009 and signed on its behalf by:

Peter Mason

Graham Kettleborough

Company Balance Sheet at 31 December 2008

	Note	31 December	
		2008 £000	2007 £000
Assets			
Non-current assets			
Financial assets			
Investment in subsidiaries	20	52,006	52,006
Current assets			
Loans and receivables	21	1,177	622
Income taxes	23	139	–
Cash and cash equivalents	24	37,372	28,994
Total current assets		38,688	29,616
Total assets		90,694	81,622
Current liabilities			
Overdrafts	24	8	–
Borrowings	28	4,168	4,127
Income taxes	34	–	3
Other payables	35	2,287	1,913
Total current liabilities		6,463	6,043
Non-current liabilities			
Borrowings	28	4,190	8,342
Total liabilities		10,653	14,385
Net assets		80,041	67,237
Shareholders' equity			
Share capital	36	5,229	5,229
Share premium	36	20,458	20,458
Treasury shares	37	(3,379)	–
Other reserves		50	50
Retained earnings	38	57,683	41,500
Total shareholders' equity		80,041	67,237

The notes and information on pages 50 to 110 form part of these financial statements.

Approved by the Board of Directors on 30 March 2009 and signed on its behalf by:

Peter Mason

Graham Kettleborough

Consolidated Statement of Cash Flows for the year ended 31 December 2008

	Year ended 31 December	
	2008 £000	2007 £000
Profit for the year	20,017	25,439
Adjustments for:		
Amortisation of deferred acquisition costs	952	1,145
Amortisation of acquired in-force value	3,577	3,734
Tax expense	2,710	2,281
Interest receivable	(24,398)	(26,650)
Dividends receivable	(35,781)	(35,997)
Interest expense	752	1,089
Change in fair value of investment properties	324	(1,873)
Fair value losses on financial assets	247,210	31,768
Interest received	22,150	28,707
Dividends received	39,278	37,810
Changes in operating assets and liabilities		
Decrease/(increase) in financial assets	38,166	(54,327)
Decrease/(increase) in reinsurers share of insurance contract provisions	30,221	(5,544)
Decrease in amounts deposited with reinsurers	5,377	36,163
Decrease/(increase) in insurance and other receivables	194	(2,259)
Increase in prepayments	1,316	284
Decrease in insurance contract provisions	(187,342)	(4,349)
Decrease in investment contract liabilities	(167,961)	(86,476)
(Decrease)/increase in provisions	(178)	2,978
Decrease in reinsurance payables	(225)	(1,437)
Increase/(decrease) in payables related to direct insurance and investment contracts	1,032	(2,068)
Decrease in other payables	(2,728)	(3,060)
Cash utilised by operations	(5,337)	(52,642)
Income tax paid	(2,921)	(5,399)
Net cash utilised by operating activities	(8,258)	(58,041)
Cash flows from financing activities		
Repayment of borrowings	(4,200)	(4,200)
Dividends paid	(16,054)	(13,910)
Interest paid	(720)	(1,169)
Purchase of treasury shares	(3,379)	–
Net cash utilised by financing activities	(24,353)	(19,279)
Net decrease in cash and cash equivalents	(32,611)	(77,320)
Cash and cash equivalents at beginning of period	223,898	301,218
Cash and cash equivalents at end of period	191,287	223,898

The notes and information on pages 50 to 110 form part of these financial statements.

Company Statement of Cash Flows for the year ended 31 December 2008

	Year ended 31 December	
	2008 £000	2007 £000
Profit for the year	32,237	34,979
Adjustments for:		
Tax (recovery)/expense	(124)	3
Interest expense	752	1,089
Dividends received from subsidiary company	(33,000)	(35,000)
Changes in operating assets and liabilities		
(Increase)/decrease in loans and receivables	(553)	82
Increase in payables	411	565
Cash (utilised by)/generated from operations	(277)	1,718
Cash flows from investing activities		
Dividends received from subsidiary company	33,000	35,000
Net cash generated from investing activities	33,000	35,000
Cash flows from financing activities		
Repayment of borrowings	(4,200)	(4,200)
Dividends paid	(16,054)	(13,910)
Interest paid	(720)	(1,169)
Purchase of treasury shares	(3,379)	–
Net cash utilised by financing activities	(24,353)	(19,279)
Net increase in cash and cash equivalents	8,370	17,439
Cash and cash equivalents at beginning of period	28,994	11,555
Cash and cash equivalents at end of period	37,364	28,994

The notes and information on pages 50 to 110 form part of these financial statements.

Consolidated Statement of Changes in Equity for the year ended 31 December 2008

	Year ended 31 December 2008					
	Share capital £000	Share premium £000	Capital redemption reserve £000	Treasury Shares £000	Retained earnings £000	Total £000
Equity shareholders' funds at 1 January 2008	41,501	20,458	50	–	63,775	125,784
Purchase of treasury shares	–	–	–	(3,379)	–	(3,379)
Profit for the period representing total recognised income and expenses	–	–	–	–	20,017	20,017
Dividends paid	–	–	–	–	(16,054)	(16,054)
Equity shareholders' funds at 31 December 2008	41,501	20,458	50	(3,379)	67,738	126,368

	Year ended 31 December 2007					
	Share capital £000	Share premium £000	Capital redemption reserve £000	Treasury Shares £000	Retained earnings £000	Total £000
Equity shareholders' funds at 1 January 2007	41,501	20,458	50	–	52,246	114,255
Purchase of treasury shares	–	–	–	–	–	–
Profit for the period representing total recognised income and expenses	–	–	–	–	25,439	25,439
Dividends paid	–	–	–	–	(13,910)	(13,910)
Equity shareholders' funds at 31 December 2007	41,501	20,458	50	–	63,775	125,784

The notes and information on pages 50 to 110 form part of these financial statements.

Company Statement of Changes in Equity for the year ended 31 December 2008

	Year ended 31 December 2008					
	Share capital £000	Share premium £000	Capital redemption reserve £000	Treasury Shares £000	Retained earnings £000	Total £000
Equity shareholders' funds at 1 January 2008	5,229	20,458	50	–	41,500	67,237
Purchase of treasury shares	–	–	–	(3,379)	–	(3,379)
Profit for the period representing total recognised income and expenses	–	–	–	–	32,237	32,237
Dividends paid	–	–	–	–	(16,054)	(16,054)
Equity shareholders' funds at 31 December 2008	<u>5,229</u>	<u>20,458</u>	<u>50</u>	<u>(3,379)</u>	<u>57,683</u>	<u>80,041</u>

	Year ended 31 December 2007					
	Share capital £000	Share premium £000	Capital redemption reserve £000	Treasury Shares £000	Retained earnings £000	Total £000
Equity shareholders' funds at 1 January 2007	5,229	20,458	50	–	20,431	46,168
Purchase of treasury shares	–	–	–	–	–	–
Profit for the period representing total recognised income and expenses	–	–	–	–	34,979	34,979
Dividends paid	–	–	–	–	(13,910)	(13,910)
Equity shareholders' funds at 31 December 2007	<u>5,229</u>	<u>20,458</u>	<u>50</u>	<u>–</u>	<u>41,500</u>	<u>67,237</u>

The notes and information on pages 50 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 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 30 March 2009.

2 Accounting policies

(a) Statement of compliance

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as adopted by the European Union ('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.

The Group has applied all IFRSs and interpretations adopted by the EU at 31 December 2008 and applicable to the Group, with the exception of IFRS8 Operating Segments and of amendments to IAS1 Presentation of Financial Statements: A Revised Presentation. The effective date for these standards is accounting periods commencing on or after 1 January 2009 and further disclosures may be required when the standards are applied.

(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 Consolidated and Parent company financial statements have been prepared on a going concern basis. The Directors believe that they have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. In making this assessment, the Directors have taken into consideration the points set out in the Operating and Financial Review in the section headed 'Going Concern'.

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 results 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.

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 58 to 59).

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

These financial statements have been prepared in accordance with the disclosure provisions of FRS27 'Life Assurance'.

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

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.

2 Accounting policies (continued)

(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. They are initial fees amortised at a rate based on the pattern of anticipated margins in respect of the related policies. An explicit deferred acquisition cost asset is established in the balance sheet to the extent that acquisition costs exceed initial fees deducted. At 31 December each year, such costs that are deferred to future years are reviewed to ensure they do not exceed 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 as set out below.

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.

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'), a subsidiary of Aegon NV. 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 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.

2 Accounting policies (continued)

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 and are presented as amounts deposited with reinsurers.

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.

(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. Present value of in-force business 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. The present value of in-force insurance contracts is tested for recoverability / impairment as part of the liability adequacy test.

The present value 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. The recoverable amount is estimated at each balance sheet date. If the recoverable amount is less than the carrying amount, an impairment loss is recognised in the income statement and the carrying amount is reduced to its recoverable amount.

(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

2 Accounting policies (continued)

(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 at 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 at 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 values of financial assets quoted in an active market are 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 classified as prepayments are held at cost and are amortised over the relevant time period.

Financial assets at fair value through income are regularly reviewed for objective evidence of impairment. In determining whether objective evidence exists, the Group considers, among other factors, the financial stability of the counterparty, current market conditions and fair value volatility.

Financial assets are derecognised when contractual rights to receive cash flows from the 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 in the balance sheet at cost less impairment.

(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 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.

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 and shares held in treasury

(i) 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.

(ii) Shares held in treasury

Where the Company purchases its own equity share capital, the consideration paid, including directly attributable costs, is deducted from total shareholders' equity and shown separately as 'treasury shares' until they are cancelled. Where such shares are subsequently sold, any consideration received is included within shareholders' equity.

2 Accounting policies (continued)

(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 25 (on page 85).

(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 5 on page 64 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.

Fair value measurement 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.

(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 25 (on page 81) 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 expected lifetime of the investment management service contracts and deferred income is amortised on a straight-line basis over the expected period over 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.

4 Management of insurance risk

Introduction

The Group's management of insurance risk is a critical aspect of the business. 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 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.

4 Management of insurance risk (continued)

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 2008		31 December 2007	
	Gross £000	Net £000	Gross £000	Net £000
Annuities-immediate (per annum)	4,568	4,514	4,200	4,108
Long-term with DPF	72,728	204	75,697	204
Long-term without DPF	5,024,349	3,632,144	5,233,417	3,712,227
Total	5,101,645	3,636,862	5,313,314	3,716,539

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 explained in the Market Risk Management section of Note 5 on page 64.

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 set out in the Credit Risk Management section of Note 5 on page 74.

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 2008				
£0 – £25,000	4,523	99.0	4,505	99.8
More than £25,000	45	1.0	9	0.2
	<u>4,568</u>	<u>100.0</u>	<u>4,514</u>	<u>100.0</u>

	Total annuities payable each year			
	Before reinsurance		After reinsurance	
	£000	%	£000	%
As at 31 December 2007				
£0 – £25,000	4,155	98.9	4,099	99.8
More than £25,000	45	1.1	9	0.2
	<u>4,200</u>	<u>100.0</u>	<u>4,108</u>	<u>100.0</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 guaranteed sum assured payable on death or at maturity, to which may be added a discretionary annual bonus and a discretionary terminal bonus.

4 Management of insurance risk (continued)

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 in the Credit Risk Management section of Note 5 on page 74.

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. Therefore, the Group is exposed only to insurance risk insofar as the value of the unit-linked fund is lower than the guaranteed minimum death benefit. 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. The insurance risk is further managed through pricing, product design and, for non-linked and quasi-linked contracts, appropriate investment strategy.

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.

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 In £000's bands	Total benefits assured			
	Before reinsurance		After reinsurance	
	£m	%	£m	%
As at 31 December 2008				
0 – 250	4,930	96.8	3,611	99.4
250 – 500	116	2.3	20	0.6
500 – 750	27	0.5	1	–
750 – 1,000	12	0.2	–	–
More than 1,000	12	0.2	–	–
	<u>5,097</u>	<u>100.0</u>	<u>3,632</u>	<u>100.0</u>

	Total benefits assured			
	Before reinsurance		After reinsurance	
	£m	%	£m	%
As at 31 December 2007				
0 – 250	5,136	96.8	3,694	99.5
250 – 500	117	2.2	17	0.4
500 – 750	33	0.6	2	0.1
750 – 1,000	12	0.2	–	–
More than 1,000	12	0.2	–	–
	<u>5,310</u>	<u>100.0</u>	<u>3,713</u>	<u>100.0</u>

In addition to the above the Group has, at 31 December 2008, a total of approximately £10.3m per annum of retained PHI sums assured (31 December 2007: approximately £17m). 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 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 give 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.

4 Management of insurance risk (continued)

Concentration of insurance risks

There are 292 such policies in force as at 31 December 2008 (as at 31 December 2007: 330). The underlying contracts have total unit funds of £2.6m (as at 31 December 2007: £4.1m), with the largest fund being less than £0.4m.

Other risks on insurance contracts

Apart from financial risks relating to the financial assets, which support life assurance contracts, as set out in Note 5 on pages 64 to 74, there are other significant types of risk pertaining to life insurance contracts, as follows:

Expense risk

The Group strategy is to outsource all operational activities 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 business 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.

Persistency risk

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.

5 Management of financial risk

Introduction

The Group's management of 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 Group is exposed to a range of financial risks through its life assurance contracts, financial assets, financial liabilities, including investment contracts and borrowings, and its reinsurance assets. In particular, the key financial risk is that in the long-term its investment proceeds are not sufficient to fund the obligations arising from its insurance and investment contracts. The most important components of this financial risk are market risk (interest rate risk and equity price risk), and credit risk, including the risk of reinsurer default.

The Group manages these risks within an asset liability management (ALM) framework that has been developed to achieve long-term investment returns at least equal to its obligations under insurance and investment contracts, with minimal risk. Within the ALM framework the Group periodically produces reports at legal entity and asset and liability class level, which are circulated to the Group's key management. The principal technique of the Group's ALM framework is to match assets to the liabilities arising from insurance and investment contracts by reference to the type of benefits payable to policyholders, with separate portfolios of assets being maintained for each distinct class of liability.

For unit-linked contracts the Group's objective is to match the liabilities, both insurance and investment contract liabilities, with units in the fund to which the value of the liability is linked. For other business, 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. By matching the cash flows of liabilities with those of suitable assets, market risk is managed effectively, whilst liquidity risk is minimised. These processes to manage the risks, which the Group has not changed from previous periods, ensure that the Group is able to meet its obligations under its contractual liabilities as they fall due.

Terms and conditions of investment 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 Note 4 on pages 59 to 64. The terms and conditions of investment contracts that have a material effect on the amount, timing and uncertainty of future cash flows arising from investment contracts are set out in the product analyses below.

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 less surrender penalties, where applicable. 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

Guaranteed Income bonds 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 that the fair value of future cash flows will fluctuate because of a change in interest or foreign currency exchange rates or 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 in Note 4 (see page 62). 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.

5 Management of financial risk (continued)

Market risk management

The notes below explain how market risks are managed using the categories utilised in the Group's ALM framework. In particular, the ALM framework requires the management of interest risk, equity price risk, and liquidity risk at the portfolio level, so that the appropriate risks for each portfolio may be managed in an effective way. The Group is not significantly exposed to foreign exchange risk as the only assets denominated in foreign currencies are matched by corresponding insurance contract provisions and financial liabilities. To reflect the Group risk management approach the required disclosures for interest rate, equity price and liquidity risks, as appropriate, are given separately for each portfolio of the ALM framework. The following tables reconcile the balance sheet to the classes and portfolios used in the Group's ALM framework.

31 December 2008	Total £000	Guaranteed bonds £000	Insurance contracts with DPF £000	Unit-linked contracts £000	Annuities in payment £000	Other non- linked contracts £000	Other £000
Assets							
Intangible assets							
Deferred acquisition costs	8,590	–	–	–	–	–	8,590
Acquired value of in-force business							
Insurance contracts	16,866	–	–	–	–	–	16,866
Investment contracts	11,610	–	–	–	–	–	11,610
Reinsurers' share of insurance							
contract provisions	182,693	–	79,484	100,093	–	3,116	–
Amounts deposited with reinsurers	22,181	–	–	22,181	–	–	–
Investment properties	3,432	–	–	2,932	–	–	500
Financial assets							
Equity securities at fair value							
through income	363,879	–	2	363,872	–	5	–
Holdings in collective investment							
schemes at fair value through income	576,502	–	2,578	554,817	–	8,041	11,066
Debt securities at fair value							
through income	279,104	51,360	–	129,517	70,957	21,392	5,878
Insurance and other receivables	11,056	2,127	–	–	–	1,423	7,506
Prepayments	1,600	–	–	–	–	–	1,600
Derivative financial instruments	5,570	–	–	5,570	–	–	–
Total financial assets	<u>1,237,711</u>	<u>53,487</u>	<u>2,580</u>	<u>1,053,776</u>	<u>70,957</u>	<u>30,861</u>	<u>26,050</u>
Reinsurers' share of accrued policyholder							
claims	4,100	–	–	–	–	1,192	2,908
Cash and cash equivalents	192,381	3,031	368	50,257	7,260	13,135	118,330
Total assets	<u>1,679,564</u>	<u>56,518</u>	<u>82,432</u>	<u>1,229,239</u>	<u>78,217</u>	<u>48,304</u>	<u>184,854</u>
Liabilities							
Bank overdraft	1,094	–	–	38	–	822	234
Insurance contract provisions	923,506	–	82,432	728,179	78,217	34,678	–
Financial liabilities							
Investment contracts at fair value							
through income	558,542	55,119	–	494,449	–	8,974	–
Borrowings	8,358	–	–	–	–	–	8,358
Derivative financial instruments	70	–	–	70	–	–	–
Total financial liabilities	<u>566,970</u>	<u>55,119</u>	<u>–</u>	<u>494,519</u>	<u>–</u>	<u>8,974</u>	<u>8,358</u>
Provisions	3,397	–	–	–	–	179	3,218
Deferred tax liabilities	10,798	90	–	–	–	147	10,561
Reinsurance payables	1,397	–	–	–	–	253	1,144
Payables related to direct insurance and							
investment contracts	23,891	1,309	–	–	–	942	21,640
Deferred income	14,575	–	–	–	–	–	14,575
Income taxes	1,074	–	–	–	–	–	1,074
Other payables	6,494	–	–	–	–	2,309	4,185
Total liabilities	<u>1,553,196</u>	<u>56,518</u>	<u>82,432</u>	<u>1,222,736</u>	<u>78,217</u>	<u>48,304</u>	<u>64,989</u>

31 December 2007	Total £000	Guaranteed bonds £000	Insurance contracts with DPF £000	Unit-linked contracts £000	Annuities in payment £000	Other non- linked contracts £000	Other £000
Assets							
Intangible assets							
Deferred acquisition costs	9,542	–	–	–	–	–	9,542
Acquired value of in-force business							
Insurance contracts	19,427	–	–	–	–	–	19,427
Investment contracts	12,627	–	–	–	–	–	12,627
Reinsurers' share of insurance contract provisions	212,353	–	87,279	122,327	–	2,747	–
Amounts deposited with reinsurers	27,558	–	–	27,558	–	–	–
Investment properties	4,983	–	–	4,483	–	–	500
Financial assets							
Equity securities at fair value through income	743,670	–	1,020	740,105	–	2,545	–
Holdings in collective investment schemes at fair value through income	508,857	–	2,093	467,916	–	5,224	33,624
Debt securities at fair value through income	247,152	80,844	–	84,424	59,589	18,727	3,568
Insurance and other receivables	15,131	2,750	–	–	–	874	11,507
Prepayments	284	–	–	–	–	–	284
Derivative financial instruments	9,525	–	–	9,525	–	–	–
Total financial assets	<u>1,524,619</u>	<u>83,594</u>	<u>3,113</u>	<u>1,301,970</u>	<u>59,589</u>	<u>27,370</u>	<u>48,983</u>
Reinsurers' share of accrued policyholder claims	4,661	–	–	–	–	1,109	3,552
Cash and cash equivalents	225,127	2,834	399	104,291	2,965	17,107	97,531
Total assets	<u>2,040,897</u>	<u>86,428</u>	<u>90,791</u>	<u>1,560,629</u>	<u>62,554</u>	<u>48,333</u>	<u>192,162</u>
Liabilities							
Bank overdraft	1,229	–	–	–	–	–	1,229
Insurance contract provisions	1,110,848	–	90,791	922,419	62,554	35,084	–
Financial liabilities							
Investment contracts at fair value through income	726,503	85,367	–	630,844	–	10,292	–
Borrowings	12,469	–	–	–	–	–	12,469
Derivative financial instruments	265	–	–	265	–	–	–
Total financial liabilities	<u>739,237</u>	<u>85,367</u>	<u>–</u>	<u>631,109</u>	<u>–</u>	<u>10,292</u>	<u>12,469</u>
Provisions	3,575	–	–	–	–	159	3,416
Deferred tax liabilities	11,847	(250)	–	–	–	25	12,072
Reinsurance payables	1,622	–	–	–	–	372	1,250
Payables related to direct insurance and investment contracts	22,859	1,311	–	–	–	504	21,044
Deferred income	16,362	–	–	–	–	–	16,362
Income taxes	743	–	–	–	–	–	743
Other payables	6,791	–	–	–	–	1,897	4,894
Total liabilities	<u>1,915,113</u>	<u>86,428</u>	<u>90,791</u>	<u>1,553,528</u>	<u>62,554</u>	<u>48,333</u>	<u>73,479</u>

Guaranteed bonds

These contracts are for a fixed term with financial benefits that are fixed and guaranteed at the inception of the contract. The Group manages its market risk, its only material risk on these products, by matching closely contracts written with fixed interest debt securities of a suitable duration and quality, as indicated by their credit rating. The result is that, for these contracts, the Group's primary financial risk is the risk that interest income and capital redemptions from the financial assets backing the liabilities are insufficient to fund the guaranteed benefits payable. By using fixed interest debt securities, there is no exposure to equity price risk for this portfolio.

Regular monitoring of the interest rate risk is carried out by analysis of expected cash flows from the financial assets held with those for the liabilities. Cash flows for the liabilities are determined assuming all contracts continue until their expected maturity date. This analysis also enables the Group to control its liquidity risk for this portfolio.

5 Management of financial risk (continued)

The following tables indicate the amount and timing of the cash flows arising from the liabilities in this category of the Group's ALM framework.

31 December 2008	Contractual cash flows (undiscounted)				
Carrying values and cash flows arising from:	Carrying amounts £000	0-1 year £000	1-2 years £000	2-3 years £000	3-4 years £000
Assets backing liabilities:					
Debt securities at fair value through income	51,360	35,498	12,455	6,907	–
Insurance and other receivables	2,127	2,127	–	–	–
Cash and cash equivalents	3,031	3,031	–	–	–
Total	56,518	40,656	12,455	6,907	–
Liabilities	56,518	36,628	13,982	7,135	–
Difference in expected cash flows	–	4,028	(1,527)	(228)	–

31 December 2007	Contractual cash flows (undiscounted)				
Carrying values and cash flows arising from:	Carrying amounts £000	0-1 year £000	1-2 years £000	2-3 years £000	3-4 years £000
Assets backing liabilities:					
Debt securities at fair value through income	80,844	36,480	35,126	11,899	5,691
Insurance and other receivables	2,750	2,750	–	–	–
Cash and cash equivalents	2,834	2,834	–	–	–
Total	86,428	42,064	35,126	11,899	5,691
Liabilities	86,428	38,137	35,480	12,579	5,068
Difference in expected cash flows	–	3,927	(354)	(680)	623

These contracts can be surrendered before maturity for a cash surrender value. For these contracts the Group is not required to separately measure this embedded derivative at fair value. The terms are such that the surrender value will broadly change in line with changes in the market value of the matching assets, and so there is no significant risk of mismatch.

Sensitivity analysis – interest rate risk

The sensitivity analysis for interest rate risk illustrates how changes in the fair value or future cash flows of a financial instrument will fluctuate because of changes in market rates at the reporting date.

The carrying amount of both the liabilities and the assets, which are fixed interest debt securities valued at fair value, will be sensitive to changes in the level of interest rates. By reviewing the matching of the cash flows by term, on a quarterly basis, management aim to minimize the impact of a change in values due to a parallel movement in all yield curves.

A 100 basis point increase or decrease in interest yields would not have a material effect on either profit for the year ended 31 December 2008 and for the year ended 31 December 2007 or shareholder equity as at those dates.

Insurance contracts with discretionary participation 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. The with-profits business is wholly reinsured 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 Management' below.

With-profits business can be surrendered before maturity for cash surrender specified in the contractual terms and conditions. The impact on the Group's current year results would be minimal as any payments to policyholders are matched by payments from Guardian under the reinsurance contract. For all these contracts the Group is not required to separately measure this embedded derivative at fair value.

A maturity analysis based on the earliest contractual repayment date would present all the liabilities as due in the earliest period of the table because these options can be exercised immediately by all policyholders.

For a small element of the with-profits business, policyholders have the option to invest a portion of their investment in unit-linked funds as an alternative to the with-profits fund. In this case a portion of the business is retained, with the management of financial risks of this portion being the same as described under 'Unit-linked Contracts' below.

Unit-linked contracts

For unit-linked contracts, which may be insurance or investment contracts, the Group matches all the financial liabilities, which are linked to units in the insurance company funds, with assets on which the unit prices are based. This approach results in the Group having no significant market risk (being interest rate, equity price and currency risks) or credit risk on these contracts. Its primary exposure to market risk is the risk of volatility in asset management fees due to the impact of interest rate and equity price movements on the fair value of the assets held in the linked funds, on which investment management fees are based.

In practice, there remain a number of areas where there is a residual risk 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. The sensitivity of the redress provision to equity price changes is disclosed in Note 26 (on page 81) to these financial statements.

(iii) *Guaranteed annuity options*

For a small number of unit-linked contracts guarantees exist regarding the rate at which the policyholder is able to convert the unit fund into an annuity at retirement, as described above. As the policyholders gain the benefit of whichever of the then-current annuity rates and guaranteed annuity rates give them the higher benefits, this creates an interest rate risk, in that yields available at the time the option is taken may be lower than those assumed in the guaranteed rates. A provision is held for the cost of this guarantee.

(iv) *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 25(f) (on page 80) for more details). A provision is held for the cost of this guarantee.

The key assumption in determining this provision is the level of potential future fall in equities. An increase in this assumption, from 25% to 30%, would result in a £0.2m decrease in profit for the year ended 31 December 2008 and to shareholder equity as at 31 December 2008 (the increase would not have had a material effect for the year ended 31 December 2007 and as at 31 December 2007).

(v) *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.

5 Management of financial risk (continued)

(vi) Bonus units

Certain contracts (primarily investment contracts) contain a condition that bonus units are allocated at fixed dates in the future, essentially as a rebate of a portion of the management fees charged during the period since the last such bonus allocation. Financial assets are held to back the units that will be allocated, so as to remove the risk of adverse market price movements. This results in an apparent excess of financial assets over liabilities with an exposure to market risk.

Unit-linked contracts can be surrendered before maturity for cash surrender specified in the contractual terms and conditions. The terms are such that the surrender value will either be equal to the carrying amount of the contract liability, or in some cases lower due to surrender penalties specified in the contract terms and conditions. The impact on the Group's current year results would therefore be minimal. For all these contracts the Group is not required to separately measure this embedded derivative at fair value.

A maturity analysis based on the earliest contractual repayment date would present all the liabilities as due in the earliest period of the table because these options can be exercised immediately by all policyholders.

Sensitivity analysis – equity risk

A decrease of 10% in the value of the assets would reduce asset management fees, which would result in a £0.8m decrease in profit for the year ended 31 December 2008 and to shareholder equity as at 31 December 2008 (year ended 31 December 2007 and as at 31 December 2007: £0.9m decrease).

Annuities in payment

These are contracts which pay guaranteed financial benefits, generally monthly, for the lifetime of the policyholder, and in some cases of their spouse. For certain contracts payments are guaranteed to be paid for a minimum term regardless of survival (e.g. for 5 or 10 years). The terms are guaranteed at the inception of the contract. The financial component of these contracts is a guaranteed fixed interest rate and hence the Group's primary financial risk on these contracts is the risk that interest income and capital redemptions from the financial assets backing the liabilities are insufficient to fund the benefits payable.

The Group manages the interest rate risk by matching closely new contracts written with fixed interest debt securities of a suitable duration and quality, as indicated by their credit rating. By using fixed interest debt securities, there is no exposure to equity price risk for this portfolio.

Regular monitoring of the interest rate risk is carried out by analysis of expected cash flows from the financial assets held with those for the liabilities. Cash flows for the liabilities are determined by means of projecting expected cash flows from the contracts using prudent estimates of mortality.

The following tables indicate the estimated amount and timing of the cash flows arising from the liabilities in this category of the Group's ALM framework.

31 December 2008	Contractual cash flows (undiscounted)					
Carrying values and cash flows arising from:	Carrying amounts £000	0-5 years £000	5-10 years £000	10-15 years £000	15-20 years £000	>20 years £000
Assets backing liabilities:						
Debt securities at fair value through income	70,957	21,085	19,958	16,581	22,341	41,035
Cash and cash equivalents	7,260	7,260	–	–	–	–
Total	78,217	28,345	19,958	16,581	22,341	41,035
Liabilities	78,217	22,488	20,513	18,228	15,705	45,216
Difference in expected cash flows	–	5,857	(555)	(1,647)	6,636	(4,181)

31 December 2007	Contractual cash flows (undiscounted)					
	Carrying amounts £000	0-5 years £000	5-10 years £000	10-15 years £000	15-20 years £000	>20 years £000
Carrying values and cash flows arising from:						
Assets backing liabilities:						
Debt securities at fair value through income	59,589	21,176	17,538	16,929	21,677	34,469
Cash and cash equivalents	2,965	2,965	–	–	–	–
Total	62,554	24,141	17,538	16,929	21,677	34,469
Liabilities	62,554	20,434	18,611	16,541	14,258	39,078
Difference in expected cash flows	–	3,707	(1,073)	388	7,419	(4,609)

Sensitivity analysis – interest rate risk

The sensitivity analysis for interest rate risk illustrates how changes in the fair value or future cash flows of a financial instrument will fluctuate because of changes in market rates at the reporting date.

The carrying amount of both the liabilities and the assets, which are debt securities valued at fair value, will be sensitive to changes in the level of interest rates. By reviewing the matching of the cash flows by term, on a quarterly basis, management aim to minimize the impact of a change in values due to a parallel movement in all yield curves.

An increase of 100 basis points in interest yields of the matching assets would result in a decrease of £0.3m in profit for the year ended 31 December 2008 and in shareholder equity as at 31 December 2008 (year ended 31 December 2007 and as at 31 December 2007: £0.4m decrease).

An increase or decrease of 100 basis points in interest yields would result in a decrease of £1.7m in profit for the year ended 31 December 2008 and in shareholder equity as at 31 December 2008 (year ended 31 December 2007 and as at 31 December 2007: £0.5m decrease).

Other non-linked contracts

This category consists of two groups of contracts. The first group, representing £10.1m of liabilities out of the total of £48.3m as at 31 December 2008 (£10.9m out of the total of £48.3m as at 31 December 2007) is operated on a quasi-linked basis; these are contracts for which, while not classed as unit-linked due to the fact that there is no surrender value which depends on unit values, all other aspects of the risk management of these contracts are the same as for unit-linked contracts. As a result the Group operates the same risk management processes as described under 'Unit-linked Contracts' above.

The following is a maturity analysis of the contractual liabilities for this group of contracts, prepared on an estimated basis using estimates of mortality. The analysis represents the gross liabilities, before taking into account offsetting linked assets that are scheduled to mature in a similar profile.

	Contractual cash flows (undiscounted)				
	0-5 years £000	5-10 years £000	10-15 years £000	15-20 years £000	>20 years £000
As at 31 December 2008	22,686	24,813	21,543	10,105	4,080
As at 31 December 2007	24,427	28,028	27,378	15,352	6,580

Sensitivity analysis – equity risk

An increase or decrease of 10% in the value of the assets which back this group of contracts would not have a material effect on either profit for the year ended 31 December 2008 and the year ended 31 December 2007 or shareholder equity as at those dates.

The second group of contracts comprises contracts which pay guaranteed benefits on death or other insurance event, the terms being guaranteed at the inception of the contract. The financial component of these contracts is a guaranteed fixed interest rate, and hence, the Group's primary financial risk on these contracts is the risk that interest income and capital redemptions from the financial assets backing the liabilities are insufficient to fund the benefits payable.

5 Management of financial risk (continued)

The Group manages the interest rate risk for this group by closely matching new contracts written with financial assets of a suitable duration and quality, as indicated by their credit rating. By using fixed interest debt securities there is no exposure to equity price risk. Regular monitoring of the interest rate risk is carried out by analysis of expected cash flows from the financial assets held with those for the liabilities. Cash flows for the liabilities are determined by means of projecting expected cash flows from the contracts using prudent estimates of mortality.

The following tables indicate the estimated amount and timing of the cash flows arising from the liabilities in the second group of this category of the Group's ALM framework.

31 December 2008	Contractual cash flows (undiscounted)					
Carrying values and cash flows arising from:	Carrying amounts £000	0-5 years £000	5-10 years £000	10-15 years £000	15-20 years £000	>20 years £000
Assets backing liabilities:						
Reinsurers' share of insurance contract provisions	6,072	411	760	1,124	1,429	6,487
Debt securities at fair value through income	17,724	4,929	4,300	2,702	3,126	9,953
Insurance and other receivables	1,423	1,423	–	–	–	–
Cash and cash equivalents	12,967	12,967	–	–	–	–
Total	38,186	19,730	5,060	3,826	4,555	16,440
Liabilities	38,186	15,022	7,048	6,211	6,182	20,601
Difference in expected cash flows	–	4,708	(1,988)	(2,385)	(1,627)	(4,161)

31 December 2008	Contractual cash flows (undiscounted)					
Carrying values and cash flows arising from:	Carrying amounts £000	0-5 years £000	5-10 years £000	10-15 years £000	15-20 years £000	>20 years £000
Assets backing liabilities:						
Reinsurer's share of insurance contract provisions	6,784	459	849	1,256	1,596	7,248
Debt securities at fair value through income	15,970	4,811	4,819	3,322	3,908	11,508
Insurance and other receivables	874	874	–	–	–	–
Cash and cash equivalents	13,805	13,805	–	–	–	–
Total	37,433	19,949	5,668	4,578	5,504	18,756
Liabilities	37,433	19,688	5,572	5,151	5,253	19,617
Difference in expected cash flows	–	261	96	(573)	251	(861)

Sensitivity analysis – interest rate risk

The sensitivity analysis for interest rate risk illustrates how changes in the fair value or future cash flows of a financial instrument will fluctuate because of changes in market rates at the reporting date.

The carrying amount of both the liabilities and the assets, which include debt securities valued at fair value, will be sensitive to changes in the level of interest rates. By reviewing the matching of the cash flows by term, on a quarterly basis, management aim to minimize the impact of a change in values due to a parallel movement in all yield curves.

An increase of 100 basis points in interest yields would result in a decrease of £0.6m in profit for the year ended 31 December 2008 and in shareholder equity as at 31 December 2008 (year ended 31 December 2007 and as at 31 December 2007: £0.2m increase).

A decrease of 100 basis points in interest yields would result in an increase of £0.5m in profit for the year ended 31 December 2008 and in shareholder equity as at 31 December 2008 (year ended 31 December 2007 and as at 31 December 2007: decrease of £0.2m).

Certain of the contracts in this second group of contracts are invested in the Guaranteed Growth Fund which provides a return to policyholders which is linked to the average mortgage rate. This creates a risk 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.

Other

This category represents assets and liabilities other than for insurance and investment contracts, relating, principally, to surplus net assets representing shareholder equity.

Borrowings issued at variable rates of interest expose the Group to cash flow interest risk. Information on borrowings is provided in Note 28 on page 97. A 1% increase in interest rates would result in a decrease of £0.1m in profit for the year ended 31 December 2008 and in shareholder equity as at 31 December 2008 (year ended 31 December 2007 and as at 31 December 2007: £0.1m decrease).

Credit risk management

The Group has exposure to credit risk, which is the risk that a counterparty will be unable to pay amounts in full when due. Key areas where the Group is exposed to credit risk are:

- Reinsurers' share of insurance liabilities;
- Amounts deposited with reinsurer in relation to investment contracts;
- Amounts due from reinsurers in respect of claims already paid; and
- Counterparty risk with respect to corporate bond, deposits and debt securities.

In addition there will be some exposures to individual policyholders, on amounts due on insurance contracts. These are tightly controlled, with plans being terminated or benefits amended if amounts owed are for more than 3 months, so there is no significant risk to the results of the Group.

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 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 current policy of investing new monies only in high-quality bonds of supra-national corporations and in government-backed debt. The Group has never purchased 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 monthly.

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

As at 31 December 2008	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	40,507	137	–	–	45,046	85,690
Non-linked	44,937	15,385	3,520	–	147,335	211,177
Government or pseudo Government deposits						
Linked	72,999	–	–	–	–	72,999
Non-linked	101,619	–	–	–	–	101,619
Total debt, deposits and cash balances	260,062	15,522	3,520	–	192,381	471,485

5 Management of financial risk (continued)

As at 31 December 2007	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	3,098	647	86	–	110,146	113,977
Non-linked	50,531	36,843	3,755	151	114,981	206,261
Government or pseudo Government deposits						
Linked	62,137	–	–	–	–	62,137
Non-linked	89,904	–	–	–	–	89,904
Total debt, deposits and cash balances	205,670	37,490	3,841	151	225,127	472,279

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 £200.6m as at 31 December 2008 (31 December 2007: £236.9m) to Guardian, which does not have a published credit rating. Of this amount £182.5m (31 December 2007: £212.0m) is in respect of currently guaranteed benefits. 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 2006 when Guardian granted to Countrywide Assured plc a floating charge over related investment assets, which ranks that company equally with Guardian policyholders.

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.

6 Net Insurance premium revenue

	Year ended 31 December 2008				Year ended 31 December 2007			
	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	71,636	19,705	2,933	94,274	77,812	23,015	2,727	103,554
Insurance premium ceded to reinsurers	(10,366)	(4,114)	(2,713)	(17,193)	(11,046)	(5,013)	(2,657)	(18,716)
Net insurance premium revenue	61,270	15,591	220	77,081	66,766	18,002	70	84,838

7 Fees and commission income

	Year ended 31 December 2008		Year ended 31 December 2007	
	Insurance contracts £000	Investment contracts £000	Insurance contracts £000	Investment contracts £000
Fee income				
Policy-based fees	6,350	4,427	7,949	3,771
Fund management-based fees	2,572	2,839	2,486	3,317
Benefit-based fees	25,916	310	27,110	241
Change in deferred income – gross	–	1,787	–	1,869
Change in deferred income – reinsurer share	–	(66)	–	(56)
Total fee income	34,838	9,297	37,545	9,142
Commission income	451	8	487	7
Total fee and commission income	35,289	9,305	38,032	9,149

8 Net investment return

	Year ended 31 December	
	2008 £000	2007 £000
Dividend income	35,781	35,997
Interest income	24,398	26,650
Rental income from investment properties	400	1,268
Net fair value gains and losses		
Equity securities designated as at fair value through income on initial recognition	(251,174)	12,674
Debt securities designated as at fair value through income on initial recognition	(6,669)	1,418
Derivative financial instruments	(25,154)	10,330
Investment properties	(324)	1,873
Total investment income	(222,742)	90,210

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 (2007: £nil).

9 Other operating income

	Year ended 31 December	
	2008 £000	2007 £000
Release of unused provisions	271	28
Recharge of shared property services to tenants	500	504
Administration fees charged to reinsurers	153	189
Professional indemnity insurance recoveries	209	104
Other	181	473
Total other operating income	1,314	1,298

Notes to the Consolidated Financial Statements (continued)

10 Insurance contract claims and benefits

	Year ended 31 December 2008				Year ended 31 December 2007			
	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 insurance contract holders	106,779	19,795	5,255	131,829	128,991	20,283	5,383	154,657
Net increase/ (decrease) in insurance contract provisions	(184,991)	13,085	(8,359)	(180,265)	(2,404)	4,776	85	2,457
Total insurance contract claims and benefits	(78,212)	32,880	(3,104)	(48,436)	126,587	25,059	5,468	157,114
Recoveries from reinsurers	9,986	(3,990)	2,740	8,736	(17,523)	(3,806)	(5,189)	(26,518)
Net insurance contract claims and benefits incurred	(68,226)	28,890	(364)	(39,700)	109,064	21,253	279	130,596

11 Change in investment contract liabilities

	Year ended 31 December	
	2008 £000	2007 £000
Net changes in the fair value of investment contracts designated on initial recognition as fair value through income	(108,516)	50,697
Reinsurer's share	4,743	(11,534)
Net change in investment contract liabilities	(103,773)	39,163

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 £(108,516,000) (2007: £50,697,000).

12 Fees, commission and other acquisition costs

	Year ended 31 December	
	2008 £000	2007 £000
Directly expensed costs		
Insurance contracts		
Commission	171	140
New business and renewal costs	144	157
Investment contracts		
Commission	87	83
New business and renewal costs	61	53
Amortisation of deferred acquisition costs		
Insurance contracts	–	–
Investment contracts-gross	952	1,145
Investment contracts-reinsurance	(38)	(32)
Total	1,377	1,546

13 Administrative expenses

	Year ended 31 December	
	2008 £000	2007 £000
Personnel-related costs	2,298	2,627
Costs paid to third-party administrators	3,430	5,268
Other goods and services	7,905	8,060
Total	13,633	15,955

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	
	2008 £000	2007 £000
Fees payable to the Company's Auditor for the audit of the company's annual accounts	55	25
Fees payable to the Company's Auditor and its associates for other services:		
The audit of the Company's subsidiaries pursuant to legislation	195	252
Other services pursuant to legislation	102	107
Tax services	58	72
Services related to corporate finance transactions	95	–
Services related to information technology	–	5
All other services	1	10
	506	471

Notes to the Consolidated Financial Statements (continued)

14 Other operating expenses

	Year ended 31 December	
	2008 £000	2007 £000
Charge for amortisation of acquired value of in-force business		
Insurance contracts	2,561	2,717
Investment contracts	1,017	1,017
Total	3,578	3,734
Other		
Increase in provisions	185	3,138
Direct operating expenses of investment properties		
Revenue-generating properties	141	524
Non revenue-generating properties	–	–
Writedown of cash deposit	1,091	–
Other	236	62
Total	1,653	3,724

The writedown of cash deposit represents the full amount of a cash deposit with Kaupthing Singer and Friedlander who entered administration in 2008.

15 Financing costs

	Year ended 31 December	
	2008 £000	2007 £000
Interest expense on bank borrowings	752	1,089

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	
	2008 £000	2007 £000
Current tax expense		
Current year	3,037	4,411
Overseas tax	730	472
Adjustment to prior years	(8)	(503)
	<u>3,759</u>	<u>4,380</u>
Deferred tax expense		
Origination and reversal of temporary differences	(1,049)	(2,099)
Total income tax expense	<u><u>2,710</u></u>	<u><u>2,281</u></u>

Reconciliation of effective tax rate on profit before tax

	Year ended 31 December	
	2008 £000	2007 £000
Profit before tax	<u>22,727</u>	<u>27,720</u>
Income tax using the domestic corporation tax rate of 28.5% (2007: 30%)	6,477	8,316
Impact of small companies rate for subsidiaries	–	(2)
Permanent differences	116	66
Effect of UK taxing bases on insurance profits		
Offset of franked investment income	(3,885)	(5,115)
Variation in rate of tax on amortisation of acquired in-force value	90	(467)
Other	(80)	(14)
(Over)/under provided in prior years	(8)	(503)
Total income tax expense	<u><u>2,710</u></u>	<u><u>2,281</u></u>

17 Deferred acquisition costs

	Insurance contracts		Investment contracts		Total	
	2008 £000	2007 £000	2008 £000	2007 £000	2008 £000	2007 £000
Balance at 1 January	–	–	9,542	10,687	9,542	10,687
Amortisation charged to income	–	–	(952)	(1,145)	(952)	(1,145)
Impairment losses	–	–	–	–	–	–
Balance at 31 December	<u>–</u>	<u>–</u>	<u>8,590</u>	<u>9,542</u>	<u>8,590</u>	<u>9,542</u>
Current	–	–	1,423	1,614	1,423	1,614
Non-current	–	–	7,167	7,928	7,167	7,928
Total	<u><u>–</u></u>	<u><u>–</u></u>	<u><u>8,590</u></u>	<u><u>9,542</u></u>	<u><u>8,590</u></u>	<u><u>9,542</u></u>

The amortisation charged to income is recognised in Fees, Commission and Other Acquisition Costs (see Note 12 on page 77).

Notes to the Consolidated Financial Statements (continued)

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 2007	33,278	15,254	48,532
Additions	–	–	–
Balance at 31 December 2007	33,278	15,254	48,532
Additions	–	–	–
Balance at 31 December 2008	33,278	15,254	48,532
Amortisation and impairment losses			
Balance at 1 January 2007	11,134	1,610	12,744
Amortisation for the year	2,717	1,017	3,734
Impairment charge	–	–	–
Balance at 31 December 2007	13,851	2,627	16,478
Amortisation for the year	2,561	1,017	3,578
Impairment charge	–	–	–
Balance at 31 December 2008	16,412	3,644	20,056
Carrying amounts			
At 1 January 2007	22,144	13,644	35,788
At 31 December 2007	19,427	12,627	32,054
At 31 December 2008	16,866	11,610	28,476
31 December 2007			
Current	2,678	1,016	3,694
Non-current	16,749	11,611	28,360
Total	19,427	12,627	32,054
31 December 2008			
Current	2,671	1,017	3,688
Non-current	14,195	10,593	24,788
Total	16,866	11,610	28,476

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 78).

19 Investment properties

	31 December	
	2008 £000	2007 £000
Balance at 1 January	4,983	27,750
Disposals	(1,227)	(24,640)
Fair value adjustments	(324)	1,873
Impairment losses	–	–
Balance at 31 December	3,432	4,983
Current	188	1,415
Non-current	3,244	3,568
Total	3,432	4,983

Investment properties were 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 2008.

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 Net Investment Return (see Note 8 on page 75). Expenses incurred in the operation and maintenance of investment properties are disclosed in Other Operating Expenses (see Note 14 on page 78).

During the year ended 31 December 2008 the Group completed its plan to dispose of directly held properties, in the unit-linked property funds, in favour of indirect property investments through holdings in collective investment schemes.

Notes to the Consolidated Financial Statements (continued)

20 Financial assets

Group	31 December	
	2008 £000	2007 £000
Financial assets by measurement category		
Fair value through income		
Designated at fair-value through income on initial recognition	1,219,485	1,499,679
Derivative financial instruments	5,570	9,525
Insurance and other receivables	11,056	15,131
Prepayments	1,600	284
Total	1,237,711	1,524,619

	31 December	
	2008 £000	2007 £000
Financial assets at fair value through income		
Equities		
Listed	363,879	743,670
Debt securities – fixed rate		
Government Bonds	174,617	152,041
Listed	68,161	95,111
Debt securities – floating rate		
Listed	36,326	–
Total debt securities	279,104	247,152
Holdings in collective investment schemes	576,502	508,857
Derivative financial instruments	5,570	9,525
Total	1,225,055	1,509,204
Current	159,047	255,189
Non-current	1,066,008	1,254,015
Total	1,225,055	1,509,204

Company	31 December	
	2008 £000	2007 £000
Investment in subsidiaries	52,006	52,006
Current	–	–
Non-current	52,006	52,006
Total	52,006	52,006

21 Insurance and other receivables and prepayments

	31 December	
	2008 £000	2007 £000
Insurance and other receivables		
Group		
Receivables arising from insurance contracts		
Policyholders	1,847	2,082
Receivables arising from investment contracts		
Policyholders	14	11
Reinsurance receivables	111	300
Commission receivables	1,005	628
Debtor for professional indemnity insurance	18	17
Other receivables		
Accrued interest income	6,456	10,505
Related party receivables	78	79
Recoveries relating to unit pricing redress	294	494
Other	1,233	1,015
Total	11,056	15,131
Current	11,056	15,131
Non-current	–	–
Total	11,056	15,131

Recoveries relating to unit pricing redress is explained in Note 29(d) on page 99.

The fair value of insurance and other receivables is £11,056,000 (2007: £15,131,000).

	31 December	
	2008 £000	2007 £000
Company		
Amounts due from subsidiary companies	662	279
Other	515	343
Total	1,177	622
Current	1,177	622
Non-current	–	–
Total	1,177	622

The fair value of insurance and other receivables is £1,177,000 (2007: £622,000).

	31 December	
	2008 £000	2007 £000
Prepayments		
Prepayments	1,600	284
Current	400	284
Non-current	1,200	–
Total	1,600	284

Notes to the Consolidated Financial Statements (continued)

22 Derivative financial instruments

The Group does not use derivatives as part of any hedging strategies to mitigate risk and does not hold derivatives outside the unit-linked funds.

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 2008		31 December 2007	
	Asset £000	Liability £000	Asset £000	Liability £000
Exchange-traded futures (by geographical investment market)				
Australia	211	–	77	(23)
Switzerland	148	(13)	199	(5)
Europe	1,038	–	1,016	–
UK	2,009	–	1,588	(2)
Hong Kong	236	(31)	2,059	–
Japan	811	–	331	(74)
South Korea	605	–	2,012	(129)
Sweden	29	(2)	28	–
Singapore	37	(1)	329	–
USA	446	(23)	1,886	(32)
Total	5,570	(70)	9,525	(265)
Current	5,570	(70)	9,525	(265)
Non-current	–	–	–	–
Total	5,570	(70)	9,525	(265)

23 Income tax assets

	31 December	
	2008 £000	2007 £000
Income tax assets, which are all current, comprise:		
Group		
Corporation tax recoverable	–	–
Company		
Corporation tax recoverable	139	–

24 Cash and cash equivalents

	31 December	
	2008 £000	2007 £000
Group		
Bank and cash balances	35,669	30,416
Call deposits due within 1 month	91,615	115,068
Call deposits due after 1 month	65,097	79,643
Total cash and cash equivalents	192,381	225,127
Bank overdrafts	(1,094)	(1,229)
Cash and cash equivalents in the statement of cash flows	191,287	223,898

The effective interest rate on short term bank deposits was 5.09% (2007: 5.91%), with an average maturity of 53 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 £45,046,000 (2007: £110,146,000) held in unit-linked policyholders' funds.

	31 December	
	2008 £000	2007 £000
Company		
Bank and cash balances	–	18
Call deposits due within 1 month	36,372	26,976
Short term deposits due within 1 year	1,000	2,000
	37,372	28,994
Bank overdrafts	(8)	–
Total	37,364	28,994

25 Capital Management

(a) Objective

The Group's objective when managing capital is to maintain a strong capital base to protect policyholders' and creditors' interests and to satisfy regulators, while continuing to maintain shareholder value. This is achieved through:

- (i) safeguarding the Group's ability to continue as a going concern so that it can continue to provide returns to shareholders and benefits for other stakeholders;
- (ii) providing an adequate return to shareholders by pricing insurance and investment contracts commensurately with the level of risk; and
- (iii) complying with the insurance capital requirements established by the regulators of the insurance markets where the Group operates. As at 31 December 2007 and 31 December 2008 the Group operated exclusively in the UK and the Group's regulatory capital requirements are, accordingly, determined by the regulations established by the FSA.

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, in which the whole of the Life operations of the Group now subsist. However, within this Note and the following Note 26 Insurance Contract Provisions reference is made to 'CWA' and to 'CA' to continue to identify respectively the long-term business which had been conducted within the respective companies prior to this transfer.

25 Capital Management (continued)

(b) Operation of the UK and EU regulatory regimes

The operation of FSA regulation with respect to the Group's life assurance business, Countrywide Assured plc (CA plc), is such as to specify the minimum amount of capital that must be held in addition to the insurance liabilities as determined for regulatory purposes. This is established by reference to two calculations, being:

- (i) the Pillar 1 calculation, which compares regulatory capital based on the characteristics of the in-force life assurance business with a concomitant measure of capital as prescribed by regulation and
- (ii) the Pillar 2 calculation, which compares a risk-based assessment of economic capital with a concomitant measure of capital based on a realistic assessment of insurance liabilities.

For the whole of the period covered by these financial statements the minimum regulatory capital requirement is determined by the first calculation, as this gives rise to the lesser measure of surplus capital. This calculation is set out below in Section (c) Regulatory Capital Resources and Requirements, together with the Board's policy in targeting regulatory capital resource cover for total regulatory capital resource requirements.

The Group's regulated life assurance business, which falls outside the scope of the FSA's 'realistic capital' regime, 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, as described above.

In addition to the UK solvency requirements the Group is subject to the requirements of the EU Insurance Group Directive, in accordance with which the Group calculates the excess of the aggregate of regulatory capital resources determined on a Group-wide basis over the aggregate minimum regulatory capital requirement imposed by local regulators. The requirement is that available Group capital resources, as set out in Section (d) Group Capital Position Statement below, should be at least 100% of capital requirements.

There has been no material change in the Group's management of capital in the period.

The Group and its individually regulated life assurance business have complied with all externally and internally imposed capital requirements during the period.

(c) Regulatory capital resources and requirements

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

	31 December	
	2008 £m	2007 £m
Available capital resources (CR)	43.0	47.6
Long-term insurance capital requirement (LTICR)	22.5	25.1
Resilience capital requirement (RCR)	1.8	1.5
Total capital resource requirements (CRR)	24.3	26.6
Target capital requirement cover	35.6	39.1
Excess of CR over target requirement	7.4	8.5
Ratio of available CR to CRR	177%	179%

Available capital resources as at 31 December 2008 are stated after provision for a dividend of £26.0m which was approved by the CA plc Board subsequent to 31 December 2008 (as at 31 December 2007: £30.0m subsequent to 31 December 2007).

CA plc'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.

(d) *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 2008:	Life business UK non- participating £000	Life business shareholder £000	Total life business £000	Other activities £000	Consolidation adjustments £000	Group total £000	Adjustment for dividend £000	Group total – IFRS basis £000
Shareholder funds outside long-term insurance funds	–	49,182	49,182	96,108	(31,703)	113,587	10,200	123,787
Shareholder funds in long-term insurance funds	2,581	–	2,581	–	–	2,581	–	2,581
Total shareholder funds	2,581	49,182	51,763	96,108	(31,703)	116,168	10,200	126,368
Adjustment onto regulatory basis								
Adjustments to assets	(717)	(8,173)	(8,890)	(52,163)	31,703	(29,350)		
Other	86	–	86	–	–	86		
Total available capital resources	1,950	41,009	42,959	43,945	–	86,904		

As at 31 December 2007:	Life business UK non- participating £000	Life business shareholder £000	Total life business £000	Other activities £000	Consolidation adjustments £000	Group total £000	Adjustment for dividend £000	Group total – IFRS basis £000
Shareholder funds outside long-term insurance funds	–	54,086	54,086	87,305	(29,109)	112,282	10,302	122,584
Shareholder funds in long-term insurance funds	3,200	–	3,200	–	–	3,200	–	3,200
Total shareholder funds	3,200	54,086	57,286	87,305	(29,109)	115,482	10,302	125,784
Adjustment onto regulatory basis								
Adjustments to assets	(888)	(8,848)	(9,736)	(51,988)	29,109	(32,615)		
Other	80	–	80	–	–	80		
Total available capital resources	2,392	45,238	47,630	35,317	–	82,947		

The tables presented above illustrate Group total available capital resources as measured for the purposes of inclusion in the related regulatory returns. As at 31 December 2008 they are stated after provision of a dividend of £10.2m and, as at 31 December 2007, after provision of a dividend of £10.3m, which were approved by the Chesnara plc Board subsequent to the respective year ends. Provision is not made for such dividends on the IFRS basis: accordingly, it is necessary to make adjustment to shareholder funds outside long-term insurance funds as at 31 December 2008, as reflected above, in order to illustrate the relationship with the total shareholder equity included in the consolidated balance sheet prepared on the IFRS basis.

Notes to the Consolidated Financial Statements (continued)

25 Capital Management (continued)

The following table summarises the movement in the available capital resources of the constituent funds of the life business for the year ended 31 December 2008:

	Life business UK non- participating £000	Life business shareholder £000	Total life business £000
At beginning of period	2,392	45,238	47,630
Effect of change in rates of interest used for discounting projected non-linked actuarial liabilities	(6,944)	–	(6,944)
Total return on assets held to match non-linked liabilities	7,596	–	7,596
Surplus arising in the year, net of the effect of the items shown above	22,906	–	22,906
Net profit arising in shareholder fund	–	771	771
Transfer from long-term business fund to shareholder fund	(24,000)	24,000	–
Dividends			
– paid to shareholders	–	(3,000)	(3,000)
– proposed	–	(26,000)	(26,000)
At end of period	1,950	41,009	42,959

The change in the rates of interest used for discounting non-linked actuarial liabilities follows from changes in yields on bonds to match those liabilities.

There were no changes in available capital resources for the year ended 31 December 2008 due to changes 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 significant.

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

The Group has no formal intragroup funding arrangements.

(e) *Technical provisions net of reinsurance*

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

	31 December	
	2008 £000	2007 £000
Technical provisions		
Unit-linked		
Unit		
– Insurance contracts	610,333	771,818
– Investment contracts	480,373	613,913
Non-unit (sterling)		
– Insurance contracts	20,980	32,386
– Investment contracts	7,294	7,919
Non-participating		
- Insurance contracts	110,249	94,891
- Investment contracts	65,464	95,763
Total	1,294,693	1,616,690

(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 2008		31 December 2007	
	CA business	CWA business	CA business	CWA business
Assurances				
Without profit: non linked business	3.40%	3.20%	3.90%	2.60%
Without profit: annual premium	3.40%	3.20%	3.90%	2.60%
Without profit: guaranteed income bonds	1.60%	–	4.80%	–
Annuities				
Without profit: deferred	3.40%	2.80%	3.90%	3.20%
Without profit: vested	3.80%	3.10%	4.40%	4.40%

The rates of interest shown above have been set after consideration of the risk of default on non-government bonds by applying the following adjustments to the earned yield:

- (i) a standard risk deduction, varying by credit rating, of 0.1% for 'AAA'-rated bonds, 0.3% for 'AA'-rated bonds and 0.5% for 'A'-rated bonds, based on ratings according to Standard and Poors credit rating system. No assets are held with a credit rating less than 'A'; and
- (ii) an overall maximum margin over the equivalent term government fixed interest security of 0.5%.

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, technical provisions are 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 26(c) (iii) on page 92.

25 Capital Management (continued)

(f) Valuation of options and guarantees

(i) Stochastically-valued options and guarantees

The Group has a small number of guaranteed annuity options, considered in Note 5, 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; and
- (ii) investment conditions were such as to require the establishment of a reserve of £1,247,000 as at 31 December 2008 (31 December 2007: £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 33% and allowing for future investment returns, including presumed future equity investment return of 3.6% 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.

Reserves for this product comprise a 'unit' reserve of the current value of the benefits held and a non-unit reserve for expenses.

The underlying fund at 31 December 2008 was £8.3m (31 December 2007: £9.0m). 922 policies invested in the fund (31 December 2007: 995), of which 118 (31 December 2007: 141) were paying premiums (for a total of approximately £41,000 per annum (31 December 2007: £47,000)).

For the valuation of contract liabilities the following are projected 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:	3.6% pa
Rate of return on cash:	2.3% pa
Discount rate:	2.6% 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 as at 31 December 2008 was £0.7m. (31 December 2007: £1.0m).

(g) 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 Notes 4 and 5 to these financial statements.

26 Insurance contract provisions

(a) Analysis of insurance contract provisions by type

	31 December 2008			31 December 2007		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Long-term business						
Unit-linked without DPF	728,006	99,918	628,088	922,183	122,092	800,091
Non-linked without DPF	113,068	3,291	109,777	97,874	2,983	94,891
With DPF	82,432	79,484	2,948	90,791	87,278	3,513
Total insurance contract provisions	923,506	182,693	740,813	1,110,848	212,353	898,495
Current	26,988	4,081	22,907	41,961	4,541	37,420
Non-current	896,518	178,612	717,906	1,068,887	207,812	861,075
Total	923,506	182,693	740,813	1,110,848	212,353	898,495

(b) Analysis of movement in insurance contract provisions

Unit-linked without DPF

	2008			2007		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Balance at 1 January	922,183	122,092	800,091	932,496	118,588	813,908
Premiums received	71,585	9,084	62,501	77,195	9,812	67,383
Fees deducted	(22,498)	(1,481)	(21,017)	(21,892)	(1,293)	(20,599)
Reserves released in respect of benefits paid	(84,932)	(8,478)	(76,454)	(109,510)	(10,518)	(98,992)
Investment return	(152,748)	(21,219)	(131,529)	47,540	5,739	41,801
Other movements	(5,584)	(80)	(5,504)	(3,646)	(236)	(3,410)
Balance at 31 December	728,006	99,918	628,088	922,183	122,092	800,091

Non-linked without DPF

	2008			2007		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Balance at 1 January	97,874	2,983	94,891	91,995	1,512	90,483
Premiums received	19,415	3,664	15,751	22,797	4,343	18,454
Fees deducted	(10,030)	(2,832)	(7,198)	(11,317)	(3,925)	(7,392)
Reserves released in respect of benefits paid	(6,042)	387	(6,429)	(6,665)	705	(7,370)
Investment return	11,146	203	10,943	1,871	(198)	2,069
Other movements	705	(1,114)	1,819	(807)	546	(1,353)
Balance at 31 December	113,068	3,291	109,777	97,874	2,983	94,891

26 Insurance contract provisions (continued)

With DPF

	2008			2007		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Balance at 1 January	90,791	87,278	3,513	90,706	87,179	3,527
Premiums received	2,933	2,822	111	3,070	2,951	119
Fees deducted	(900)	(888)	(12)	(959)	(944)	(15)
Reserves released in respect of benefits paid	(4,155)	(4,035)	(120)	(4,179)	(3,974)	(205)
Investment return	587	1,129	(542)	1,925	1,838	87
Other movements	(6,824)	(6,822)	(2)	228	228	–
Balance at 31 December	82,432	79,484	2,948	90,791	87,278	3,513

The residual net liability of £2,948,000 as at 31 December 2008 (31 December 2007: £3,513,000) 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 reinsured 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 reinsured, as provided to the Group by Guardian.

For all the other classes of linked and quasi-linked business, the insurance contract 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.

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.

(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 2008		31 December 2007	
	CA business	CWA business	CA business	CWA business
Assurances				
– without profit: non linked business	3.40%	3.20%	3.90%	2.60%
– without profit: annual premium	3.40%	3.20%	3.90%	2.60%
Annuities				
– without profit: deferred	3.40%	2.80%	3.90%	3.20%
– without profit: vested	3.80%	3.10%	4.40%	4.40%

The rates of interest shown above have been set after consideration of the risk of default on non-government bonds by applying the following adjustments to the earned yield:

- (i) a standard risk deduction, varying by credit rating, of 0.1% for 'AAA'-rated bonds, 0.3% for 'AA'-rated bonds and 0.5% for 'A'-rated bonds, based on ratings according to Standard and Poors credit rating system. No assets are held with a credit rating less than 'A'; and
- (ii) an overall maximum margin over the equivalent term government fixed interest security of 0.5%.

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 and to a lesser extent the net premium method, the insurance contract 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.

26 Insurance contract provisions (continued)

Taxation

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

(iii) Changes in assumptions and sensitivity to changes 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 smaller number of in-force policies. Consequently the per policy expense reserve has increased. This increased the reserves by £0.3m as at 31 December 2008 (31 December 2007: £0.7m).

The reserve held in respect of the CWA business for guaranteed annuity rates was reduced by £0.7m, making allowance principally for the vesting of policies with the guarantee, changes in unit values and interest rates.

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 2008 £m
Investment return	+1	(1.7)
Investment return	-1	(0.6)
Mortality/morbidity	+10	0.6
Policy maintenance expenses	+10	(1.8)

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.

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 £1.3m for increased mortality

rates and a reduction in consolidated net of tax profits and equity by £0.7m for increased morbidity rates. The sensitivities to changes in these assumptions in the opposite direction will result in changes of similar magnitude but in the opposite direction.

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 endowment misselling complaints

The insurance liabilities include an amount of £4.2m (31 December 2007: £6.7m) in respect of potential compensation payments arising from endowment misselling complaints. 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 or 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 £0.2m. A 10% increase in assumed cost of redress to settle each complaint would increase insurance contract provisions by £0.4m.

Notes to the Consolidated Financial Statements (continued)

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

(a) Analysis by contract type

	31 December 2008			31 December 2007		
	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	494,148	21,733	472,415	630,843	27,128	603,715
Non-linked	9,275	–	9,275	10,293	–	10,293
Guaranteed income and guaranteed growth bonds	55,119	–	55,119	85,367	–	85,367
Other	–	448	(448)	–	430	(430)
Total	558,542	22,181	536,361	726,503	27,558	698,945
Current	42,583	402	42,181	65,818	–	65,818
Non-current	515,959	21,779	494,180	660,685	27,558	633,127
Total	558,542	22,181	536,361	726,503	27,558	698,945

(b) Analysis of movements in investment contract liability and amounts deposited with reinsurer

	31 December 2008			31 December 2007		
	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	630,843	27,128	603,715	658,352	63,229	595,123
Deposits received	18,956	953	18,003	18,340	902	17,438
Fees deducted from account balances	(8,190)	115	(8,305)	(4,227)	(2)	(4,225)
Account balances paid on terminations in the year	(34,761)	(1,667)	(33,094)	(45,689)	(1,449)	(44,240)
Investment yield	(115,345)	(4,795)	(110,550)	29,127	893	28,234
Other movements	2,645	(1)	2,646	(25,060)	(36,445)	11,385
Balance at 31 December	494,148	21,733	472,415	630,843	27,128	603,715

	31 December 2008			31 December 2007		
	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	10,293	–	10,293	10,992	–	10,992
Deposits received	13	–	13	75	–	75
Fees deducted	(117)	–	(117)	–	–	–
Account balances paid on terminations in the year	(1,454)	–	(1,454)	(1,549)	–	(1,549)
Investment yield	316	–	316	617	–	617
Other movements	224	–	224	158	–	158
Balance at 31 December	9,275	–	9,275	10,293	–	10,293

	31 December 2008			31 December 2007		
	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	85,367	–	85,367	143,635	–	143,635
Deposits received	3,280	–	3,280	12,645	–	12,645
Account balances paid on terminations in the year	(37,282)	–	(37,282)	(76,696)	–	(76,696)
Investment yield	2,777	–	2,777	5,221	–	5,221
Other movements	977	–	977	562	–	562
Balance at 31 December	55,119	–	55,119	85,367	–	85,367

28 Borrowings

Group and Company

	31 December	
	2008 £000	2007 £000
Bank loan	8,358	12,469
Current	4,168	4,127
Non-current	4,190	8,342
Total	8,358	12,469

The bank loan, which was drawn down on 2 June 2005 under a facility made available on 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 2008, being that payable within one year, is £4,168,000 and the non-current portion is £4,190,000. 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 2008 was £8,400,000 (31 December 2007: £12,600,000).

29 Provisions

	MECR £000	Other complaints redress £000	Onerous contracts £000	Unit pricing redress £000	Total £000
Balance at 1 January 2007	126	54	417	–	597
Provisions made during the year	61	16	67	2,994	3,138
Provisions used during the year	(67)	(4)	(61)	–	(132)
Provisions reversed during the year	(18)	(9)	(1)	–	(28)
Balance at 31 December 2007	102	57	422	2,994	3,575
Provisions made during the year	13	56	116	–	185
Provisions used during the year	(48)	–	(44)	–	(92)
Provisions reversed during the year	(1)	–	(70)	(200)	(271)
Balance at 31 December 2008	66	113	424	2,794	3,397
31 December 2007					
Current	102	57	61	2,994	3,214
Non-current	–	–	361	–	361
Total	102	57	422	2,994	3,575
31 December 2008					
Current	66	113	49	2,794	3,022
Non-current	–	–	375	–	375
Total	66	113	424	2,794	3,397

(a) Mortgage endowment complaints redress (MECR)

As part of the mortgage endowment complaint redress process (refer to Note 26 Insurance Contract Provisions on page 81), 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.

(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 41 Operating Leases on page 107. 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:

- (a) The provision model assumes that if the rent is reduced to a lower percentage of the Company contract, the percentage sublet occupancy of the properties will change accordingly. The rent reduction and occupancy rates vary from property to property, depending on location and prevailing tenancy rates within the various locations: the rents are assumed to be in a range between 50% and 80% of the contractual rental and the occupancy rates are assumed to be in a range between 50% and 82% of the current occupancy rates.

(b) Future cash flows are discounted within the provision model at 5%.

Sensitivities

	Provision at 31 December 2008 £000	Post sensitivity provision £000	Change in provision £000	%
Discount rate – decreased by 1% to 4%	424	438	14	+3
Sublease rent mitigation – reduction of 10%	424	459	35	+8
Occupancy mitigation – reduction of 10%	424	457	33	+8

(d) Unit pricing redress

A data error in the indexation of the costs of underlying financial assets in certain of the unit-linked funds was identified during 2007. As a result, the amount of capital gains chargeable to tax had been overestimated for unit pricing purposes and greater deductions were made from these funds than would otherwise have been the case. The effect of this became more significant during 2006 and 2007 as investment markets recovered from their previous lows. Restitution has been made to the relevant unit-linked funds, thus correcting the position for continuing policyholders. An exercise is under way to review payments to policyholders who exited the funds prior to the restitution and who may have suffered loss. A provision of £2,994,000 was established at 31 December 2007 to cover the estimated cost of redress and the administration costs of performing the review. Associated recoveries from third parties were established at £494,000 as at the same date and these have been included in 'Insurance and other receivables' as at 31 December 2007 as set out in Note 21 on page 83. The net charge to the income statement for the year ended 31 December 2007 in establishing the provision and associated recoveries was, accordingly, £2,500,000.

The provision established at 31 December 2007 was estimated insofar as it was not based on specific individual calculations for each policyholder, but was established on the basis of generic data relating to the amount of payments to policyholders who exited from the funds in specific periods, of the unit prices ruling in those periods and of an estimate of the extent of the pricing error pertaining to those periods. Subsequently, a revised estimate has been established at £2,794,000 based on specific policy-by-policy data and this has resulted in a release of £200,000 from the provision to income during the year ended 31 December 2008. However, this re-estimate is subject to uncertainty until the associated administration procedures are completed. The Directors consider that the methodology used to establish the provision continues to be prudent.

During the year ended 31 December 2008, £200,000 was received from a third party and the balance of estimated recoveries from third parties of £294,000 is included in 'Insurance and other receivables' as at 31 December 2008 as also set out in Note 21 on page 83.

Notes to the Consolidated Financial Statements (continued)

30 Deferred tax liabilities

(a) Recognised deferred tax assets and liabilities

As at 31 December 2008	Assets £000	Liabilities £000	Net £000
Insurance contract provisions	–	4,987	(4,987)
Intangible assets			
Deferred acquisition costs	–	2,253	(2,253)
Acquired value of in-force business	–	7,456	(7,456)
Deferred income	3,837	–	3,837
Property and equipment	61	–	61
Total	3,898	14,696	(10,798)
Current	–	–	–
Non-current	3,898	14,696	(10,798)
Total	3,898	14,696	(10,798)

As at 31 December 2007	Assets £000	Liabilities £000	Net £000
Insurance contract provisions	–	5,476	(5,476)
Intangible assets			
Deferred acquisition costs	–	2,509	(2,509)
Acquired value of in-force business	–	8,269	(8,269)
Deferred income	4,319	–	4,319
Property and equipment	88	–	88
Total	4,407	16,254	(11,847)
Current	–	–	–
Non-current	4,407	16,254	(11,847)
Total	4,407	16,254	(11,847)

(b) Unrecognised deferred tax assets

	31 December	
	2008 £000	2007 £000
Tax losses arising in pensions business	56,022	49,157
Capital losses	17,312	29,151
Unrelieved expenses	95,499	123,582
Total	168,833	201,890

- (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.

Normally, deferred tax would be recognised in respect of the taxable element of unrealised gains or losses on equities. However, the current expectation is that the Life business will continue to be taxed on a basis equivalent to surplus less franked investment income. As any unrealised amounts have already been included in surplus the theoretical taxable temporary difference is expected to have no practical consequences for tax payable at the time the assets are disposed of. Accordingly no amount is provided.

(c) *Movement in temporary differences during the year*

	Year ended 31 December 2008			Year ended 31 December 2007		
	Balance at 1 January £000	Recognised in income £000	Balance at 31 December £000	Balance at 1 January £000	Recognised in income £000	Balance at 31 December £000
Insurance contract provisions	(5,476)	489	(4,987)	(6,147)	671	(5,476)
Contingency reserves	–	–	–	120	(120)	–
Intangible assets						
Deferred acquisition costs	(2,508)	255	(2,253)	(3,356)	848	(2,508)
Acquired value of in-force business	(8,270)	814	(7,456)	(9,856)	1,586	(8,270)
Deferred income	4,319	(482)	3,837	5,171	(852)	4,319
Property and equipment	88	(27)	61	122	(34)	88
Total	(11,847)	1,049	(10,798)	(13,946)	2,099	(11,847)

31 Reinsurance payables

	31 December	
	2008 £000	2007 £000
Payable to reinsurance		
Payables in respect of insurance contracts	1,288	1,557
Payables in respect of investment contracts	109	65
Total	1,397	1,622
Current	1,397	1,622
Non-current	–	–
Total	1,397	1,622

32 Payables related to direct insurance and investment contracts

	31 December 2008			31 December 2007		
	Gross £000	Reinsurance £000	Net £000	Gross £000	Reinsurance £000	Net £000
Accrued claims	22,068	4,100	17,968	20,854	4,661	16,193
Policyholder premium liabilities	1,823	–	1,823	2,005	–	2,005
Total	23,891	4,100	19,791	22,859	4,661	18,198
Current	23,891	4,100	19,791	22,859	4,661	18,198
Non-current	–	–	–	–	–	–
Total	23,891	4,100	19,791	22,859	4,661	18,198

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

Notes to the Consolidated Financial Statements (continued)

33 Deferred income

	31 December	
	2008 £000	2007 £000
Balance at 1 January	16,362	18,231
Release to income	(1,787)	(1,869)
Balance at 31 December	14,575	16,362
Current	1,438	1,876
Non-current	13,137	14,486
Total	14,575	16,362

The release to income is included in Fee and Commission Income (see Note 7 on page 69).

34 Income tax liabilities

	31 December	
	2008 £000	2007 £000
Group		
Income tax liabilities, which are all current, comprise:		
Corporation tax	1,074	743
Company		
Income tax liabilities, which are all current, comprise:		
Corporation tax	–	3

35 Other payables

	31 December	
	2008 £000	2007 £000
Group		
Accrued expenses	2,599	3,720
Other	3,895	3,071
Total	6,494	6,791
Current	6,494	6,791
Non-current	–	–
Total	6,494	6,791
Company		
Accrued expenses	1,638	1,630
Amounts due to Group companies	420	–
Other	229	283
Total	2,287	1,913
Current	2,287	1,913
Non-current	–	–
Total	2,287	1,913

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

36 Share capital and share premium

Group

	31 December 2008		31 December 2007	
	Number of shares	Share capital £000	Number of shares	Share capital £000
Share capital	<u>104,588,785</u>	<u>41,501</u>	<u>104,588,785</u>	<u>41,501</u>

There have been no changes in Group share capital and share premium during the year ended 31 December 2008.

The number of shares in issue at the balance sheet date included 3,096,194 shares held in treasury (31 December 2007: nil).

Under the reverse acquisition basis of accounting referred to in Note 2 on page 47, 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, 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 2008 £	31 December 2007 £
Authorised 201,000,000 Ordinary shares of 5p each	<u>10,050,000</u>	<u>10,050,000</u>

	Number of Shares	Share Capital £	Share Capital £
Issued Ordinary shares of 5p each	<u>104,588,785</u>	<u>5,229,439</u>	<u>5,229,439</u>

The number of shares in issue at the balance sheet date included 3,096,194 shares held in treasury (31 December 2007: nil).

There have been no changes in Company share capital and share premium during the year ended 31 December 2008.

Notes to the Consolidated Financial Statements (continued)

37 Treasury shares

Group and Company

	Year ended 31 December	
	2008 £000	2007 £000
Balance at 1 January	–	–
Purchases during the year	3,379	–
Balance at 31 December	<u>3,379</u>	<u>–</u>

The Company purchased 3,096,194 of its own shares between 24 September 2008 and 20 November 2008 for a total consideration of £3,379,000.

38 Retained earnings

Group

Retained earnings attributable to equity holders of the parent company comprise

	Year ended 31 December	
	2008 £000	2007 £000
Balance at 1 January	63,775	52,246
Profit for the year	20,017	25,439
Dividends		
Final approved and paid for 2006	–	(8,419)
Interim approved and paid for 2007	–	(5,491)
Final approved and paid for 2007	(10,302)	–
Interim approved and paid for 2008	(5,752)	–
Balance at 31 December	<u>67,738</u>	<u>63,775</u>

The interim dividend in respect of 2007, approved and paid in 2007, was paid at the rate of 5.25p per share. The final dividend in respect of 2007, approved and paid in 2008, was paid at the rate of 9.85p per share so that the total dividend paid to the equity shareholders of the Parent Company in respect of the year ended 31 December 2007 was made at the rate of 15.10p per share.

The interim dividend in respect of 2008, approved and paid in 2008, was paid at the rate of 5.50p per share to equity shareholders of the Parent Company registered at the close of business on 12 September 2008, the dividend record date.

A final dividend of 10.05p per share in respect of the year ended 31 December 2008 payable on 20 May 2009 to equity shareholders of the Parent Company registered at the close of business on 14 April 2008, the dividend record date, was approved by the Directors after the balance sheet date. The resulting total final dividend of £10.2m 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 2007 and 31 December 2008:

	2008 p	2007 p
Interim – approved and paid	5.50	5.25
Final – proposed	10.05	9.85
Total	<u>15.55</u>	<u>15.10</u>

Company

	Year ended 31 December	
	2008 £000	2007 £000
Balance at 1 January	41,500	20,431
Profit for the year	32,237	34,979
Dividends paid		
Final approved and paid for 2006	–	(8,419)
Interim approved and paid for 2007	–	(5,491)
Final approved and paid for 2007	(10,302)	–
Interim approved and paid for 2008	(5,752)	–
Balance at 31 December	57,683	41,500

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

39 Employee benefit expense

Group

	Year ended 31 December	
	2008 £000	2007 £000
Wages and salaries	1,786	2,134
Social security costs	216	252
Pension costs-defined contribution plans	296	241
Total	2,298	2,627

Company

	Year ended 31 December	
	2008 £000	2007 £000
Wages and salaries	300	921
Social security costs	33	108
Pension costs-defined contribution plans	62	113
Total	395	1,142
Average number of employees		
Company	17	20
Subsidiaries	7	10
Total	24	30

At the end of May 2005 the Group allowed eligible employees to enter a pension scheme known as 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 their predecessor scheme continued, provided that employee contributions also continued 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 continue to be members of the pre-existing defined contribution Group Personal Pension scheme, to which employer and employee contributions are made.

39 Employee benefit expense (continued)

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 and, otherwise, has no residual obligation or commitments in respect of any defined benefit scheme.

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.

40 Earnings per share

Earnings per share is based on the following:

	Year ended 31 December	
	2008	2007
Profit for the year (£000)	20,017	25,439
Weighted average number of ordinary shares	104,021,765	104,588,785
Basic earnings per share	19.24p	24.32p
Diluted earnings per share	19.24p	24.32p

The weighted average number of ordinary shares in respect of the year ended 31 December 2008 is based on 104,588,785 shares in issue at the beginning of the period and on 104,588,785 shares in issue at the end of the period less 3,096,194 own shares held in treasury as disclosed in Note 37, taking account of the timing of the purchases of own shares.

The weighted average number of ordinary shares in respect of the years ended 31 December 2008 and 31 December 2007 is based on 104,588,785 shares in issue at the beginning and end of those periods.

There were no share options outstanding during the year ended 31 December 2007 or during the year ended 31 December 2008. Accordingly, there is no dilution of the average number of ordinary shares in issue in respect of these periods.

41 Operating leases

Leases as lessee

Non-cancellable operating lease rentals are payable as follows:

	31 December 2008				31 December 2007			
	Investment properties £000	Non-investment properties £000	Motor vehicles £000	Total £000	Investment properties £000	Non-investment properties £000	Motor vehicles £000	Total £000
Operating lease rentals								
Less than one year	–	687	31	718	20	670	37	727
Between one and two years	–	678	20	698	–	670	27	697
Between two and five years	–	1,981	1	1,982	–	2,010	16	2,026
More than five years	–	2,843	–	2,843	–	3,817	–	3,817
Expenses recognised in the year in respect of operating leases	–	685	40	725	–	452	35	487

The Group's investment property portfolio is typically freehold. However it had short-term leasehold interests in two properties, which both expired in 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 7 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 £424,000 at 31 December 2008 (31 December 2007: £422,000) in respect of these leases (see Note 29 Provisions on page 98).

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 2008			31 December 2007		
	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	–	464	464	–	312	312
Between one and two years	–	450	450	–	314	314
Between two and five years	–	1,133	1,133	–	941	941
More than five years	–	2,055	2,055	–	1,757	1,757
Rental income recognised in the year	–	447	447	–	207	207
Repairs and maintenance costs recognised in the year	–	110	110	–	10	10

42 Contingencies

(a) Insurance solvency regulations

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.

(b) Past sales

The Group has made provision for the estimated cost of settling complaints in respect of past sales of endowment mortgages. Although the provisions are regularly reviewed, the final outcome could be different from the provisions established as these costs cannot be calculated with certainty and are influenced by external factors beyond the control of management. In particular, uncertainty exists in relation to future regulatory actions and to the outcome of ongoing cases which have been referred to the Financial Ombudsman Service. The outcome of such referrals may lead to a review of other similar cases and the financial effect of these cannot be assessed with any certainty until the cases, which the Company continues to contest, have been concluded.

43 Capital commitments

There were no capital commitments as at 31 December 2008 or as at 31 December 2007.

44 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; and
- (iii) other companies over which its Directors have significant influence.

(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	
	2008 £000	2007 £000
Short-term employee benefits	684	680
Post-employment benefits	160	84
Long-term employment benefits	209	325
Total	1,053	1,089

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.

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

	31 December	
	2008 £000	2007 £000
Annual bonus scheme	152	176
Long-term incentive plan	1,006	983
Total	1,158	1,159

These amounts have been included in Group and Company Accrued expenses as disclosed in Note 35 on page 102.

The amounts payable under the annual bonus scheme were payable within one year. At 31 December 2008, £313,000 of the amount payable under the long-term incentive plan was payable within one year (2007: £251,000).

(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	
	2008 £000	2007 £000
	2,017	1,964

(iii) Transactions with companies over which Chesnara plc 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 or was controlled or significantly influenced by Directors of the Company.

	Year ended 31 December	
	2008 £000	2007 £000
Amounts payable/(receivable)		
Commission payable in respect of arrangement of the Groups' insurance and investment contracts (Included in Fees, Commission and Other Acquisition Costs: see Note 12 on page 77)	227	221
Administration services (Included in Other Operating Income: see Note 9 on page 69)	(55)	(80)
Property services	(39)	(15)
Total	133	126

Amounts outstanding in respect of the above transactions at each period end were:

	31 December	
	2008 £000	2007 £000
Payables (included in Other Payables: see Note 35 on page 102)	7	7
Receivables (included in Other receivables within Note 21 on page 83)	14	1

Notes to the Consolidated Financial Statements (continued)

45 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	
		2008	2007
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	Dissolved 05/02/08	100% of all share capital ⁽¹⁾
Reefwise Limited	England & Wales	Dissolved 08/01/08	100% of all share capital ⁽²⁾
Countrywide Assured Commission Services Limited	England & Wales	Dissolved 18/02/08	100% of all share capital ⁽³⁾
The Greenways Management Company (Deepcar) Limited	England & Wales	Dissolved 19/02/08	100% of all share capital ⁽³⁾
CWA Trustee Company Limited	England & Wales	100% of all share capital ⁽⁵⁾	100% of all share capital ⁽⁵⁾
CWA Life Holdings plc	England & Wales	100% of all share capital	100% of all share capital
City of Westminster Assurance Company Limited	England & Wales	Dissolved 29/04/08	100% of all share capital ⁽⁵⁾

- (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

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 123 in respect of the year ended 31 December 2008. 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 119. The EEV supplementary information should be read in conjunction with the Group's financial statements which are on pages 43 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 119. 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 2008 has been properly prepared in accordance with the EEV Principles using the methodology and assumptions set out on pages 116 to 119.

KPMG Audit Plc

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

30 March 2009

Supplementary Information – European Embedded Value Basis

Summarised consolidated income statement

	Note	Year ended 31 December	
		2008 £000	2007 £000
Operating profit of covered business	6	25,521	13,522
Other operational result		385	(16)
Operating profit		25,906	13,506
Variation from longer-term investment return		(16,831)	(3,020)
Effect of economic assumption changes		6,951	(4,043)
Profit before tax		16,026	6,443
Tax		(1,200)	5,674
Profit for the period		14,826	12,117
Earnings per share			
Based on profit for the period		14.25p	11.59p
Diluted earnings per share			
Based on profit for the period	14.25p	11.59p	

The notes and information on pages 116 to 119 form part of this supplementary information.

Supplementary Information – European Embedded Value Basis (continued)

Summarised consolidated balance sheet

	Note	31 December	
		2008 £000	2007 £000
Assets			
Value of in force business	5,8	84,940	94,007
Reinsurers' share of insurance contract provisions		165,648	187,486
Amounts deposited with reinsurers		21,404	26,702
Investment properties		3,432	4,983
Deferred tax assets		–	88
Financial assets			
Equity securities at fair value through income		363,879	743,670
Holdings in collective investment schemes at fair value through income		576,502	508,857
Debt securities at fair value through income		279,104	247,152
Insurance and other receivables		11,056	15,131
Prepayments		1,600	284
Derivative financial instruments		5,570	9,525
Total financial assets		1,237,711	1,524,619
Reinsurers' share of accrued policy claims		4,100	4,660
Cash and cash equivalents		192,381	225,127
Total assets		1,709,616	2,067,672
Liabilities			
Bank Overdraft		1,094	1,229
Insurance contract provisions		907,071	1,086,581
Financial liabilities			
Investment contracts at fair value through income		573,955	744,222
Borrowings		8,358	12,469
Derivative financial instruments		70	265
Total financial liabilities		582,383	756,956
Provisions		3,397	3,575
Reinsurance payables		1,397	1,622
Payables related to direct insurance and investment contracts		23,891	22,859
Income taxes		1,181	743
Other payables		6,494	6,792
Total liabilities		1,526,908	1,880,357
Net assets		182,708	187,315
Shareholders' equity			
Share capital		41,501	41,501
Share premium		20,458	20,458
Treasury shares		(3,379)	–
Other reserves		50	50
Retained earnings		124,078	125,306
Total shareholders' equity	5,8	182,708	187,315

The notes and information on pages 116 to 119 form part of this supplementary information.

Approved by the Board of Directors on 30 March 2009 and signed on its behalf by:

Ken Romney

Graham Kettleborough

Summarised consolidated statement of changes in equity

	Year ended 31 December	
	2008 £000	2007 £000
Shareholders' equity at 1 January	187,315	189,108
Purchase of treasury shares	(3,379)	–
Profit for the period representing total recognised income and expense	14,826	12,117
Dividends paid	(16,054)	(13,910)
Shareholders' equity at 31 December	<u>182,708</u>	<u>187,315</u>

The notes and information on pages 116 to 119 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.

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 significant 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.

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 cash flow.

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 cash flows 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 cash flows 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, where appropriate, for reinsurer default

(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 cash flows 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.

3 Methodology (continued)

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.

(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

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 reported at each reporting date. The current practice is detailed below.

Each year the demographic assumptions are reviewed as part of year-end processes and hence were reviewed in December 2008.

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 principally allocated to the covered business to reflect effort expended within the holding company relating to 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 guarantee on pension business with annuity guarantees have been set equal to best-estimate assumptions.

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 equities, the return is split between franked income and capital gains based on a best estimate of long-term average dividend yields. For linked business the aggregate return has been determined by reference to the benchmark asset mix within the Managed Funds.

	31 December	
	2008	2007
Equity risk premium	2.7%	2.7%
Property risk premium	2.7%	2.7%
Investment return		
Fixed Interest	3.6%	4.6%
Equities	6.3%	7.3%
Property	6.3%	7.3%
UK equities dividend yield	3.1%	3.0%
Inflation		
RPI	1.5%	3.1%

(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, except where future tax rates or practices have been announced.

(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 mid 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 reinsured;

Notes to the Supplementary Information (continued)

4 Assumptions (continued)

- (iii) expense risk is limited as a result of the outsourcing of substantially all policy administration and related 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	
	2008	2007
Risk-free rate	3.6%	5.0%
Non-diversifiable risk	0.5%	0.5%
Risk margin	2.2%	2.2%
Risk discount rate	6.3%	7.7%

5. Analysis of shareholders' equity

	31 December	
	2008 £000	2007 £000
Covered business		
Required capital	35,615	39,149
Free surplus	33,774	38,483
Shareholder net worth	69,389	77,632
Value of in-force business	84,940	94,007
Embedded value of covered business	154,329	171,639
Less: amount financed by borrowings	(8,358)	(12,469)
Embedded value of covered business attributable to shareholders	145,971	159,170
Net equity of other Group companies	36,737	28,145
Total shareholders' equity	182,708	187,315
The movement in the value of in-force business comprises:		
Value at beginning of period	94,007	109,941
Amount charged to operating profit	(9,067)	(15,934)
Value at end of period	84,940	94,007

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. 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 2007 and a further £4.2m was repaid on 2 June 2008, leaving principal outstanding at that date of £8.4m.

6. Analysis of profit of covered business

	Year ended 31 December	
	2008 £000	2007 £000
New business contribution	715	1,261
Return from in-force business		
Expected return	10,445	10,206
Experience variances	9,166	4,238
Operating assumption changes	4,590	(4,236)
Return on shareholder net worth	605	2,053
Operating profit	25,521	13,522
Variation from longer-term investment return	(16,831)	(3,020)
Effect of economic assumption changes	6,951	(4,043)
Profit on covered business before tax	15,641	6,459
Tax	(1,376)	5,677
Profit on covered business after tax	14,265	12,136

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', and in respect of any tax pertaining thereto, which is included in 'other tax'.

In respect of the year ended 31 December 2007, £3,844,000 of adverse variances, previously reported as adverse experience variances within the return from in-force business, have been re-classified as variation from longer-term investment return, as this more properly reflects the nature of the variances. This has the effect of increasing the net return from in-force experience variances from £394,000, as previously reported, to £4,238,000 and of re-stating the variation from longer-term investment return from a net credit of £824,000, as previously reported, to a net charge of £3,020,000. In accordance with this, operating profit has increased from £9,678,000, as previously reported, to £13,522,000. The profit on covered business before tax remains unchanged at £6,459,000.

7. Sensitivities to alternative assumptions

The following table shows the sensitivity of the embedded value of the covered business as reported at 31 December 2008 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 2008 as the reported level of new business contribution is not considered to be material (see Note 3a 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 2008	£154.2m
	Change in EV (£m)
Economic sensitivities	
100 basis point increase in risk discount rate	(5.0)
100 basis point reduction in yield curve	2.9
10% decrease in equity and property values	(4.8)
Operating sensitivities	
10% decrease in maintenance expenses	2.0
10% decrease in lapse rates	3.2
5% decrease in mortality/morbidity rates	
Assurances	1.7
Annuities	(0.9)
Reduction in the required capital to statutory minimum	1.7

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 6.3% RDR increases to 7.3%;
- 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 95% of the parameters in a selected mortality/morbidity table reducing to 90% 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 shareholder equity on the EEV basis

	31 December	
	2008 £000	2007 £000
Shareholders' equity on the IFRS basis	126,368	125,784
Adjustments		
Deferred acquisition costs		
Investment contracts	(8,047)	(8,961)
Deferred income	13,705	15,426
Adjustment to provisions on investment contracts, net of amounts deposited with reinsurers	(15,863)	(18,220)
Adjustments to provisions on insurance contracts, net of reinsurers' share	(610)	(600)
Acquired in-force value	(21,020)	(23,785)
Deferred tax	3,235	3,664
Group shareholder net worth	97,768	93,308
Value of in-force business	84,940	94,007
Shareholders' equity on the EEV basis	182,708	187,315
Group shareholder net worth comprises:		
Shareholder net worth in covered business	69,389	77,632
Shareholder's equity in other Group companies	36,737	28,145
Debt finance	(8,358)	(12,469)
Total	97,768	93,308

Notice of Annual General Meeting

Chesnara plc

Company No. 4947166

NOTICE OF ANNUAL GENERAL MEETING

Notice is given that the 2009 Annual General Meeting of Chesnara plc will be held at the offices of Panmure Gordon (UK) Limited, Moorgate Hall, 155 Moorgate, London EC2M 6XB on 14 May 2009 at 11 a.m. for the following purposes:

Ordinary Business

As ordinary business, to consider and, if thought fit, to pass the following resolutions (resolutions 1 to 8 as ordinary resolutions and resolutions 9 and 10 as special resolutions):

- 1 To receive and adopt the Financial Statements for the financial year ended 31 December 2008 together with the reports of the directors and auditor thereon.
- 2 To declare a final dividend of 10.05 pence per share for the financial year ended 31 December 2008.
- 3 To approve the directors' remuneration report set out in the Financial Statements for the financial year ended 31 December 2008.
- 4 To re-elect Peter Mason as a director who retires by rotation in accordance with the Company's Articles of Association.
- 5 To re-elect Graham Kettleborough as a director who retires by rotation in accordance with the Company's Articles of Association.
- 6 To elect Peter Wright as a director.
- 7 To re-appoint KPMG Audit Plc as auditors of the Company to hold office until the conclusion of the next general meeting of the Company at which accounts are laid before shareholders and to authorise the directors to fix the auditors' remuneration.
- 8 That the directors be generally and unconditionally authorised in accordance with section 80 of the Companies Act 1985 (the 'Act') to exercise all the powers of the Company to allot:
 - (a) relevant securities (as defined in section 80 of the Act) up to an aggregate nominal amount of £1,691,373; and
 - (b) equity securities (as defined in section 94 of the Act) up to a further aggregate nominal amount of £1,691,373 in connection with an offer by way of a rights issue,

such authorities to expire 15 months after the passing of this resolution or, if earlier, on the date of the next Annual General Meeting (or adjournment thereof) after the passing of this resolution. Notwithstanding such expiry, the authorities shall in each case still permit the Company to make allotments of relevant securities in respect of offers or agreements made before such expiry, which would or might require relevant securities to be allotted after such expiry. These authorities revoke all previous authorities to directors pursuant to section 80 of the Act, without prejudice to any allotment of securities made pursuant to such authorities.

For the purposes of this resolution 'rights issue' means an offer to ordinary shareholders in proportion (as nearly as may be practicable) to their existing holdings (and, if applicable, to the holders of any other class of equity security in accordance with the rights attached to such class) to subscribe further securities by means of the issue of a renounceable letter (or other negotiable document) which may be traded for a period before payment for the securities is due, subject to such exclusions or other arrangements as the directors may deem necessary or expedient in relation to (i) fractions of such securities, (ii) the issue, transfer and/or holding of any securities in certificated form or in uncertificated form, (iii) the use of one or more currencies for making payments in respect of such offer, (iv) any such shares or other securities being represented by depositary receipts, (v) treasury shares or (vi) any legal or practical problems arising under the laws of, or the requirements of any regulatory body or any stock exchange in, any territory.

- 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:
- (a) 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;
 - (b) the allotment of equity securities pursuant to the terms of any share scheme for employees approved by the members in General Meetings; and
 - (c) the allotment of equity securities for cash (otherwise than as mentioned in sub-paragraphs (a) and (b) 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 2010 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.
- 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 Act) on the London Stock Exchange of ordinary shares of 5p each in the capital of the Company provided that:
- (a) the maximum aggregate number of ordinary shares hereby authorised to be purchased is 10,149,259 (representing 10% of the Company's issued share capital excluding shares held in Treasury);
 - (b) the minimum price (exclusive of expenses) which may be paid for such ordinary shares is 5p per share;
 - (c) 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 Daily Official List for the five business days before the purchase is made;
 - (d) the authority hereby conferred shall expire at the conclusion of the next Annual General Meeting of the Company held in 2010 or, if earlier, the date 15 months after the date on which the resolution is passed; and
 - (e) 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.

Special Business

To consider and, if thought fit, to pass the following resolutions 11, 12 and 13 as special resolutions:

- 11 That the regulations contained in the document produced to the meeting, described as the 'New Articles' and signed for identification purposes by the chairman of the meeting be adopted as the Company's new articles of association in substitution for and to the exclusion of the Company's existing articles of association.
- 12 That with effect from 00.01 a.m. on 1 October 2009 or such other time as the remaining parts of the Companies Act 2006 are first in force:
- (a) the articles of association of the Company be amended by deleting all the provisions of the Company's memorandum of association which, by virtue of section 28 Companies Act 2006, are to be treated as provisions of the Company's articles of association; and

Notice of Annual General Meeting (continued)

- (b) the regulations produced to the meeting, described as the 'New October Articles' and initialled by the chairman of the meeting for the purpose of identification be adopted as the new articles of association of the Company in substitution for, and to the exclusion of, the existing articles of association.
- 13 That a general meeting of the Company other than an annual general meeting may be called on not less than 14 clear days' notice.

By order of the Board

Ken Romney
Company Secretary

Registered office:
Harbour House
Portway
Preston
Lancashire
PR2 2PR

Registered in England No. 4947166

Dated 30 March 2009

Notes:

- 1 Any Member entitled to attend and vote at this Meeting may appoint a proxy or proxies to attend and vote instead of him. A Member may appoint more than one proxy in relation to the Annual General Meeting provided that each proxy is appointed to exercise the rights attached to a different share or shares held by that Member. A proxy need not be a Member of the Company. A form of proxy for this Meeting is enclosed, and in order to be valid, any form of proxy and power of attorney or other authority under which it is signed, or a notarially certified or office copy of such power of attorney, must reach the Company's Registrars, Capita Registrars at 34 Beckenham Road, Beckenham, Kent BR3 4TU or by post to Business Reply Licence No MBI22, Capita Registrars (Proxies), PO Box 25, Beckenham, Kent, BR3 4BR not less than 48 hours before the time appointed for the holding of the meeting or, in the case of an adjournment, by no later than 48 hours before the time for the holding of the adjourned meeting. The appointment of a proxy will not preclude a shareholder from attending and voting at the meeting.
- 2 To appoint a proxy or give or amend an instruction to a previously appointed proxy via the CREST system, the CREST message must be received by the issuer's agent RA10 not less than 48 hours before the time appointed for the holding of the meeting or of any adjournment of the meeting. For this purpose, the time of receipt will be taken to be the time (as determined by the timestamp applied to the message by the CREST Applications Host) from which the issuer's agent is able to retrieve the message. After this time any change of instructions to a proxy appointed through CREST should be communicated to the proxy by other means. CREST Personal Members or other CREST sponsored members, and those CREST Members who have appointed voting service provider(s) should contact their CREST sponsor or voting service provider(s) for assistance with appointing proxies via CREST. For further information on CREST procedures, limitations and system timings please refer to the CREST Manual. We may treat as invalid a proxy appointment sent by CREST in the circumstances set out in Regulation 35(5) (a) of the Uncertificated Securities Regulations 2001. In any case your proxy form must be received by the company's registrars not less than 48 hours before the time appointed for the holding of the meeting to be valid.
- 3 The Register of Directors' shareholdings and transactions and copies of Directors' service contracts and letters of appointment 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 (and for the purpose of the determination by the Company of the votes they may cast) is 11 a.m. on 12 May 2009 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.
- 5 In accordance with Section 325 of the Companies Act 2006, the right to appoint proxies does not apply to persons nominated to receive information rights under section 146 of the Companies Act 2006. Persons nominated to receive information rights under section 146 of the Companies Act 2006 who have been sent a copy of this notice of meeting are hereby informed, in accordance with Section 149 (2) of the Companies Act 2006, that they may have a right under an agreement with the registered member by whom they were nominated to be appointed, or to have someone else appointed, as a proxy for this meeting. If they have no such right, or do not wish to exercise it, they may have a right under such an agreement to give instructions to the member as to the exercise of voting rights. Nominated persons should contact the registered member by whom they were nominated in respect of these arrangements.
- 6 As at 30 March 2009 (being the last business day prior to the publication of this Notice) the Company's issued share capital consists of 104,588,785 ordinary shares, carrying one vote each. The total voting rights in the Company as at 30 March 2009 (being the last business day prior to the publication of this Notice) are 101,492,591.
- 7 Arrangements will be put in place at the meeting in order to facilitate voting by representatives of members which are corporations on a poll (if required) in accordance with the procedures set out in the Institute of Chartered Secretaries and Administrators' January 2008 guidance note on 'Proxies & Corporate Representatives at General Meetings'.

EXPLANATORY NOTES TO THE NOTICE OF ANNUAL GENERAL MEETING

The notes on the following pages give an explanation of the proposed resolutions:

Resolution 1:

Report and accounts

For each financial year the directors are required to present the directors' report, the audited accounts and the auditors' reports to shareholders at a general meeting.

Resolution 2:

Final dividend

The payment of the final dividend requires the approval of shareholders in general meeting. If the meeting approves resolution 2, the final dividend of 10.05 pence per share will be paid on 20 May 2009 to ordinary shareholders who are on the register of members on 14 April 2009 in respect of each ordinary share.

Resolution 3:

Approval of the directors' remuneration report

The Company is required by law to seek the approval of shareholders of its annual report on remuneration policy and practice. This does not affect the directors' entitlement to remuneration and the result of this resolution is advisory only.

The remuneration report for the year ended 31 December 2008 is set out in full on pages 34 to 39 of this document.

Your directors are satisfied that the Company's policy and practice in relation to directors' remuneration are reasonable and that they deserve shareholder support.

Resolutions 4 – 5:

Re-election of directors

Under the Company's articles of association directors are obliged to retire by rotation at annual general meetings and may not serve beyond three years without being re-elected by shareholders. The directors who now fall due for retirement and re-election, through separate resolutions numbered 4 to 5 are Peter Mason and Graham Kettleborough. Brief biographical details of both directors seeking re-election can be found on page 7 of this document. Following formal performance evaluation of the Board, both continue to be effective and demonstrate commitment to the role. The remaining directors therefore unanimously recommend that each of these directors be re-elected as a director of the Company.

Resolutions 6:

Election of Peter Wright as director

Peter Wright joined the Chesnara board on 1 January 2009 as an independent non-executive director and was appointed as chairman of the audit committee. Brief biographical details for Peter Wright can be found on page 7 of this document.

In accordance with the Articles of Association, Peter Wright offers himself for election to the Board following his appointment by the directors on 1 January 2009. He has not yet been through the formal Board evaluation process but will do so in the next financial year. The Chairman considers that he continues to be effective and demonstrate commitment to the role. The remaining directors unanimously recommend that he be elected as a director of the Company.

Resolution 7:

Re-appointment of auditors

The Company is required to appoint auditors, at each general meeting before which accounts are laid, to hold office until the end of the next such meeting. KPMG Audit Plc have indicated that they are willing to continue as the Company's auditors for another year. You are asked to re-appoint them and, following normal practice, to authorise the directors to determine their remuneration. The directors recommend their re-appointment.

Resolution 8:

Power to allot shares

The directors are currently authorised to allot relevant securities of the Company, but their authorisation ends on the date of the annual general meeting. This resolution seeks to renew the directors' authority to allot shares. The Association of British Insurers (ABI) published guidance on 31 December 2008 to the effect that ABI Members will regard as routine a request for authorisation to allot new shares in an amount of up to one third of the existing issued share capital and additionally that they will regard as routine requests to authorise the allotment of a further one third, provided that such additional headroom shall be applied to fully pre-emptive rights issues only and the authorisation shall be valid for one year only. The directors recommend that the Company should have this additional headroom and this authority is therefore limited to the amounts set out in the resolution, being approximately 33.33% in each of parts (a) and (b) of the resolution and approximately 66.66% in aggregate of the total ordinary share capital in issue as at 30 March 2009, being the latest practicable date prior to the publication of this document. As at 30 March 2009, the Company held 3,096,194 treasury shares, being approximately 3.05% of the total ordinary share capital in issue (calculated exclusive of treasury shares). The renewed authority will remain in force until the date of the next annual general meeting in 2010.

The directors have no present intention of exercising this authority. The purpose of giving the directors this authority is to maintain the Company's flexibility to take advantage of any appropriate opportunities that may arise. The directors also understand that ABI Members will expect that all members of the Board wishing to remain in office will stand for re-election at the next Annual General Meeting of the Company following the decision to make the issue in question.

Resolution 9:

Disapplication of pre-emption rights

This resolution, which will be proposed as a special resolution, seeks to renew the authority conferred on the directors at last year's annual general meeting to issue equity securities of the Company for cash without first offering them to existing shareholders in proportion to their existing shareholdings. Other than in connection with a rights or other similar issue or scrip dividend (where difficulties arise in offering shares to certain overseas shareholders and in relation to fractional entitlements) the authority contained in this resolution will be limited to an aggregate nominal value of £261,471 which represents 5% of the Company's issued ordinary share capital as at 30 March 2009 (being the latest practicable date prior to the publication of this Notice). The renewed authority will remain in force until the date of the annual general meeting in 2010 or 15 months after the passing of the resolution, whichever is the earlier. It is a standard resolution for most UK listed companies each year.

In accordance with the Statement of Principles on disapplying pre-emption rights issued in 2006 by the Pre-Emption Group (which is supported by the Association of British Insurers, the National Association of Pension Funds Limited and the Investment Managers Association), the board confirms its intention that no more than 7.5% of the issued share capital will be issued for cash on a non pre-emptive basis during any rolling three year period. The directors have no present intention of exercising this authority.

Resolution 10:

Authority to purchase own shares

This resolution, which will be proposed as a special resolution, is to renew the authority granted to the directors at last year's annual general meeting, which expires on the date of the forthcoming annual general meeting, and to give the Company authority to buy back its own ordinary shares in the market as permitted by the Companies Act 2006. The authority limits the number of shares that could be purchased to a maximum of 10,149,259 (representing 10% of the issued ordinary share capital of the Company as at 30 March 2009 (being the latest practicable date prior to the publication of this Notice)) and sets minimum and maximum prices. This authority will expire no later than 15 months after the date of the annual general meeting.

Your Directors believe that the Company should continue to have the authority to purchase its own shares. The authority will be exercised only if the directors believe that to do so would result in an increase in earnings per share and would promote the success of the Company for the benefit of its shareholders generally. To the extent that any shares so purchased are held in treasury (see below), earnings per share will be enhanced until such time, if any, as such shares are resold or transferred out of treasury.

Any purchases of ordinary shares would be by means of market purchases through the London Stock Exchange.

Notice of Annual General Meeting (continued)

The Treasury Shares Regulations, which came into force on 1 December 2003, permit the Company to purchase and hold as treasury shares, ordinary shares with an aggregate nominal value not exceeding 10% of the nominal value of the issued ordinary shares of the Company at the relevant time. Shares held in treasury in this manner can be cancelled, sold for cash or, in appropriate circumstances, used to meet obligations under employee share schemes. Any shares held in treasury would not be eligible to vote nor would any dividend be paid on any such shares. If any ordinary shares purchased pursuant to this authority are not held by the Company as treasury shares then such shares would be immediately cancelled in which event the number of ordinary shares in issue would be reduced.

The directors believe that it continues to be desirable for the Company to have this choice. Holding the repurchased shares as treasury shares gives the Company the ability to re-issue them quickly and cost effectively and provides the Company with additional flexibility in the management of its capital base. No dividends will be paid on, and no voting rights will be exercised in respect of, treasury shares. In 2008 3,096,194 shares were purchased into treasury and none was cancelled.

This resolution also authorises the Company to transfer any treasury shares held by it for the purposes of its employee share plans. Treasury shares transferred for these purposes will, so long as required under the guidelines of the Association of British Insurers Investment Committee, count towards the limits in those plans on the number of new shares which may be issued.

Resolution 11:

Immediate amendments to the articles of association

This special resolution will approve the making of amendments to the Company's current articles of association (the '**Current Articles**') that take into account changes to the law that are already in force as a result of the Companies Act 2006.

It is proposed to make these changes, which will take effect immediately, by adopting new articles (the '**New Articles**') in place of the existing Articles. This is a simpler and shorter procedure than amending the text of the Current Articles.

The main changes are summarised on pages 131 to 132 of this document. Other changes, which are of a minor, technical or clarifying nature and also some more minor changes which merely reflect changes made by the Companies Act 2006 have not been summarised. The New Articles are available for inspection.

Resolution 12:

Subsequent amendments to the New Articles

It is proposed in resolution 12 to adopt new articles of association (the '**New October Articles**') in order to update the Company's New Articles primarily to take account of the implementation on 1 October 2009 of the last parts of the Companies Act 2006. The resolution adopting the New October Articles will only become effective on 1 October 2009.

The principal changes introduced in the New October Articles are summarised on pages 133 to 134 of this document. Other changes, which are of a minor, technical or clarifying nature and also some more minor changes which merely reflect changes made by the Companies Act 2006 have not been summarised. The New October Articles are available for inspection.

Resolution 13:

Notice of general meetings

This resolution is required to reflect the proposed implementation in August 2009 of the Shareholder Rights Directive. The regulation implementing this Directive will increase the notice period for general meetings of the Company to 21 days. Following the adoption of the New Articles as proposed by resolution 11 above, the Company will be able to call general meetings (other than an AGM) on 14 clear days notice. In order to be able to preserve this ability after August 2009, shareholders must have approved the calling of meetings on 14 days' notice. Resolution 13 seeks such approval. The approval will be effective until the Company's next annual general meeting, when it is intended that a similar resolution will be proposed. The Company will also need to meet the requirements for electronic voting under the Directive before it can call a general meeting on 14 days' notice.

The directors recommend all shareholders to vote in favour of all the resolutions, as the directors intend to do so in respect of their own shares, and consider that they are in the best interests of the Company and the shareholders as a whole.

APPENDIX I

Summary of the principal changes to the Current Articles

This Appendix summarises the principal changes from the Current Articles to the proposed New Articles. All of them reflect changes in the law resulting from the Companies Act 2006 and the repeal of provisions in the Companies Act 1985, save for item 7 which reflects a change in practice around the calling of polls at general meetings.

1. **Age limit for directors** – the restrictions in the Companies Act 1985 on the appointment of a person aged 70 or over as a director have been repealed. The provisions in the Current Articles which disapply such restrictions will therefore be deleted.
2. **Directors' conflicts of interest** – a new article will allow the board to authorise a director coming into or remaining in a situation in which he has or could have an interest that conflicts with the Company's interests. This power of authorisation is permitted under section 175 of the Companies Act 2006. If this power is not given to the board, situations could arise in which a director would be unable to remain on the board through no fault of his own as a result of changes to the law.
3. **Directors' indemnification** – a new article will confirm that the Company may indemnify a director or purchase Directors' and Officers' liability insurance on his behalf or fund his costs in defending himself in litigation or regulatory proceedings that might be brought against him in his capacity as a director, but in each case only to the extent permitted under the Companies Act 2006. Another new provision will permit any director concerned to be included in the quorum and to vote on any board resolution to approve such an arrangement. The law in relation to these matters has changed significantly since the Company adopted the Current Articles. The relevant provisions in the Current Articles are not consistent with the Companies Act 2006 and are less favourable to the Company.
4. **Electronic communications with shareholders** – further amendments will be made to the provisions in the Current Articles concerning electronic communications so as to make them more consistent with the 'company communication provisions' in the Companies Act 2006.
5. **General meetings (except AGMs) held on 14 days' notice** – a new provision will allow the Company to hold a general meeting at which a special resolution is to be proposed on 14 days' notice, as permitted by the Companies Act 2006, rather than on 21 days' notice as required by the Current Articles.
6. **Joint shareholders** – a new provision will confirm that the giving of a document or other information by the Company to a joint shareholder with that shareholder's agreement, and vice versa, will be effective so far as all the joint shareholders are concerned notwithstanding that it was not necessarily agreed to by the other joint shareholder(s). This is to avoid any such action being ineffective and invalid as a result of a technical infringement of the Companies Act 2006.
7. **Polls** – a new provision will allow the chairman of a shareholder meeting, at his discretion, to put a resolution to a vote on a poll without first putting it to a vote on a show of hands. The provision will not prevent a resolution from first being put to a vote on a show hands should the chairman consider it appropriate to do so. The provision is consistent with what has become usual practice among FTSE 100 companies over the last few years.
8. **Proxies** – new provisions will be added relating to proxies. One will confirm the right that proxies now have under the Companies Act 2006 to speak at shareholder meetings. Another will allow the Company to disregard weekends and bank holidays when determining the time by which proxy forms must be lodged prior to a shareholder meeting. This will enable the Company to fix a deadline for lodging a proxy that is up to 48 hours earlier (and sometimes more) than what is permitted under the Current Articles.
9. **Quorum at shareholder meetings** – a provision will be added requiring two different members to be present at a shareholder meeting in person or through a corporate representative or a proxy in order for the meeting to be quorate. This provision will avoid the possibility of a shareholder meeting being quorate if it is attended by a proxy and a corporate representative appointed by the same corporate member, and no one else. This has been a possibility since October 2007 as a result of a change to the law made by the Companies Act 2006.

10. **Requisitions** – provisions in the Current Articles that confer power on shareholders to requisition shareholder meetings or to requisition the circulation of AGM resolutions will be removed. These powers are conferred on shareholders by the Companies Act 2006 and do not need to be replicated in the New Articles.
11. **Shareholder resolutions and meetings** – various amendments will be made to make the provisions in the Current Articles concerning shareholder resolutions and meetings consistent with those in the Companies Act 2006 that came into force in October 2007. One purpose of these changes is to reduce the risk of a conflict between the articles and the Companies Act 2006 jeopardising the validity of any resolution passed at a shareholder meeting.
12. **Statutory references and definitions** – references to sections of the Companies Act 1985 will be replaced by references to the corresponding sections in the Companies Act 2006, where applicable. Various new terms will be defined in the ‘definitions’ section of the articles. Certain terms used in the Companies Act 1985 but not in the Companies Act 2006 will be removed from the articles.

APPENDIX 2

Summary of the principal changes to the New Articles

This Appendix summarises the principal changes from the New Articles to the New October Articles. All of them reflect changes in the law that will become effective upon the remaining parts of the Companies Act 2006 coming into force and the repeal of provisions in the Companies Act 1985, with the exception of item 9 which relates to proposed changes in law resulting from the draft Shareholder Rights Regulations.

1. **Authorised share capital and unissued shares** – The Companies Act 2006 abolishes the requirement for a company to have an authorised share capital and the New October Articles reflect this. Directors will still be limited as to the number of shares they can at any time allot because allotment authority continues to be required under the Companies Act 2006, save in respect of employee share schemes.
2. **Authority to purchase own shares, consolidate and sub-divide shares, and reduce share capital** – under the law currently in force a company requires specific enabling provisions in its articles to purchase its own shares, to consolidate or sub-divide its shares and to reduce its share capital or other undistributable reserves as well as shareholder authority to undertake the relevant action. The New Articles include these enabling provisions. Under the Companies Act 2006 a company will only require shareholder authority to do any of these things and it will no longer be necessary for articles to contain enabling provisions. Accordingly the relevant enabling provisions have been removed in the New October Articles.
3. **Objects clause** – the provisions regulating the operations of the Company are currently set out in the Company's memorandum and articles of association. The Company's memorandum contains, among other things, the objects clause which sets out the scope of the activities the Company is authorised to undertake. This is drafted to give a wide scope.

The Companies Act 2006 significantly reduces the constitutional significance of a company's memorandum. The Companies Act 2006 provides that a memorandum will record only the names of subscribers and the number of shares each subscriber has agreed to take in the company. Under the Companies Act 2006 the objects clause and all other provisions which are currently contained in a company's memorandum, for existing companies at 1 October 2009, will be deemed to be contained in a company's articles of association but the company can remove these provisions by special resolution.

Further the Companies Act 2006 states that unless a company's articles provide otherwise, a company's objects are unrestricted. This abolishes the need for companies to have objects clauses. For this reason the Company is proposing to remove its objects clause together with all other provisions of its memorandum which, by virtue of the Companies Act 2006, are to be treated as forming part of the Company's articles of association as of 1 October 2009. Resolution 12 (a) confirms the removal of these provisions for the Company. As the effect of this resolution will be to remove the statement currently in the Company's memorandum of association regarding limited liability, the New October Articles also contain an express statement regarding the limited liability of the shareholders.

4. **Overseas branch register** – The Companies Act 2006 provides that a company may make by its articles such provision as it thinks fit as to the keeping of overseas branch registers. The New October Articles include such a provision.
5. **Provision for employees on cessation of business** – The Companies Act 2006 provides that the powers of the directors of a company to make provision for a person employed or formerly employed by the company or any of its subsidiaries in connection with the cessation or transfer to any person of the whole or part of the undertaking of the company or that subsidiary, may only be exercised by the directors if they are so authorised by the company's articles or by the company in general meeting. The New October Articles provide that the directors may exercise this power.
6. **Redeemable shares** – at present if a company wishes to issue redeemable shares, it must include in its articles the terms and manner of redemption. The Companies Act 2006 enables directors to determine such matters instead provided they are so authorised by the articles. The New October Articles contain such an authorisation. The Company has no plans to issue redeemable shares.
7. **Seals** – a company currently requires authority in its articles to have an official seal for use abroad. After 1 October 2009 such authority will no longer be required. Accordingly the relevant authorisation has been removed in the New October Articles.

APPENDIX 2 (continued)

8. **Share warrants to bearer** – An article will be inserted allowing the Company to issue ‘share warrants to bearer’ (bearer shares), and to provide for the future payment of dividends on them, as permitted by the Companies Act 2006.
9. **Shareholder Rights Directive** – A number of amendments have been made to ensure that, to the extent possible, the New October Articles do not conflict with the provisions of the draft Shareholder Rights Regulations. The Shareholder Rights Regulations (which are currently under consultation) are intended to implement the Shareholder Rights Directive in August 2009.
10. **Statutory references and definitions** – References to sections of the Companies Act 1985 will be replaced by references to the corresponding sections in the Companies Act 2006.

