



## **Chesnara plc**

Interim Financial Statements  
for the six months ended  
30 June 2007



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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 the transfer.

# Financial Highlights

	Unaudited 6 months ended 30 June		Year ended 31 December 2006
	2007	2006	
<b>IFRS basis</b>			
Operating profit	13.0	11.5	26.5
Financing costs	(0.6)	(0.6)	(1.2)
Loss on sale of subsidiary company	—	(0.3)	(0.3)
<b>Profit before income taxes</b>	<b>£12.4m</b>	<b>£10.6m</b>	<b>£25.0m</b>
Basic earnings per share	9.68p	7.34p	18.41p
Dividend per share	5.25p	5.05p	13.1p
<b>Shareholders' net equity</b>	<b>£116.0m</b>	<b>£108.0m</b>	<b>£114.3m</b>
<b>European Embedded Value basis (EEV)</b>			
Operating profit	6.0	5.9	15.0
Investment variances and economic assumption changes	5.1	0.9	15.6
<b>Profit before tax</b>	<b>£11.1m</b>	<b>£6.8m</b>	<b>£30.6m</b>
<b>Covered Business</b>			
Shareholder net worth	77.1	71.9	84.5
Value of in-force business	105.6	108.7	109.9
Embedded value	182.7	180.6	194.4
Acquired embedded value financed by debt	(12.6)	(16.8)	(16.8)
Shareholders' equity in other Group companies	18.3	11.9	11.5
<b>Shareholders' equity on EEV basis</b>	<b>£188.4m</b>	<b>£175.7m</b>	<b>£189.1m</b>
Life annual premium income (AP)	£52.3m	£58.7m	£113.4m
Life single premium income (SP)	£17.8m	£19.3m	£54.8m
Life annualised premium income (AP + 1/10 SP)	£54.1m	£60.6m	£118.9m

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 period-end, as a component of shareholder equity. Accordingly, the EEV result recognises, within profit, the movement in this component. Investment variances and economic assumption changes for the six months ended 30 June 2006 and for the year ended 31 December 2006 are stated net of a £0.3m loss arising on the sale of a subsidiary company.

I am pleased to present the fourth interim statements of Chesnara plc ("Chesnara").

## Background

Chesnara was listed on the London Stock Exchange in May 2004. Originally formed to become the holding company of Countrywide Assured plc on its demerger from Countrywide plc, in June 2005 it acquired City of Westminster Assurance Company Limited, a further closed life assurance company, the long-term business of which was transferred to Countrywide Assured plc on 30 June 2006.

Countrywide Assured plc now manages a portfolio of some 215,000 life assurance and pension policies and is substantially closed to new business. It writes a small amount of Guaranteed Bond and protection business and accepts top-ups to existing contracts. As a substantially closed book it is expected that the embedded value of the business will decline over time as the number of policies in force reduces and as the 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.

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

## Review of the Business

With the recent lack of value-enhancing acquisition opportunities in the closed life sector in our target value range of £50m to £200m, we have, during the first half of 2007, concentrated on enhancing shareholder value in the existing business. As the business matures such opportunities reduce. However, it is particularly pleasing that in this half year the key business drivers have all demonstrated positive trends.

In particular our recent experience of mortgage endowment misselling complaints has been more positive. The number of complaints has reduced significantly and an increasing proportion of those received are time barred in line with FSA rules. Whilst we do not believe that this issue has fully run its course we do feel able to reduce our redress provisions, whilst maintaining an element of conservatism, by £1.8m, based on our revised expectation of future complaint activity.

Policy lapse experience has also demonstrated better trends than we had anticipated and, whilst we do not plan to reset our baseline assumptions until we have a greater degree of certainty, the experience to the half-year adds £3.3m to our embedded value.

Similarly, mortality experience has also proved positive leading to an addition of £1.5m to the embedded value while favourable economic assumption changes have added a further £1.4m (largely due to hardening long-term interest rates).

Against this we have, as part of our ongoing Treating Customers Fairly project and the ongoing work to migrate our policy bases to our outsourcers' systems, made some changes to our practice and procedures. Whilst, in the main, these have not involved any significant project work or customer compensation we have identified one issue worthy of mention. This relates to our unit pricing system for the CA business which we are migrating to an updated system. Due to a data error in the indexation of costs, estimates of capital gains tax were incorrect. This has led to overdeductions from unit-linked funds for capital gains tax and we have initiated a project to make restitution to the funds and to recompense policyholders. Accordingly, we have established a provision of £2.3m (£1.8m net of tax) in respect of this exposure. Overall, though, the underlying positive performance of the key business drivers has more than compensated for the adverse impact of this one-off charge to IFRS and EEV profits.

On the IFRS basis we have posted a pre-tax profit of £12.4m for the half-year ended 30 June 2007 compared with £10.6m for the corresponding period last year.

On the European Embedded Value ("EEV") basis of reporting, the Group recognises a pre-tax profit of £11.1m for the half-year ended 30 June 2007 compared to a £6.8m profit for the same period in 2006.

Total shareholder equity, as stated on an EEV basis, pre interim dividend appropriation, has increased, despite the reducing policy base, from £175.7m (£1.68p per share) at 30 June 2006 to £188.4m (£1.80p per share) at 30 June 2007.

Countrywide Assured plc's capital solvency ratio at 267% is at a healthy premium to the target set by the Board of 150% having increased from 219% at the corresponding point last year. The Group's solvency ratio

has also strengthened to 267% from 188% as at 30 June 2006, stated after allowing for proposed dividend payments.

The strength of these results allows the Board to recommend an interim dividend of 5.25p (2006: 5.05p), which represents an increase of 4.0% and equates to a total interim dividend of £5.5m.

## Outlook

Experience in the key areas of mortgage endowment complaints and persistency has proved favourable with the added and welcome improvements in mortality. This leads the Board to continue to look to the future with some optimism. We remain aware of the importance of these issues and, in particular, of moves by some complaint handling companies to legally challenge the time bar rules as they relate to mortgage endowment complaints. The key outsourcing providers are achieving excellent levels of service and, importantly for shareholders, certainty of cost. During the first half of 2007 investment performance provided a positive underpin to our results although recent volatility serves to remind us that this cannot be taken for granted.

Value-enhancing acquisition opportunities have been notable by their absence although we continue to pursue possible deals in this space, as we believe it is a matter of when, not if, companies will come to market. In addition we continue to seek other opportunities which could leverage value from our existing capabilities. If there is no clearly superior investment alternative then the possibility of a return of surplus capital to shareholders will receive increasing focus.

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

**Christopher Spborg**

Chairman

4 September 2007

## Background

Chesnara plc ("Chesnara") seeks to participate in the consolidation of the closed life business sector in the UK. In 2004, at the same time that we listed on the London Stock Exchange, we acquired Countrywide Assured plc on its effective demerger from the estate agency business which now forms the core of the operations of Countrywide plc, while in 2005 we acquired City of Westminster Assurance Company Limited from Irish Life and Permanent plc. In 2006 we merged the long-term business of the two companies in order to realise significant financial and operational synergies.

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

## Review of the Business

During the first half of 2007 Chesnara has continued, in the absence of any compelling acquisition opportunities, to concentrate on its policy of delivering enhanced value to shareholders through focusing on the efficient run-off of its Life business. The strong emergence of surplus has contributed, despite the reducing policy base, to a further improvement in profit as reported on the IFRS basis, compared with the corresponding position in 2006, and to a very healthy regulatory solvency position.

Underlying the strength of the surplus emergence is positive performance in the fundamental drivers of the business. Investment markets were strong up to the half-year position (albeit some volatility has been evident latterly), improvement in the rate of policy attrition has continued and mortality experience has been better than expected. Overall, financial exposures – including the provision for mortgage endowment misselling redress costs – have, apart from one exception, provided positive returns while regulatory issues have not given rise to any significant concerns or costs and the expense base has remained under tight control. These key areas are reviewed in more detail in the following sections.

### Investment Funds

Superior performance in the unit-linked funds helps promote policy retention and increases the embedded value of the Group as future management charges will be of a higher magnitude. The CA Managed Fund, which represents a significant proportion of the CA policyholder funds under management, returned 4.47% during the six months ended 30 June 2007 while the CWA Global Managed Fund, which represents a significant proportion of CWA policy funds under management, returned 5.82% over the same period. These returns compare favourably with the average of 4.38% achieved by the ABI Life Balanced Managed Funds sector.

The Company has noted recent equity market volatility as a result of developments in the credit markets. Whilst shareholders do not have any direct exposure to the sub-prime market this recent market volatility will have affected fund values and consequently, the embedded value. Guidance as to the sensitivity of embedded value to market movements is provided on page 27.

The Board continue to have a conservative approach to the investment of shareholder funds, which underpins our strong solvency position. The benchmark of 70% cash and 30% fixed interest has been maintained.

### Policy Attrition

The longer a policy stays in force the greater the profit that accrues to the Group. 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. At the 2006 year-end we reported that the rate of policy attrition had decreased. This improvement has been sustained and further reduction in policy cessation rates has been evident. Should this persist through to the year-end then a positive re-rating of the value of the in-force policies, and consequently of the embedded value, through a restatement of persistency assumptions, is likely to occur.

### Mortality

As would be expected of a life assurance company a significant part of our business comprises policies that offer a payment on death. Should the rate of claim in this regard be less than expected then profits will increase. This will be offset to a degree by annuity business where payments are made on a regular basis until death occurs. In the first half of 2007 we have experienced a lower rate of claim than allowed for, with a consequent positive contribution to the results.

### *Financial Exposures*

The Group pays particular attention to any area where it has potentially significant financial exposure. In life and pensions these typically arise in the areas of onerous policy options and guarantees and of compensation claims for past mis-selling of products. Whilst the Group's portfolios have very little exposure to the impact of investment market performance on options and guarantees, it does have significant exposure to potential mis-selling of policies sold in connection with an endowment mortgage. We are required to make redress to a subset of mortgage endowment policyholders who have been mis-sold their product and to write to policyholders on a biennial basis setting out their potential returns based on specified growth rates. In the past there has been significant media attention and aggressive advertising by claims management firms. This activity has continued to decline in the first half of the year as more potential claims become time-barred from making a successful complaint. A number of the claims management firms, whose business has been significantly affected by the time-bar rules, are raising a challenge to the legality of these rules. However, at the present time, over 70% of our mortgage endowments are time-barred and this is expected to rise to approximately 80% by the end of 2008 with the balance of the population carrying little, if any, potential liability to compensation. We are pleased to report that, during the first half of 2007, the number of complaints we have received, despite a relatively heavy mailing schedule, has reduced significantly and this, combined with the number of complaints that we are rejecting under the time-barring rules, has led us to review the provision we hold for future claims. Whilst maintaining a degree of prudence, we have reduced the provision for future redress costs by £1.8m pre-tax (£1.3m net of tax).

The ongoing work we have been doing on the FSA's Treating Customers Fairly ("TCF") initiative and the migration of our two life assurance books of business to third party outsourcing firms has provided an excellent opportunity for us to undertake a thorough review of our practice and procedures. As might be expected a number of improvements to our processes have been identified. The majority of these have already been rectified with little financial effect and a significant number of the remainder can be resolved as we migrate to our outsourcers' systems.

One issue has, however, been identified in the pricing of our unit-linked funds, whereby, due to a data error in the indexation of the costs of our underlying investment holdings, we have overstated our estimate of capital gains chargeable to tax. As a result, we have made greater deductions from unit-linked funds than would otherwise have been the case. The effect of this has become more significant over the last two years as investment markets have recovered: prior to this, the effect was masked by previously accumulated capital gains tax losses. To rectify the position, we will make restitution to the linked funds and will also compensate policyholders who may have suffered loss. Accordingly, we have established a provision of £2.3m (£1.8m net of tax) as at 30 June 2007.

Together, the net effect of the provision adjustments in respect of the two exposures detailed above has led to a charge of £0.5m to pre-tax profit on both the IFRS and EEV bases (£0.4m net of tax).

### *Regulatory Issues*

The key focus on the regulatory front in the first part of the year was to ensure we met the FSA's target of being 'substantially into the implementation stage' of the TCF project. I am pleased to say that we met that target and have made significant progress since. We note that the FSA has issued two new TCF targets for the industry which relate to the development of Management Information by March 2008 and the ability to demonstrate full TCF compliance by December 2008. We believe we are in good shape to meet these targets.

We have also been the subject of an FSA Arrow Lite review. This was undertaken in early July and, although we have not yet received formal feedback from the FSA, we are not expecting any significant requirements in the Risk Mitigation Programme. We have been informed that we will now be on a three-year cycle for future Arrow assessments. We have also submitted an updated Individual Capital Assessment to the FSA, as is required on an annual basis, and, although we await written confirmation of their review, we expect that our current regulatory capital resources requirement (as set out on Page 9) will continue to be adequate. We believe that these outcomes are a strong testament to our regulatory compliance ethos and our strong risk management culture and processes.

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.



### Expense Base

Operational and outsourcer costs are being kept under control and our policy attrition rate is better than expected. The result is that there are more policies in force over which fixed costs can be allocated, leading to cost efficiencies reflected in lower per policy costs.

Key to our strategy of expense base management is the outsourcing of our back office functions to professional outsourcing organisations. This results in predictable levels of per policy cost each year for the term of the relevant contract and removes cost inefficiencies that can occur as a result of a diminishing policy base. As reported at the year-end, we finalised an arrangement with Capita Life and Pension Services Limited (“Capita”) for the outsourcing of the CWA book early in 2007. The resultant migration project, which will transfer the business to their systems, is well under way and has enabled us to develop our plans for the closure, in Q2 2008, of the inherited Luton operation which will, as a result of the outsourcing, reduce headcount by the equivalent of 7 employees. Service levels from both Capita and Liberata Financial Services Limited, who are managing the CA book of business and its transition to their systems, are in line with agreed standards.

### IFRS Result

The following summarises information reflected in the IFRS Income Statement, showing the contribution from the constituent members of the Group:

	CA £000	CWA £000	Parent company £000	Amortisation of AVIF £000	Total £000
<b>Six months ended 30 June 2007</b>					
Operating profit	8,892	5,803	30	(1,751)	12,974
Financing costs	–	–	(579)	–	(579)
<b>Profit before income taxes</b>	<b>8,892</b>	<b>5,803</b>	<b>(549)</b>	<b>(1,751)</b>	<b>12,395</b>
<b>Six months ended 30 June 2006</b>					
Operating profit	7,367	5,714	136	(1,751)	11,466
Financing costs	–	–	(628)	–	(628)
Loss on sale of subsidiary company	(248)	–	–	–	(248)
<b>Profit before income taxes</b>	<b>7,119</b>	<b>5,714</b>	<b>(492)</b>	<b>(1,751)</b>	<b>10,590</b>
<b>Year ended 31 December 2006</b>					
Operating profit	17,184	12,506	313	(3,502)	26,501
Financing costs	–	–	(1,206)	–	(1,206)
Loss on sale of subsidiary company	(248)	–	–	–	(248)
<b>Profit before income taxes</b>	<b>16,936</b>	<b>12,506</b>	<b>(893)</b>	<b>(3,502)</b>	<b>25,047</b>

#### Notes

- (1) Financing costs relate to 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.

Overall, the result for the six months ended 30 June 2007 reflects the continuing strong emergence of surplus in both CA and CWA, as the underlying in-force insurance and investment contracts run off. Strong investment performance over the period, together with favourable policy lapse and mortality experience, particularly in CA, have led to a situation where both principal businesses have posted results in excess of the prior year first half period, notwithstanding that the in-force policy base is smaller. Within CA, this outcome has absorbed the net adverse pre-tax impact of £0.8m in respect of the financial exposures described in the ‘Review of the Business’ above, while the CWA result recognises the release of £0.3m pre-tax in respect of its mortgage endowment mis-selling claims provision.

### EEV Result

Supplementary information prepared in accordance with EEV principles is set out on pages 19 to 29 and is presented to provide alternative information to that provided under IFRS.

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

	6 months ended 30 June		Year ended 31 December 2006
	2007 £000	2006 £000	2006 £000
Operating profit of covered business	6,498	6,386	15,684
Other operational result	(549)	(492)	(699)
Operating profit before tax	5,949	5,894	14,985
Variation from longer term investment return	(571)	487	6,307
Economic assumption changes	5,697	407	9,284
<b>Profit before tax</b>	<b>11,075</b>	<b>6,788</b>	<b>30,576</b>

Profit before tax at £11.1m for the six months ended 30 June 2007 is significantly greater than the underlying return of £5.2m expected to arise from the unwind of the risk discount rate within the embedded value. The principal factors which have contributed to the net excess are:

- (i) Favourable policy lapse experience of £3.3m;
- (ii) Favourable mortality experience of £1.5m; and
- (iii) Net favourable assumption changes of £1.4m following largely from an increase of some 0.8% in risk-free rates over the period as longer-term interest rates have hardened, together with the consequential impact on projected investment returns;

offset by:

- (iv) The net adverse impact of £0.5m in respect of the financial exposures described in the 'Review of the Business' above.

Although the life businesses are substantially closed to new business, there was a net new business contribution of £0.6m to the operating profit of the covered business.

The prospective reduction in the rate of Corporation Tax from 30% to 28% has given rise to a reduction in the deferred tax liability for future profits of £2.1m with a consequential reduction in the reported tax charge for the period.

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

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

	30 June		31 December 2006
	2007 £000	2006 £000	2006 £000
Value of in-force business	105,607	108,703	109,941
Other net assets	82,807	67,046	79,167
	<b>188,414</b>	<b>175,749</b>	<b>189,108</b>
Represented by:			
Embedded value ("EV") of covered business	182,669	180,589	194,401
Less: amount financed by borrowings	(12,600)	(16,800)	(16,800)
EV of covered business attributable to shareholders	170,069	163,789	177,601
Net equity of other Group companies	18,345	11,960	11,507
<b>Shareholders' equity</b>	<b>188,414</b>	<b>175,749</b>	<b>189,108</b>

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

	30 June		31 December 2006 000
	2007 000	2006 000	
<b>Number of policies</b>			
Endowment	70	80	75
Protection	80	93	86
Annuities	4	4	4
Pensions	52	54	53
Other	9	10	10
<b>Total</b>	<b>215</b>	<b>241</b>	<b>228</b>

	30 June		31 December 2006 £m
	2007 £m	2006 £m	
<b>Value in-force</b>			
Endowment	68.1	72.8	70.3
Protection	70.3	72.3	73.1
Annuities	2.7	3.5	2.8
Pensions	41.9	37.9	41.7
Other	0.3	4.9	0.8
<b>Total at product level</b>	<b>183.3</b>	<b>191.4</b>	<b>188.7</b>
Valuation adjustments			
Holding company expenses	(21.2)	(23.8)	(21.7)
Other	(16.0)	(22.2)	(16.9)
Cost of capital	(3.0)	(3.1)	(3.4)
<b>Value in-force pre-tax</b>	<b>143.1</b>	<b>142.3</b>	<b>146.7</b>
Taxation	(37.5)	(33.6)	(36.8)
<b>Value in-force post-tax</b>	<b>105.6</b>	<b>108.7</b>	<b>109.9</b>

## Solvency and Regulatory Capital

### *Regulatory Capital Resources and Requirements*

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

The following summarises the capital resources and requirements of the Life company for regulatory purposes, before and after making provision for dividend payments from the Life company to Chesnara, which were approved after the respective period ends. There were no such dividends relating to 30 June 2007 or 30 June 2006.

	30 June		31 December 2006 £m
	2007 £m	2006 £m	
<b>Pre-dividend</b>			
Available capital resources ("CR")	77.1	71.9	84.4
Long-term insurance capital requirement ("LTICR")	26.9	30.5	28.8
Resilience capital requirement ("RCR")	2.0	2.4	2.6
Total capital resources requirement ("CRR")	28.9	32.9	31.4
Target capital requirement cover	42.4	48.1	45.8
Excess of CR over target requirement	34.7	23.8	38.6
Ratio of available CR to CRR	267%	219%	269%
<b>Post-dividend</b>			
Available capital resources ("CR")	77.1	71.9	64.4
Long-term insurance capital requirement ("LTICR")	26.9	30.5	28.8
Resilience capital requirement ("RCR")	2.0	2.4	2.6
Total capital resources requirement ("CRR")	28.9	32.9	31.4
Target capital requirement cover	42.4	48.1	45.8
Excess of CR over target requirement	34.7	23.8	18.6
Ratio of available CR to CRR	267%	219%	205%

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

### Insurance Group Directive

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

	30 June		31 December
	2007 £m	2006 £m	2006 £m
<b>Pre-dividend</b>			
Available group capital resources	82.8	67.0	79.2
Group regulatory capital requirement	(28.9)	(32.9)	(31.4)
Excess	53.9	34.1	47.8
Cover	287%	204%	252%
<b>Post-dividend</b>			
Available group capital resources	77.3	61.7	70.8
Group regulatory capital requirements	(28.9)	(32.9)	(31.4)
Excess	48.4	28.8	39.4
Cover	267%	188%	225%

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

### Individual Capital Assessments

As stated above, we have submitted an updated Individual Capital Assessment to the FSA. This was based on risk conditions prevailing at the end of 2006 and, for the first time, covered the CA and CWA businesses on a combined basis. Although we have not yet received written confirmation from the FSA as to the result of their review, we believe that the effective current and medium-term capital requirement constraints on distributions to Chesnara will continue to be made on the basis set out under 'Regulatory Capital Resources and Requirements' above.

### Developments

In the second half of the year Chesnara will continue to search for consolidation or other value-enhancing acquisition opportunities, work with our outsource partners to ensure continuing delivery of acceptable service levels and progress towards the transition of the policy base to their systems. We will also continue our strong progress on the Treating Customers Fairly project and maintain our focus on mortgage endowment and persistency issues.

### Consolidation

We remain convinced that opportunities for consolidation of suitably sized life assurance companies will arise. However, whilst there has been activity at the top end of the market, as measured by Embedded Value, there has been little, if any, opportunity in our £50m to £200m target range.

### Regulatory

With our TCF project on track, our Arrow Lite requirements expected to be manageable and our Individual Capital Assessment indicating that, at present, we have no requirement to hold additional regulatory capital, we will look to ensure that we build on our progress to date and ensure we maintain strong and focussed management of our regulatory and risk programmes.

### Mortgage Endowments and Persistency

Notwithstanding the positive results in both these areas for the first half of the year, we remain aware that they are both primary drivers of current and future profitability. Therefore they will, necessarily, receive ongoing focussed management attention.

## Outlook

The results for the first six months have benefited from the positive effects of a release from the mortgage endowment misselling provision and further improvement in policy attrition rates.

Whilst we have released £1.8m from the mortgage endowment misselling redress provision we still retain an element of conservatism within it. As stated in previous reports the level of this provision could be affected by macroeconomic factors, as could policy attrition rates. We have purposefully not implemented the full financial effects of the improvement in the policy attrition rate as it is too early to assess the mid to longer-term effects of increases in interest rates, which test policyholders' budgets, and of the recent stock market volatility, which affects policyholder sentiment and policy values.

On the acquisition front we will continue to search for opportunities for consolidation in the small to medium sector. In the absence of value-enhancing transactions we will continue to seek other opportunities which could leverage value from our existing capabilities. If no clearly superior investment alternative is identified in the second half of the year the possibility of a return of surplus capital will be considered.

We continue to believe we are well placed to fulfil our stated objective of delivering a reliable and progressive dividend flow.

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

## Dividend

We have signalled that we aim to provide a reliable and progressive dividend payment. With the continuing healthy emergence of surplus from the underlying product base, the improving situation in the key areas of mortgage endowment and persistency and the strong solvency position of the business, the Board are able to recommend an interim dividend of 5.25p, which represents an increase of 4.0% over the 2006 interim payment.

**Graham Kettleborough**

Chief Executive Officer

4 September 2007

# Consolidated Interim Income Statement for the six months ended 30 June 2007

	Note	Unaudited 6 months ended 30 June		Year ended 31 December 2006 £000
		2007 £000	2006 £000	
Insurance premium revenue		52,669	57,267	112,800
Insurance premium ceded to reinsurers		(9,453)	(11,216)	(22,194)
<b>Net insurance premium revenue</b>		<b>43,216</b>	<b>46,051</b>	<b>90,606</b>
Fee and commission income				
Insurance contracts		19,770	22,539	43,519
Investment contracts		4,570	4,161	9,085
Investment income		83,290	38,885	151,470
<b>Total revenue (net of reinsurance payable)</b>		<b>150,846</b>	<b>111,636</b>	<b>294,680</b>
Other operating income		543	504	1,195
<b>Net income</b>		<b>151,389</b>	<b>112,140</b>	<b>295,875</b>
Policyholder claims and benefits incurred	3	(102,809)	(85,566)	(218,541)
Reinsurers' share of claims and benefits incurred		15,837	13,412	32,761
Net policyholder claims and benefits incurred		(86,972)	(72,154)	(185,780)
Change in investment contract liabilities		(40,875)	(14,968)	(58,905)
Reinsurers' share of investment contract liabilities		1,341	579	1,304
Net change in investment contract liabilities		(39,534)	(14,389)	(57,601)
Fees, commission and other acquisition costs		(790)	(1,865)	(2,881)
Administrative expenses		(8,750)	(10,081)	(17,184)
Other operating expenses				
Charge for amortisation of intangible assets		(1,889)	(1,915)	(3,773)
Reinsurance recapture premium		–	–	(1,374)
Other		(480)	(270)	(781)
<b>Total expenses</b>		<b>(138,415)</b>	<b>(100,674)</b>	<b>(269,374)</b>
<b>Operating profit</b>		<b>12,974</b>	<b>11,466</b>	<b>26,501</b>
Financing costs		(579)	(628)	(1,206)
Loss on sale of subsidiary company		–	(248)	(248)
<b>Profit before tax</b>		<b>12,395</b>	<b>10,590</b>	<b>25,047</b>
Income tax expense		(2,275)	(2,913)	(5,791)
<b>Profit for the period</b>	<b>5</b>	<b>10,120</b>	<b>7,677</b>	<b>19,256</b>
Basic earnings per share	4	9.68p	7.34p	18.41 p
Diluted earnings per share	4	9.68p	7.34p	18.41 p

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 Interim Balance Sheet at 30 June 2007

	Note	Unaudited 30 June		31 December 2006 £000
		2007 £000	2006 £000	
<b>Assets</b>				
Intangible assets				
Deferred acquisition costs		10,088	11,508	10,687
Acquired value of in-force business				
Insurance contracts		20,762	23,495	22,144
Investment contracts		13,135	14,152	13,644
Reinsurers' share of insurance contract provisions		211,097	198,835	207,279
Amounts deposited with reinsurers		62,126	61,455	63,721
Investment properties		19,935	26,982	27,750
Financial assets				
Equity securities at fair value through income		850,876	684,551	738,487
Holdings in collective investment schemes at fair value through income		411,083	335,278	342,352
Debt securities at fair value through income		312,775	372,012	350,524
Loans and receivables including insurance receivables	6	49,847	24,679	17,310
Derivative financial instruments		25,610	16,788	30,642
Total financial assets		1,650,191	1,433,308	1,479,315
Reinsurers' share of accrued policyholder claims		5,631	5,072	4,191
Income taxes		153	147	260
Cash and cash equivalents		247,802	282,537	301,218
<b>Total assets</b>		<b>2,240,920</b>	<b>2,057,491</b>	<b>2,130,209</b>
<b>Liabilities</b>				
Insurance contract provisions		1,134,689	1,065,270	1,115,197
Financial liabilities				
Investment contracts at fair value through income		798,671	794,902	812,979
Borrowings	7	12,425	16,496	16,574
Derivative financial instruments		367	371	1,421
Total financial liabilities		811,463	811,769	830,974
Provisions		537	1,237	597
Deferred tax liabilities		12,862	13,327	13,946
Reinsurance payables		2,192	1,935	3,059
Payables related to direct insurance and investment contracts		25,974	25,037	24,927
Deferred income		17,276	19,159	18,231
Income taxes		4,626	2,788	2,023
Other payables	6	115,345	9,011	7,000
<b>Total liabilities</b>		<b>2,124,964</b>	<b>1,949,533</b>	<b>2,015,954</b>
<b>Net assets</b>		<b>115,956</b>	<b>107,958</b>	<b>114,255</b>
<b>Shareholders' equity</b>				
Share capital		41,501	41,501	41,501
Share premium		20,458	20,458	20,458
Other reserves		50	50	50
Retained earnings	5	53,947	45,949	52,246
<b>Total shareholders' equity</b>		<b>115,956</b>	<b>107,958</b>	<b>114,255</b>



# Consolidated Interim Statement of Cash Flows

## for the six months ended 30 June 2007

	Unaudited 6 months ended 30 June		Year ended 31 December
	2007 £000	2006 £000	2006 £000
<b>Profit for the year</b>	<b>10,120</b>	<b>7,677</b>	<b>19,256</b>
Adjustments for:			
Amortisation of deferred acquisition costs	599	1,492	2,312
Amortisation of acquired in-force value	1,891	1,914	3,772
Tax expense	2,275	2,913	5,791
Interest receivable	(12,357)	(13,672)	(26,331)
Dividends receivable	(17,681)	(18,472)	(30,266)
Interest expense	579	628	1,206
Change in fair value of investment properties	(1,682)	(1,560)	(2,328)
Fair value losses/(gains) on financial assets	918	15,275	(54,154)
Loss on sale of subsidiary company	–	248	248
Interest received	9,876	13,534	28,981
Dividends received	19,107	14,175	27,099
Changes in operating assets and liabilities			
(Increase)/decrease in financial assets	(129,760)	3,986	20,039
(Increase)/decrease in reinsurers' share of insurance contract provisions	(5,258)	466	(7,097)
Decrease/(increase) in amounts deposited with reinsurers	1,595	1,242	(1,024)
(Increase)/decrease in other loans and receivables	(31,482)	(434)	2,932
Increase/(decrease) in insurance contract provisions	19,492	(5,871)	44,056
(Decrease)/increase in investment contract liabilities	(14,308)	(8,244)	9,833
(Decrease) in provisions	(60)	(196)	(836)
(Decrease)/increase in reinsurance payables	(867)	(114)	1,010
Increase in payables related to direct insurance and investments contracts	1,047	1,171	1,061
Increase/(decrease) in other payables	106,518	415	(1,650)
<b>Cash (utilised by)/generated from operations</b>	<b>(39,438)</b>	<b>16,573</b>	<b>43,910</b>
Income tax paid	(645)	(3,418)	(6,470)
<b>Net cash (utilised by)/generated from operating activities</b>	<b>(40,083)</b>	<b>13,155</b>	<b>37,440</b>
<b>Cash flows from investing activities</b>			
Disposal of subsidiary, net of cash disposed of	–	(295)	(295)
<b>Net cash utilised by investing activities</b>	<b>–</b>	<b>(295)</b>	<b>(295)</b>
<b>Cash flows from financing activities</b>			
Repayment of borrowings	(4,200)	(4,200)	(4,200)
Dividends paid	(8,419)	(7,986)	(13,268)
Interest paid	(714)	(589)	(911)
<b>Net cash utilised by financing activities</b>	<b>(13,333)</b>	<b>(12,775)</b>	<b>(18,379)</b>
<b>Net (decrease)/increase in cash and cash equivalents</b>	<b>(53,416)</b>	<b>85</b>	<b>18,766</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>301,218</b>	<b>282,452</b>	<b>282,452</b>
<b>Cash and cash equivalents at end of period</b>	<b>247,802</b>	<b>282,537</b>	<b>301,218</b>

# Consolidated Interim Statement of Changes in Equity for the six months ended 30 June 2006

	Unaudited Six months ended 30 June 2007				
	Share capital £000	Share premium £000	Capital redemption reserve £000	Retained earnings £000	Total £000
<b>Equity shareholders' funds at 1 January 2007</b>	<b>41,501</b>	<b>20,458</b>	<b>50</b>	<b>52,246</b>	<b>114,255</b>
Profit for the period representing total recognised income and expenses	—	—	—	10,120	10,120
Dividends paid	—	—	—	(8,419)	(8,419)
<b>Equity shareholders' funds at 30 June 2007</b>	<b>41,501</b>	<b>20,458</b>	<b>50</b>	<b>53,947</b>	<b>115,956</b>

  

	Unaudited Six months ended 30 June 2006				
	Share capital £000	Share premium £000	Capital redemption reserve £000	Retained earnings £000	Total £000
<b>Equity shareholders' funds at 1 January 2006</b>	<b>41,501</b>	<b>20,458</b>	<b>50</b>	<b>46,258</b>	<b>108,267</b>
Profit for the period representing total recognised income and expenses	—	—	—	7,677	7,677
Dividends paid	—	—	—	(7,986)	(7,986)
<b>Equity shareholders' funds at 30 June 2006</b>	<b>41,501</b>	<b>20,458</b>	<b>50</b>	<b>45,949</b>	<b>107,958</b>

  

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

# Notes to the Consolidated Interim Financial Statements (Unaudited)

## 1. Basis of preparation

The financial information presented herein has been prepared in accordance with the accounting policies used for the Chesnara plc Annual Report and Accounts for the year ended 31 December 2006.

The financial information shown in this half year review is unaudited and does not constitute statutory accounts within the meaning of Section 240 of the Companies Act 1985.

The comparative figures for the financial year ended 31 December 2006, are not the company's statutory accounts for that financial year. Those accounts have been reported on by the company's auditors and delivered to the Registrar of Companies. The report of the auditors was (i) unqualified, (ii) did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying their report and (iii) did not contain a statement under Section 237 (2) or (3) of the Companies Act 1985.

## 2. Transfer of long-term business fund

On 30 June 2006, under the provisions of Part VII of the Financial Services and Markets Act 2000, the long-term business of City of Westminster Assurance Ltd ("CWA") was transferred to Countrywide Assured plc ("CA"). As a result, the whole of the FSA regulated activity of the Group effectively subsists within CA with effect from that date.

The transfer gives rise to a number of recognised and prospective benefits within the combined CA entity, including the determination of the capital requirement of the business, savings on operational expenses and the relief of some accumulated tax losses in CA.

## 3. Policyholder claims and benefits incurred

Policyholder claims and benefits incurred for the six months ended 30 June 2006 include an amount of £1,116,882 representing a recovery under a professional indemnity insurance policy of previously recognised misselling complaints administration costs.

## 4. Earnings per share

Earnings per share is based on the following:

	Unaudited 6 months ended 30 June		Year ended 31 December 2006
	2007	2006	
Profit for the period (£000)	10,120	7,677	19,256
Weighted average number of ordinary shares	104,588,785	104,588,785	104,588,785
Basic earnings per share	9.68p	7.34p	18.41 p
Diluted earnings per share	9.68p	7.34p	18.41 p

The weighted average number of ordinary shares in respect of the six months ended 30 June 2007, the six months ended 30 June 2006 and the year ended 31 December 2006 is based on 104,588,785 shares in issue at the beginning and end of all related periods.

There were no share options outstanding during the periods covered by these financial statements. Accordingly, there is no dilution of the average number of ordinary shares in issue in respect of the periods reported.

# Notes to the Consolidated Interim Financial Statements (Unaudited) (continued)

## 5. Retained earnings

	Unaudited 6 months ended 30 June		Year ended 31 December 2006
	2007 £000	2006 £000	2006 £000
<b>Balance at 1 January</b>	<b>52,246</b>	<b>46,258</b>	<b>46,258</b>
Profit for Period	10,120	7,677	19,256
Dividends			
Final approved and paid for 2005	–	(7,986)	(7,986)
Interim approved and paid for 2006	–	–	(5,282)
Final approved and paid for 2006	(8,419)	–	–
<b>Balance at 30 June/31 December</b>	<b>53,947</b>	<b>45,949</b>	<b>52,246</b>

The final dividend in respect of 2005, approved and paid in 2006, was paid at the rate of 7.55p per share.

The interim dividend in respect of 2006, approved and paid in 2006, was paid at the rate of 5.05p per share.

The final dividend in respect of 2006, approved and paid in 2007, was paid at the rate of 8.05p per share, so that the total dividend paid to the equity shareholders of the parent company in respect of the year ended 31 December 2006 was 13.1p per share.

An interim dividend of 5.25p per share in respect of the year ending 31 December 2007, payable on 12 October 2007 to equity shareholders of the parent company registered at the close of business on 14 September 2007, the dividend record date, was approved by the Directors after 30 June 2007. The resulting interim dividend of £5.5m has not been provided in these financial statements.

The following summarises dividend per share information in respect of the year ended 31 December 2006 and the year ending 31 December 2007:

	2007	2006
Interim dividend	5.25p	5.05p
Final dividend		8.05p
<b>Total for the year</b>		<b>13.10p</b>

## 6. Loans and receivables/other payables

Included in loans and receivables and other payables as at 30 June 2007 are amounts of £30,071,000 and £109,745,000 respectively, which result from a change in investment policy whereby the Group repositioned a significant portion of its financial assets portfolio. These amounts were subsequently settled for cash.

## 7. Borrowings

	Unaudited 30 June		31 December 2006
	2007 £000	2006 £000	2006 £000
Bank Loan	12,425	16,496	16,574

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 amounts on the anniversary of the draw-down date. The outstanding principal on the loan bears interest at a rate based on the London Inter-bank Offer Rate and is 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 30 June 2007 was £12,600,000 (30 June 2006 and 31 December 2006: £16,800,000).

## 8. 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.

## 9. Approval of interim report

This interim report was approved by the Board of Directors on 4 September 2007. A copy of the report will be available to the public at the company's registered office, Harbour House, Portway, Preston PR2 2PR, UK and at [www.chesnara.co.uk](http://www.chesnara.co.uk).

## Summarised Consolidated Interim Income Statement for the six months ended 30 June 2007

	Note	Unaudited 6 months ended 30 June		Year ended 31 December 2006 £000
		2007 £000	2006 £000	
<b>Operating profit of covered business</b>	<b>6</b>	<b>6,498</b>	<b>6,386</b>	<b>15,684</b>
Other operational result		(549)	(492)	(699)
<b>Operating profit</b>		<b>5,949</b>	<b>5,894</b>	<b>14,985</b>
Variation from longer-term investment return		(571)	487	6,307
Effect of economic assumption changes		5,697	407	9,284
<b>Profit before tax</b>		<b>11,075</b>	<b>6,788</b>	<b>30,576</b>
Tax		(3,350)	774	(4,373)
<b>Profit for the period</b>		<b>7,725</b>	<b>7,562</b>	<b>26,203</b>
<b>Earnings per share</b>				
Based on profit for the period		7.39p	7.23p	25.05p
<b>Diluted earnings per share</b>				
Based on profit for the period		7.39p	7.23p	25.05p

## Summarised Consolidated Interim Balance Sheet as at 30 June 2007

	Note	Unaudited 30 June		31 December 2006
		2007 £000	2006 £000	£000
<b>Assets</b>				
Value of in force business	5,8	105,607	108,703	109,941
Reinsurers' share of insurance contract provisions		186,853	173,426	183,033
Amounts deposited with reinsurers		61,230	59,738	62,794
Investment properties		19,935	26,982	27,750
Deferred tax assets		122	122	121
Financial assets				
Equity securities at fair value through income		850,876	684,551	738,487
Holdings in collective investment schemes at fair value through income		411,083	335,278	342,352
Debt securities at fair value through income		312,775	372,012	350,524
Loans and receivables including insurance receivables		49,847	24,679	17,310
Derivative financial instruments		25,610	16,788	30,642
Total financial assets		1,650,191	1,433,308	1,479,315
Reinsurers' share of accrued policy claims		5,631	5,072	4,191
Income taxes		153	147	260
Cash and cash equivalents		247,802	282,537	301,218
<b>Total assets</b>		<b>2,277,524</b>	<b>2,090,035</b>	<b>2,168,623</b>
<b>Liabilities</b>				
Insurance contract provisions		1,111,109	1,046,071	1,091,889
Financial liabilities				
Investment contracts at fair value through income		816,535	811,340	832,025
Borrowings		12,425	16,496	16,574
Derivative financial instruments		367	371	1,421
Total financial liabilities		829,327	828,207	850,020
Provisions		537	1,237	597
Reinsurance payables		2,192	1,935	3,059
Payables related to direct insurance and investment contracts		25,974	25,037	24,927
Income taxes		4,626	2,788	2,023
Other payables		115,345	9,011	7,000
<b>Total liabilities</b>		<b>2,089,110</b>	<b>1,914,286</b>	<b>1,979,515</b>
<b>Net assets</b>		<b>188,414</b>	<b>175,749</b>	<b>189,108</b>
<b>Shareholders' equity</b>				
Share capital		41,501	41,501	41,501
Share premium		20,458	20,458	20,458
Other reserves		50	50	50
Retained earnings		126,405	113,740	127,099
<b>Total shareholders' equity</b>	5,8	<b>188,414</b>	<b>175,749</b>	<b>189,108</b>

## Supplementary Information – European Embedded Value basis

(continued)

### Summarised Consolidated Interim Statement of Changes in Equity for the six months ended 30 June 2007

	Unaudited 6 months ended 30 June		Year ended 31 December 2006
	2007 £000	2006 £000	2006 £000
<b>Shareholders' equity at 1 January</b>	<b>189,108</b>	<b>176,173</b>	<b>176,173</b>
Profit for the period representing total recognised income and expense	7,725	7,562	26,203
Dividends paid	(8,419)	(7,986)	(13,268)
<b>Shareholders' equity at 30 June/31 December</b>	<b>188,414</b>	<b>175,749</b>	<b>189,108</b>



# Notes to the Supplementary Information (unaudited)

## 1. Basis of presentation

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 business activities other than those relating to the covered business. In particular, the operating activities of the holding company, Chesnara plc, are treated as an integral part of the covered business. Under EEV principles no distinction is made between insurance and investment contracts, as there is under IFRS, which accords these classes of contracts different accounting treatments.

On 30 June 2006, under the provisions of Part VII of the Financial Services and Markets Act 2000, the long-term business of City of Westminster Assurance Company Limited, the principal operating subsidiary of CWA Life Holdings plc, was transferred to Countrywide Assured plc, the primary operating subsidiary company of the Group. As a result, the whole of the covered business of the Group effectively subsists within Countrywide Assured plc with effect from that date. The transfer gives rise to benefits which have been recognised within the covered business, including determination of the capital requirement of the covered business on a combined basis and reduced costs relating largely to audit and consultancy fees. The impact of these, together with the consequential relief of tax losses in Countrywide Assured plc, which had not hitherto been recognised in the cash flow projections relating to the value of business in force, was recognised in the comparative financial statements as at 30 June 2006 and for the six months then ended.

## 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.

## 3. Methodology (continued)

### **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 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

### 3. Methodology (continued)

diversifiable no adjustment to the risk margin has been made. For any remaining risks that are considered to be non-diversifiable risks there is no risk premium observable in the market and therefore a constant margin of 50 basis points has been added to the risk margin. The RDR is determined by equating the results from the traditional embedded value approach, including the assumed actual investment returns and traditional cost of capital, to that derived using the market-consistent method, this process being known as calibration of the RDR. The risk margin is then the difference between the derived RDR and the risk-free rate. The selection of the assumed actual investment returns and the reported cost of capital will have no impact on the reported result, as changes in these produce corresponding changes in the RDR.

A market-consistent valuation approach also generally requires consideration of 'frictional' costs of holding shareholder capital: in particular, the cost of tax on investment returns and the impact of investment management fees can reduce the face value of shareholder funds. In the Group's case, the expenses relating to corporate governance functions eliminate any taxable investment return in shareholder funds, while investment management fees are not material.

The risk margin established on the basis set out above is normally calculated at each financial year-end. At interim periods, the discount rate normally remains consistent with the investment return assumptions. The margin over investment return assumptions is, however, reassessed if market conditions change significantly.

#### (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 determined at each reporting date. The current practice is detailed below.

Each year the demographic assumptions are reviewed as part of year-end processing and hence were last reviewed in December 2006. For mid-year reporting, the previous year-end assumptions are usually considered in light of recent experience, particularly persistency, to ensure robustness, but are not necessarily expected to change.

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

## 3. Methodology (continued)

and externally published data. Favourable changes in operating experience, particularly in relation to expenses and persistency, are not anticipated until the improvement in experience has been observed. Holding company expenses (for the Chesnara Group such expenses relate largely to listed company functions) are allocated to the covered business as the whole business of the Chesnara Group is the transaction of life assurance business through the subsidiary companies. Hence the expense assumptions used for the cash flow projections include the full cost of servicing this business.

The economic assumptions are reviewed and updated at each reporting date based on underlying investment conditions at the reporting date. The assumed discount rate and inflation rates are consistent with the investment return assumptions.

In addition, the demographic assumptions used at December 2006 are considered to be best estimate and, consequently, no further adjustments are required, except for the persistency assumptions relating to one particular product, where, following recent observed experience, it has been considered prudent to strengthen the assumptions. The assumptions required in the calculation of the value of the annuity rate guarantee on pension business have been set equal to best-estimate assumptions.

## 4. Assumptions

### (a) Investment Returns (pre-tax)

The assumed future pre-tax returns on fixed interest and RPI linked securities are set by reference to redemption yields available in the market at the end of the reporting period. The corresponding return on equities and property is equal to the fixed interest gilt assumptions plus an appropriate risk margin. For linked business the aggregate return has been determined by reference to the benchmark asset mix within the Managed Funds.

	30 June		31 December 2006
	2007	2006	
Equity risk premium	2.7%	2.7%	2.7%
Property risk premium	2.7%	2.7%	2.7%
Investment return			
Fixed Interest	5.3%	4.7%	4.6%
Equities	8.0%	7.4%	7.3%
Property	8.0%	7.4%	7.3%
Inflation			
RPI	3.2%	2.9%	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.

#### 4. Assumptions (continued)

##### (e) Risk Discount Rate

The risk-free rate is set by reference to the sterling bid swap rates available in the market at the end of the reporting period. Where, however, non-linked business is substantially backed by government bonds, the yields on these assets have been used.

An explicit constant margin of 50 basis points is added to the risk-free rate to cover any remaining risks that are considered to be non-market, non-diversifiable risks, as there is no risk premium observable in the market. This margin gives due recognition to the fact that:

- (i) The covered business is substantially closed to new business;
- (ii) There is no significant exposure in the with-profits business, which is wholly reassured;
- (iii) Expense risk is limited as a result of the outsourcing of substantially all policy administration functions to third-party business process administrators; and
- (iv) For much of the Life business the Group has the ability to vary risk charges made to policyholders.

	30 June		31 December 2006
	2007	2006	
Risk-free rate	5.6%	4.8%	4.8%
Non-diversifiable risk	0.5%	0.5%	0.5%
Risk margin	0.7%	0.9%	0.8%
Risk discount rate	6.8%	6.2%	6.1%

#### 5. Analysis of shareholders' equity

	30 June		31 December 2006
	2007 £000	2006 £000	
<b>Covered business</b>			
Required capital	42,314	48,120	45,792
Free surplus	34,748	23,766	38,668
Shareholder net worth	77,062	71,886	84,460
Value of in-force business	105,607	108,703	109,941
<b>Embedded value of covered business</b>	<b>182,669</b>	<b>180,589</b>	<b>194,401</b>
Less: amount financed by borrowings	(12,600)	(16,800)	(16,800)
Embedded value of covered business attributable to shareholders	170,069	163,789	177,601
Net equity of other Group companies	18,345	11,960	11,507
<b>Total shareholders' equity</b>	<b>188,414</b>	<b>175,749</b>	<b>189,108</b>
The movement in the value of in-force business comprises:			
<b>Value at beginning of period</b>	<b>109,941</b>	<b>109,961</b>	<b>109,961</b>
Amount charged to operating profit	(4,334)	(1,258)	(20)
<b>Value at end of period</b>	<b>105,607</b>	<b>108,703</b>	<b>109,941</b>

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, by way of debt finance, a purchase of part of the underlying value in force within that company, which, as stated in Note 2, was subsequently transferred to Countrywide Assured plc 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, a further £4.2m of the loan was repaid on 2 June 2007, leaving principal outstanding at that date of £12.6m.

## 6. Analysis of profit of covered business

	Six months ended 30 June		Year ended 31 December
	2007 £000	2006 £000	2006 £000
New business contribution	615	444	1,599
Return from in-force business			
Expected return	5,217	5,477	10,386
Experience variances	4,092	2,511	7,459
Operating assumption changes	(4,242)	(3,060)	(5,072)
Return on shareholder net worth	816	1,014	1,312
<b>Operating profit</b>	<b>6,498</b>	<b>6,386</b>	<b>15,684</b>
Variation from longer-term investment return	(571)	487	6,307
Effect of economic assumption changes	5,697	407	9,284
<b>Profit before tax</b>	<b>11,624</b>	<b>7,280</b>	<b>31,275</b>
Tax	(3,350)	774	(4,496)
<b>Profit after tax</b>	<b>8,274</b>	<b>8,054</b>	<b>26,779</b>

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”. The variation from longer-term investment return for the six months ended 30 June 2006 and for the year ended 31 December 2006 is stated net of a loss of £248,000 arising on the sale of a subsidiary company.

## 7. Sensitivities to alternative assumptions

The following table shows the sensitivity of the embedded value of the covered business as reported at 30 June 2007 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 six months ended 30 June 2007 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.

<b>Embedded Value (“EV”) of covered business as at 30 June 2007</b>	<b>£182.7m</b>
	<b>Change in EV (£m)</b>
<b>Economic sensitivities</b>	
100 basis point increase in risk discount rate	(5.1)
100 basis point reduction in yield curve	(3.3)
10% decrease in equity and property values	(2.8)
<b>Operating sensitivities</b>	
10% decrease in maintenance expenses	2.4
10% decrease in lapse rates	3.3
5% decrease in mortality/morbidity rates	
Assurances	2.0
Annuities	(0.5)
Reduction in the required capital to statutory minimum	0.8

The key assumption changes represented by each of these sensitivities are as follows:

### Economic sensitivities

- 100 basis point increase in the risk discount rate. The 6.8% RDR increases to 7.8%;
- 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

## 7. Sensitivities to alternative assumptions (continued)

- (iii) 10% decrease in the equity and property values. This gives rise to a situation where, for example, a Managed Fund unit liability with a 60% equity holding would reduce by 6% in value.

### Operating sensitivities

- (i) 10% decrease in maintenance expenses, giving rise to, for example, a base assumption of £20 per policy pa reducing to £18 per policy pa;
- (ii) 10% decrease in persistency rates giving rise to, for example, a base assumption of 10% of policy base lapsing pa reducing to 9% pa;
- (iii) 5% decrease in mortality/morbidity rates giving rise to, for example, a base assumption of 100% of the parameters in a selected mortality/morbidity table reducing to 95% of the parameters in the same table; and
- (iv) The sensitivity to the reduction in the required capital to the statutory minimum shows the effect of reducing the required capital from 150% of the LTICR plus 100% RCR to the amounts of 100% LTICR plus 100% RCR, being the minimum requirement prescribed by FSA regulation.

In each sensitivity calculation all other assumptions remain unchanged except where they are directly affected by the revised economic conditions: for example, as stated, changes in interest rates will directly affect the risk discount rate.

The sensitivities to changes in the assumptions in the opposite direction will result in changes of similar magnitude to those shown in the above table but in the opposite direction.

## 8. Reconciliation of shareholders' equity on the IFRS basis to shareholder equity on the EEV basis

	30 June		31 December 2006 £000
	2007 £000	2006 £000	
<b>Shareholders' equity on the IFRS basis</b>	<b>115,956</b>	<b>107,958</b>	<b>114,255</b>
Adjustments			
Deferred acquisition costs			
Insurance contracts	–	(234)	–
Investment contracts	(9,488)	(10,647)	(10,074)
Deferred income	16,309	18,141	17,239
Adjustment to provisions on investment contracts, net of amounts deposited with reinsurers	(18,393)	(17,915)	(19,596)
Adjustments to provisions on insurance contracts, net of reinsurers' share	(664)	(59)	(936)
Acquired in-force value	(24,544)	(27,292)	(25,933)
Deferred tax	3,631	3,094	4,212
Reinsurer default reserve	–	(6,000)	–
<b>Group shareholder net worth</b>	<b>82,807</b>	<b>67,046</b>	<b>79,167</b>
Value of in-force business	105,607	108,703	109,941
<b>Shareholders' equity on the EEV basis</b>	<b>188,414</b>	<b>175,749</b>	<b>189,108</b>
Group shareholder net worth comprises:			
Shareholder net worth in covered business	77,062	71,886	84,460
Shareholder's equity in other Group companies	18,345	11,960	11,507
Debt finance	(12,600)	(16,800)	(16,800)
<b>Total</b>	<b>82,807</b>	<b>67,046</b>	<b>79,167</b>



### 8. Reconciliation of shareholders' equity on the IFRS basis to shareholder equity on the EEV basis (continued)

The reinsurer default reserve adjustment as at 30 June 2006 relates to a reserve which was established for FSA prudential reporting and which was recognised for reporting on the EEV basis, but not for reporting on the IFRS basis. The reserve was not recognised for reporting in accordance with IFRS as the events to which they related were, in the opinion of the Directors, considered to be remote or uncertain. However, the reserve was charged to the shareholder net worth component of the embedded value of the covered business, as this was held to be consistent with the market-consistent valuation approach adopted in accordance with EEV principles. The reserve was maintained against the effect of possible default by a major reinsurer, Guardian Assurance plc, which is a subsidiary of Aegon NV. As a result of mitigating action that was taken during 2006, the reserve was no longer required at 31 December 2006.



# Independent Review Report by KPMG Audit Plc to Chesnara plc

## Introduction

We have been instructed by the Company to review the financial information for the six months ended 30 June 2007, which comprises the Consolidated income statement, the Consolidated balance sheet, the Consolidated statement of changes in equity, the Consolidated statement of cash flows and the related notes (the “Financial Information”) and to review the EEV basis supplementary information for the six months ended 30 June 2007, which comprises the Summarised consolidated income statement, the Summarised consolidated balance sheet, the Summarised consolidated statement of changes in equity and the related notes (the “Supplementary Information”).

The Supplementary Information has been prepared in accordance with the European Embedded Value Principles issued in May 2004 by the European 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 in notes 3 and 4 to the Supplementary Information.

We have read the other information contained in the interim report and considered whether it contains any apparent misstatements or material inconsistencies with either the Financial Information or the Supplementary Information.

This report is made solely to the Company in accordance with the terms of our engagement to assist the Company in meeting the requirements of the Listing Rules of the Financial Services Authority and also to provide a review conclusion to the Company on the Supplementary Information. Our reviews have been undertaken so that we might state to the Company those matters we are required to state to it 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 review work, for this report, or for the conclusions we have reached.

## Directors’ responsibilities

The interim report, including the Financial Information and the Supplementary Information contained therein, is the responsibility of, and has been approved by, the Directors. The Directors are responsible for preparing the Financial Information in accordance with the Listing Rules of the Financial Services Authority which require that the accounting policies and presentation applied to the interim figures should be consistent with those applied in preparing the preceding annual financial statements except where any changes, and the reasons for them, are disclosed. The directors have accepted responsibility for preparing the Supplementary Information in accordance with the EEV Principles and for determining the assumptions used in the application of those principles.

## Review work performed

We conducted our review of the Financial Information in accordance with guidance contained in Bulletin 1999/4 issued by the Auditing Practices Board for use in the UK. We conducted our review of the Supplementary Information having regard to that Bulletin. A review consists principally of making enquiries of group management and applying analytical procedures to the Financial Information, the Supplementary Information and underlying financial data and, based thereon, assessing whether the accounting policies and presentation have been consistently applied unless otherwise disclosed. A review excludes audit procedures such as tests of controls and verification of assets, liabilities and transactions. It is substantially less in scope than an audit performed in accordance with International Standards on Auditing (UK & Ireland) and therefore provides a lower level of assurance than an audit. Accordingly we do not express an audit opinion on the Financial Information or the Supplementary Information.

## Review conclusions

On the basis of our reviews we are not aware of any material modifications that should be made either to the Financial Information or to the EEV basis Supplementary Information as presented for the six months ended 30 June 2007.

**KPMG Audit Plc**  
Chartered Accountants  
St James Square  
Manchester M2 6DS

4 September 2007





