

Company Number 2339826

Royal & Sun Alliance Insurance Group Plc
Annual Report & Accounts 2005

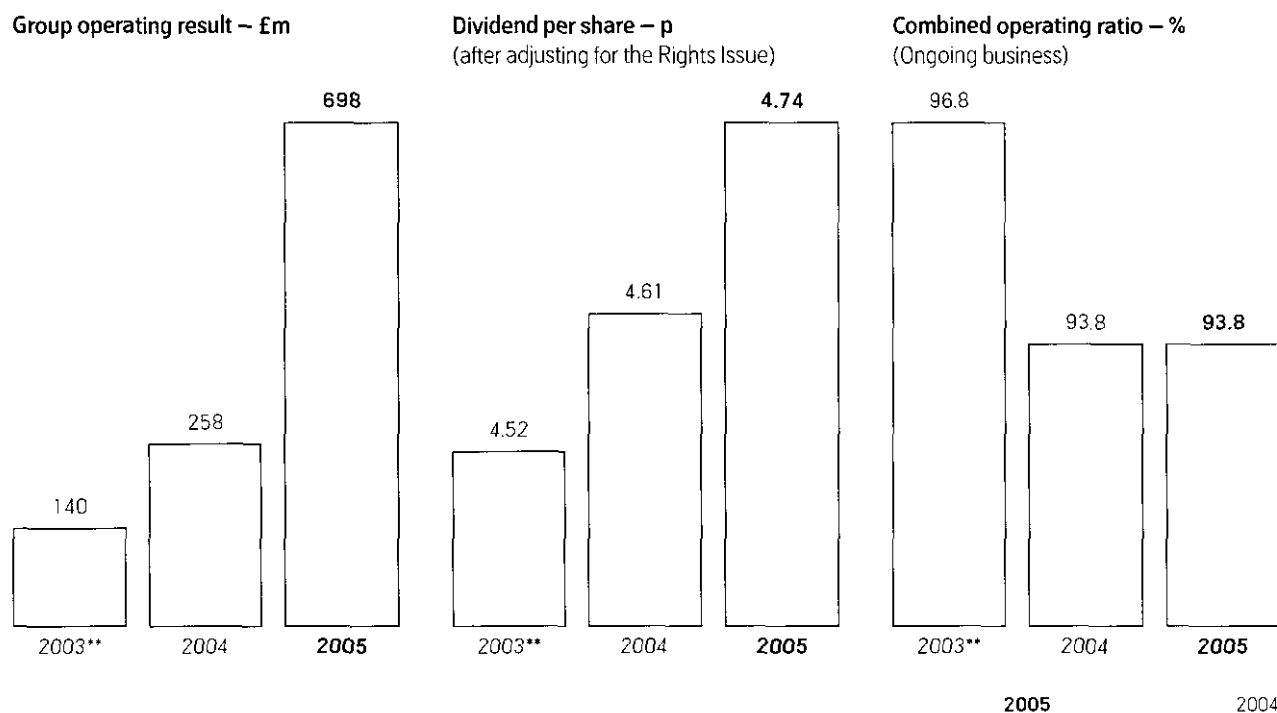


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It has been a productive year. The Core Group performed strongly and we have made continued progress in derisking the US. We are delivering against our strategic objectives and with our focus on operational excellence, execution and the strength of our operations we expect to continue to deliver sustainable profitable performance.

Highlights



Revenue		
Net written premiums ¹	£5,400m	£5,082m
Results*		
Operating result ²	£698m	£258m
Profit before tax ³	£865m	£38m
Profit/(loss) after tax	£605m	(£80m)
Balance sheet at 31 December		
Total capital ⁴	£4,205m	£3,740m
Shareholders' funds ⁵	£2,743m	£2,321m
Net asset value per share (pre IAS 19) ⁶	103p	95p
Net asset value per share (post IAS 19) ⁷	90p	76p
Dividend		
Total dividend for the year per ordinary share	4.74p	4.61p
Combined operating ratio (COR)⁸		
Ongoing business	93.8%	93.8%
Core Group	94.1%	96.1%

*For an explanation of 'results', please see the Financial review on pages 26–31.

**2003 results on a UK GAAP basis, 2004 and 2005 on an IFRS basis.

Guide to terms

1. Net written premiums

The amounts receivable from policyholders, less the amounts payable to our own reinsurers, in respect of policies that have commenced in the year.

2. Operating result

The Group's underwriting result plus investment return and other activities.

3. Profit before tax

Profit before tax is shown on a management basis. Profit before tax on a statutory basis is shown on page 54.

4. Total capital

The assets invested in the business by (1) shareholders, (2) minority shareholders in part owned subsidiaries and (3) subscribers to loan capital issued.

5. Shareholders' funds

The assets invested in the business by shareholders of ordinary and preference shares.

6. Net asset value per share (pre IAS 19)

Net assets attributable to holders of ordinary shares; stated as the assets before the pension fund deficit per ordinary share in issue.

7. Net asset value per share (post IAS 19)

Net assets attributable to holders of ordinary shares; stated as the assets after the pension fund deficit per ordinary share in issue.

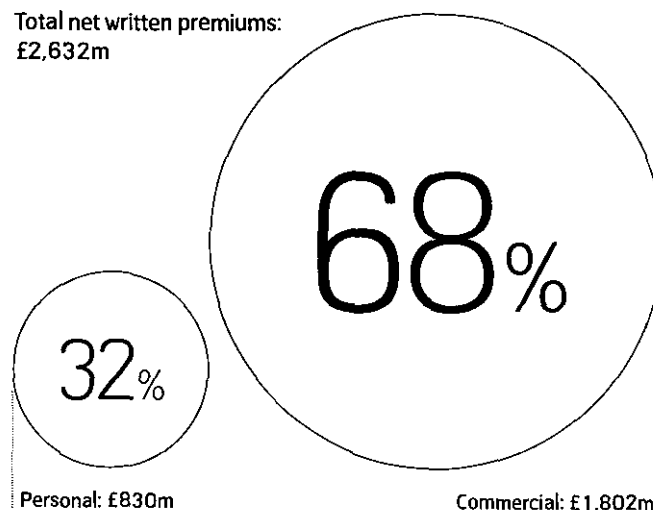
8. Combined operating ratio (COR)

The ratio of premiums to claim costs and expenses (including commission).

Key business information – Core Group

UK

Total net written premiums:
£2,632m



Key areas of business

US

In addition to the Core Group we have a discontinued operation in the US. For details on this operation refer to pages 24-25.

The UK Commercial business primarily writes property, motor, liability and marine insurance. Property is the largest insurance line, accounting for around 40% of Commercial net written premiums. The business has a strong reputation, insures 40% of FTSE 100 companies and is one of the leading carriers of Professional & Financial and Marine risks outside of Lloyd's of London. UK Personal primarily provides household, motor and travel insurance through our intermediated channels and MORE TH>N® our direct business. Our UK Personal business has 3.5 million covers in place and is ranked third largest in the UK.

Key strategies

We are committed to continuous operational improvement and through our change programmes are focused on; risk selection, underwriting and claims discipline and expense management. We are further enhancing our motor and household pricing sophistication and targeting expense reductions in MORE TH>N®. We are focused on building our distribution capabilities. In Personal this year, we have signed 12 new broker and brand panels and 10 affinity deals. In Commercial we launched a web based proposition, MORE TH>N® Business, aimed at the attractive small and medium enterprise market.

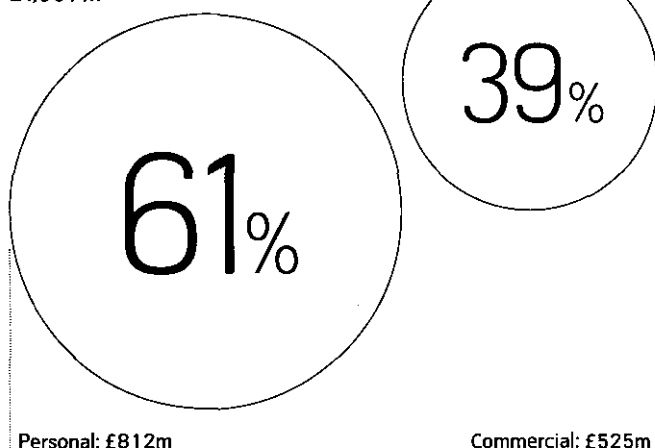
Highlights 2005

We delivered a COR of 93.1% which was 3.2 points better than last year and a 62% increase in the underwriting result. Commercial delivered a COR of 91.9% an improvement of 4.1 points on 2004. In Personal the business achieved a 1.7 point improvement in its COR of 95.6%.

We are seeing the benefits of our claims transformation programme in the results. We have developed a market leading claims supply chain which has been recognised through contracts with Lloyds TSB and Co-operative Insurance Society to use our supply chain infrastructure.

International

Total net written premiums:
£1,337m



We operate in 21 countries. The business comprises a balanced portfolio of operations in the mature markets of Canada, Ireland and Italy and selected emerging markets in Latin America, Asia and the Middle East. Canada accounts for around 40% of the International business. In Canada we are ranked number one in marine. In Latin America our largest operations are Argentina, Brazil and Chile where we are market leader. In Ireland we are ranked fourth overall. We have strong partners in India and China and consider these markets as longer term opportunities.

We are focused on building our position within countries, market segments and target trades where we have a competitive advantage. Our approach is to maintain pricing discipline and target profitable growth through continuously raising standards in underwriting, claims and customer management. We will balance organic growth with bolt on acquisitions in our current markets. We are focused on sustainable cost reduction and in 2005 there were major change programmes in Canada and Ireland. Our focus on development opportunities is balanced against our disciplined approach towards risk selection and pricing.

The COR improved by 1.9 points to 94.7% and the underwriting result increased by 40%. This reflects our focus on risk selection and underwriting discipline despite absorbing significant weather events. Johnson Corporation, our Canadian Personal direct business, continued to deliver double digit growth and acquired Morgex doubling our size in Alberta. Our Latin American operation demonstrated strong growth. In Brazil we consolidated our strong market position in marine and in Chile we acquired the leading general insurer Cruz del Sur.

Scandinavia

Total net written premiums:
£1,324m



We are the third largest general insurer in the Nordic region comprising Denmark, Sweden, Norway, Latvia and Lithuania. In both Denmark and Sweden our businesses are ranked third largest, operating under the Codan brand in Denmark and the Trygg-Hansa brand in Sweden. Our businesses in Latvia and Lithuania have gained market share consolidating our number one position.

We provide a range of personal insurance including: motor, household and personal accident and travel. In Commercial we write property, marine and liability insurance. We are ranked number one in Danish marine.

We target markets where we hold strong positions and are committed to continuously improving claims handling and underwriting capabilities and enhancing our product offering. We have a pan Nordic proposition but recognise each country is different and customer propositions, pricing and brands are adapted for each market. We operate a multi brand strategy in our primary markets, Denmark and Sweden. In 2005 we enhanced our customer value propositions for both Commercial and Personal lines.

We achieved a 20% increase in underwriting result and improved the COR by 1.2 points to 94.4%. Net written premiums were up 8% on 2004.

We are focused on building distribution capabilities and in the year signed an agreement with Swedbank, the largest nationwide bank in Sweden. In Denmark we have 68 bancassurance relationships giving us access to two thirds of the attractive local bank market and we consolidated our number one marine position through the acquisition of TopDanmark's marine portfolio.

Chairman's statement

In 2003 we set out on a journey to run a general insurance business that delivers sustainable profitable performance.

I am pleased to report continued excellent progress in the delivery of our detailed plans to improve the performance of your Company on a continuing and sustainable basis. Improvements include:

- A significant increase in year to year Group operating profit at £698m, including net written premium growth of 6%,
- Benefits in costs and efficiencies with a combined operating ratio for the Core Group of 94.1% compared to prior year 96.1%,
- Further strengthening of our capital position due to internal initiatives and improved results,
- Continuing progress in derisking our US business and reducing our exposures.

These results were achieved in a year of unprecedented natural disasters. Although the financial cost for the insurance industry have been substantial, it is such years that remind us of the social and economic benefits that insurance brings to society. Responding rapidly is, however, as important as meeting insured losses. Our customers need to get their businesses and homes back to normal as quickly as possible. In the UK, our loss adjusters and claims handlers were the first on the scene after the Carlisle floods; in Canada we acted immediately to provide emergency living expenses after storms swept Alberta; and after the January storms in Scandinavia we worked around the clock to handle over 22,000 calls. In what has been clearly a challenging year for the industry, our results confirm that we continue to make good progress. Over the last two years we have created a strong business foundation that enables us to deliver a sustainable and profitable future. We remain focused on driving performance forward in all areas.

Although the delivery of our investment in the operational improvement programme remains important, the key to our success remains the improved standards of management performance in all functions. We continue to invest in the formal

training and development of our people, linked to detailed objective setting and rigorous performance assessment. Where necessary to meet resource gaps or accelerate the achievement of required performance standards, we make use of active external recruitment. It is against the above philosophies of detailed objective setting and measured management performance that we have developed a new long term incentive plan for approval at the Annual General Meeting. It is strongly performance and results orientated and supports the key outcomes that are beneficial to all shareholders.

We have resolved the majority of our substantive strategic issues with the exception of the US. Here, our approach has been to stabilise the business and work through the portfolio to reduce our exposures, whilst simultaneously exploring opportunities to achieve an acceptable exit. This outcome requires us to resolve a number of highly complex issues on which we are making good headway, in an area which will remain difficult to predict.

We continue to strengthen our capital position in order to facilitate growth and meet any changing regulatory requirements. Improved profit performance is of course helpful as are the actions we have taken to restructure the nature of assets and liabilities to optimise our capital position. The sale of our Rothschilds holding helped to diversify our equity exposures, whilst important initiatives in the area of pension liabilities help address that specific issue and have further strengthened the balance sheet.

In the UK the scale and finance of future pension liabilities is a national issue and related to the whole economy and wider society. Independent of progress at national level, it is essential to work on industry and company solutions. After a long period of consultation with staff and unions we obtained an agreement, supported by an overwhelming majority of staff, on a revised arrangement which reduced the current deficit via accelerated payments by the Company, and reduced the scale of future liabilities by agreement to modify the scope of future benefits. We believe that this is an innovative and market leading

John Napier Chairman

initiative. As a consequence our pension deficit has been reduced by £266m gross of tax, £86m from accelerated funding and £180m from agreed changes in future benefits.

An important part of our approach continues to be to develop an open and constructive relationship with all regulatory agencies. This is particularly important given the pace of change and complexity of the legislative and regulatory environment both at a UK and European level. Where country of registration, regulatory interpretation and regulatory liability are intertwined, there is scope for significant competitive and commercial disadvantage unless there is an active and adequate company and industry dialogue with regulators.

More specifically, the industry is dealing with a number of issues, including a new solvency regime, the FSA's Treating Customers Fairly initiative and the broader issues of financial exclusion. In all these areas we continue to take an active role. On European regulation and issues, our input is more directly to Government, whilst on Treating Customers Fairly we have clear principles under which we conduct our business. On matters of financial exclusion we are a leading provider of insurance for social housing schemes helping many families who would otherwise find it difficult to find acceptable terms of protection. We continue to lobby for greater priority on this issue within the broader financial exclusion agenda.

Following an active period of restructuring and reshaping your Board, we have made a further appointment of an additional executive director, namely Bridget McIntyre, who is responsible for our UK business. The Board has settled well and works effectively as a compact unit. It is extremely active with the non-executive directors averaging 23 meetings per year, including formal Boards and key committees. In addition, the Board meets as required on single issue meetings to facilitate effective decision making on complex issues. Further details of the approach of the Board are given in the Corporate Governance section of the Report & Accounts.

At the beginning of 2005 the Chief Executive and his team set the following priority areas:

- To stabilise and restructure the US,
- Target profitable growth,
- Sustain strong results,
- Deliver our operational improvement programme,
- To embed our management performance culture.

The progress the management team has made on the Group's issues sees us in a much stronger position at the end of 2005. We continue to concentrate on making R&SA, one of the world's oldest insurance companies, an industry leader in each of our chosen markets. This emphasis brings new and exciting challenges and we proceed from a strong foundation and we are confident of our prospects to deliver sustainable profitable performance.

Against this background, the directors have recommended a final dividend of 3.05p per share, which if approved will be due for payment on 2 June 2006 to holders of ordinary shares on the Register at close of business on 17 March 2006. This payment, together with an interim dividend of 1.69p per share, will make a total dividend for the year of 4.74p per share, an increase of 2.8% on prior year. This is consistent with our dividend policy of maintaining the dividend in real terms.

Finally, I would like to thank all staff for their efforts and responses to date. In particular I would like to note the contribution and support of the Board and the all round performance of the Executive Team ably lead by Andy Haste.

Group CEO's review

We have maintained our track record of consistently delivering on our objectives.

Group

£m	2005	2004
General business		
Net written premiums	5,400	5,082
Underwriting result	118	(277)
Operating result	698	258
Combined operating ratio (COR)	94.1%	96.1%
Core Group underlying return on equity	21.6%	17.7%

2005 was a very good year for the Group. The impact of three years of management actions and the continued delivery against our strategic objectives has resulted in a greatly improved financial performance. This improvement has been achieved against the backdrop of a high number of natural disasters – and is a clear demonstration of the strength of the business and its capability of delivering continued sustainable earnings in 2006 and beyond.

2005 saw an extreme range of weather events with floods in the UK and India, hurricanes Emily, Katrina and Wilma, and storms in Scandinavia and Canada. While the human impact has been tragic, the financial effect on the Group was relatively limited, largely due to the actions we've taken to reduce our exposure in high risk areas and improve our underwriting selection.

We delivered a strong improvement in financial performance with a £440m increase in the operating result to £698m. The Core operating regions of the UK, International and Scandinavia again achieved sub 100 combined operating ratios (CORs) and all improved on last year. These achievements are a direct result of the actions we have taken to restructure the business and to focus on excellence in underwriting, claims and expense management.

Our profit after tax was £605m, up from a loss of £80m in 2004. This includes the net benefit of £285m from the changes we've

made to the UK pension schemes as discussed in the Chairman's statement, as well as the disposal of non core assets.

Strong Core Group

Before discussing our performance you will notice that there are some differences in the way we present our 2005 results. This is due to the change from UK GAAP (Generally Accepted Accounting Principles) to IFRS (International Financial Reporting Standards). The impact of these changes is discussed in depth in the Financial Review. You will also note changes to how we classify our operations. We have previously reported on the 'Total Group' result and that of our 'Ongoing Business'. Going forward these distinctions are no longer relevant as our successful sale of Nonstandard Auto has closed our US operation to its last remaining ongoing business. In future we will report the Core Group (UK, International and Scandinavia) alongside the result for our discontinued US business.

Our 2005 results show the strength of the Core Group. We have a good balance of premiums by geography and business line and exposure to both mature and emerging markets. Approximately 50% of our premiums are from the UK, with 25% each from International and Scandinavia. In the UK, we're the second largest commercial insurer and third largest personal motor and household insurer. In Scandinavia, we're the third largest insurer in both Denmark and Sweden, and we have leading positions in the fast growing Baltic economies of Latvia and Lithuania.

Within International we have a strong balance across developed and emerging markets. In our developed markets we have good businesses in Canada and Italy and we're a leading household insurer in Ireland. We are also building our presence in the emerging regions of the Middle East and Latin America and in the long term markets of India and China.

Delivery against strategic objectives

At the beginning of 2005, I set out five key priorities: to stabilise and restructure the US; target profitable growth; sustain strong

Andy Haste Group CEO

results; deliver our operational improvement programme; and embed a performance culture. We have delivered against each of these.

Stabilisation and restructure of the US

Our objective in the US is to bring certainty and finality to our exposure. We have been consistent with our strategy to achieve this – we continue to reduce exposure, while at the same time, actively exploring alternative solutions to accelerate coming off risk.

In 2005 we improved the insurance loss from £372m to a loss of £29m. We have reduced open claims by 37%, claims reserves by \$1.2bn to \$3.4bn and collected over \$1.3bn of reinsurance debtors. We cut expenses by 28% and headcount is down from 6,000 in 2003 to 860.

The sale of Nonstandard Auto provided additional capital support to the discontinued operation. We also made significant progress in simplifying our business from a regulatory standpoint by reducing our regulatory structure to two domiciliary states and four insurance entities, from 11 states and 25 entities in 2004.

Since the year end we have announced the appointment of Edward Muhl to the US Board. He has served in a number of senior regulatory roles including President of the NAIC (National Association of Insurance Commissioners). His extensive experience will be a strong asset as we continue with the restructuring.

While risks and uncertainties remain in the US, and it will not be a totally smooth ride, we continue to make good progress and remain focused on our objective.

Targeting profitable growth

In 2005 we delivered net written premium growth of 6%, driven by the recapture of the Munich Re quota share and targeted growth in each of our core markets with premiums up by 3% in the UK, 8% in Scandinavia and 13% in International. We have also been successful in building a pipeline for the future.

Our growth strategies are tailored to each market but there are consistent themes: building distribution; targeting specific trades and segments; expanding our footprint in key emerging markets; making selective bolt on acquisitions; and focusing on customer management and retention.

In Canada we expanded distribution by signing 147 new brokers and in Scandinavia we transferred our successful Danish bancassurance model to Sweden, signing a major agreement with FöreningsSparbanken (Swedbank). We also continued to improve our web offering with 50% of UK motor sales now online. In India we signed partnerships with Standard Chartered, Citibank, GE and Maruti Suzuki and in China we signed four corporate partnership deals.

We are using clear segmentation and unique propositions to achieve growth in specific customer groups. In Canada, our direct business Johnsons achieved a 26% increase in premiums driven by our focus on the 50 plus age group and preferred occupations including teachers and nurses. In the UK, we increased customers in Marine, Risk Solutions and the growing SME market.

We continue to strengthen our position through selective acquisitions. In Canada we acquired the ING marine portfolio securing our leading marine position, while the acquisition of Morgex doubled our market share in Alberta, a province with GDP growth over 40% above the national average. In Scandinavia our acquisition of TopDanmark's marine portfolio consolidated our number one position in Danish Marine.

We have expanded our footprint in emerging markets. Our acquisition of Cruz del Sur made us Chile's number one player and significantly widened our reach in Argentina.

We have also focused on improved customer management which has driven growth in retention across the Group with increases of three points in UK and Danish Commercial and four points in Swedish Commercial.

Group CEO's review

continued

Sustainable strong results

We continued to deliver against our strategic objective of achieving sustainable profitable performance and we've been consistent with our position of not chasing volume at the expense of profit. We've now achieved eight consecutive quarters for the Core Group of combineds in the 90s. In 2005 the combined ratio for our Core Group was two points better at 94.1% and we increased our underwriting result by 42% to £263m.

In the UK we delivered a three point improvement in the combined to 93.1%. This was driven by an excellent performance from Commercial with a combined of under 92% and a 60% increase in the underwriting profit to £115m. Personal achieved a nearly two point improvement in the combined to 95.6% and a 70% increase in underwriting profit. MORE TH>N® maintained its strong performance with a combined of 92.4%, 11% premium growth and an improved expense ratio of 24.1%.

International had another good year despite the impact of weather events. We improved the combined by almost two points to 94.7% and the underwriting result by 40% to £63m. Canada performed strongly with a combined of 94.8%, a 37% increase in underwriting profit to £26m and premium growth of 19% driven by a continued excellent performance from Johnsons, and our focus on retention as well as a favourable exchange rate movement. In Latin America we continued to achieve profitable double digit growth in Brazil, Chile and Argentina. However, the result was impacted by last year's weather events and the combined for the region of just over 101% includes over seven points of storm related costs.

Asia and the Middle East had another good year with a combined of 89.5%. We grew premiums by 15% in the Middle East and in our longer term plays in Asia our Indian business delivered profitable premium growth of 40%.

In Scandinavia we improved the combined to 94.4% with a 20% improvement in the underwriting profit to £65m. Again the result was driven by an outstanding performance from Scandinavian Commercial which delivered a combined of under 86% reflecting the benefits of our portfolio review and operational improvement programme.

Operational excellence

Operational excellence is key to our sustained financial performance. This is not a one off programme – it's about continuous operational improvement. Its scope covers investment in our technical skills, underwriting, pricing, claims,

and expense management, and improving customer service. To date we've achieved £240m of annualised expense savings of our targeted £270m.

Improvement is evident across the Group. We've halved claims leakage in Ireland, and in Canada, we integrated our Western Assurance and Ontario Claims centres, increasing productivity by 10%. In the UK we have continued to invest in our claims supply chain management. We're market leaders in this area and given the strength of our capability, we have won contracts with Lloyds TSB and Co-operative Insurance Society to use our supply chain infrastructure.

We are also harnessing technology to improve transparency and deliver better service to our customers. In Scandinavia we have implemented a web system allowing customers to track progress of their claim and receive automatic updates.

Alongside our operational improvement programme we've continued to focus on getting the right controls, procedures and accountability. We've defined the Group risk appetite and enforce a strict programme of underwriting licences and delegated authorities. We back this up with regular detailed reviews by our independent Group risk and actuarial functions, all of which we have continued to strengthen in the last year.

Accountability is not just about rules, it's also about embedding a culture of responsibility. We have a clear set of Group business principles built around performance, responsibility and integrity with clear commitments to our key stakeholders. It's incumbent on every member of staff to act upon these and they are enforced by global risk policies.

Leadership and performance culture

Throughout the year I continued to strengthen my leadership team and in November Bridget McIntyre joined the Board as UK Chief Executive. In the last three years we have significantly strengthened the 'top 100' management team, bringing on 12 of our own high performers and making 43 external appointments.

A key part of the new culture is differentiated reward at all levels throughout the organisation. Over 80% of employees now have a significant proportion of their pay linked to their performance, up from just 15% in April 2003. Our target is 90% by the end of 2006.

We continue to embed our performance culture. This is about accountability and responsibility – but it's also about investing in the development of our people. We want R&SA to be a place where people can fulfil their career aspirations.

Looking ahead

It has been a productive year during which we've delivered against our strategic objectives and built an excellent foundation for the Group:

- We continued to reduce risk and volatility – we have made good progress in the US, we disposed of non core assets and significantly reduced our pension deficit,
- We have strengthened our capital position, with good margins against all key regulatory measures and sufficient capital to deliver our current plans,
- We have continued to embed discipline in underwriting, pricing and claims,
- We have built a balanced portfolio of Core businesses with good market positions. Each is delivering a strong financial performance and each is capable of sustaining it.

As mentioned earlier, going forward we will be reporting on the Core Group rather than the Ongoing Business. This means that our previous financial target for our Ongoing Business of a combined ratio of 100% on average across the cycle is no longer relevant. Our objective is to deliver sustainable profitable performance and this remains unchanged. My current expectation is that the Core Group will deliver a combined ratio of around 95% in 2006.

Our achievements in 2005 build on the excellent job that everyone throughout the organisation has done to work through our issues and rebuild the franchise and I'd like to thank all staff for their continuing hard work and commitment.

We have an excellent team with a track record of delivery, and the drive, energy and ambition to take this business forward. We will continue to leverage our strengths and move the business on, whether this is through delivering further operational improvements, improving segmentation, increasing retention or expanding distribution.

We have a strong franchise and a focus on great execution. I'm confident that we'll continue to deliver sustainable profitable performance.

Industry overview

The dominating events of 2005 were weather related – in particular hurricanes Emily, Katrina, Rita and Wilma. Despite this, the insurance industry proved remarkably resilient and outside the US, performances were generally strong.

The hurricanes prompted speculation about a knock on effect on reinsurance prices. However, this has so far been largely ring fenced to core US storm affected sectors including property and energy.

The rating environment in 2005 was mixed by class and region and the Group benefited from its balance of exposure to different markets at different points in the cycle. In Personal we have generally achieved single digit rating increases across core territories. In Commercial the market has been more mixed with a competitive but stable environment in some countries, including the UK, resulting in downward pressure on rates of around 5%, while in other regions, including Scandinavia, we achieved single digit rate increases. We have a similar outlook of a mixed rating environment by region and class in 2006 and in all markets we'll continue to target growth opportunities while maintaining our underwriting disciplines. Claims inflation remains in line with our expectations.

The FTSE rose 16% and the positive impact on companies' balance sheets coincided with a cross industry focus on capital efficiency and risk management. A key UK focus was implementation of the FSA's enhanced risk based capital framework – Individual Capital Assessment (ICA). We endorse this approach as a way of assessing capital risk and we've incorporated its tools in a wide range of decision making processes. The Group also supports the broad principles behind the EU's Solvency II initiative which aims to introduce a more risk sensitive solvency framework. It's currently in its preparatory phase and we've been active in industry consultations.

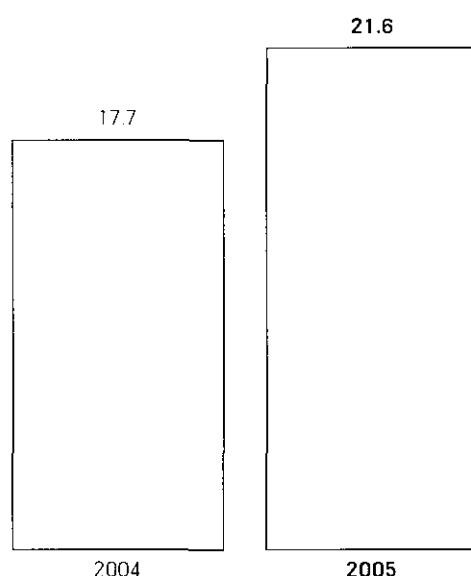
In the US, work continues to secure legislation to deal with asbestos related claims. In February, debate by the Senate resulted in Senate Bill 852, the trust fund legislation, being sent back to committee. As it stands today, there is heavy opposition to the trust fund concept (although support by Senate leadership for it remains) and it's possible that the focus could shift to a medical criteria bill or another version of asbestos reform. We'll continue to monitor developments.

Royal & SunAlliance today

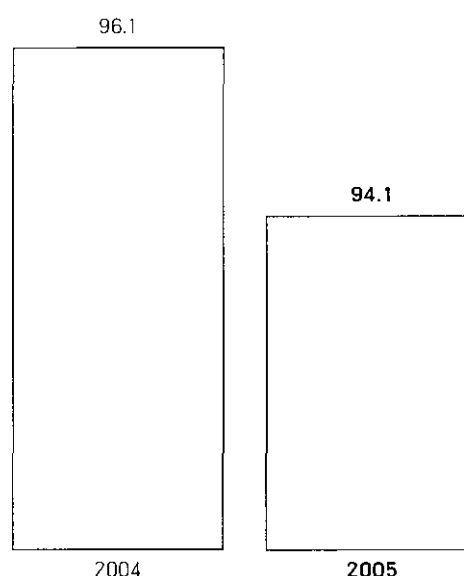
Our strategy is to run general insurance businesses with strong market positions delivering sustainable profitable performance.

We are delivering strong financial results

Core Group underlying return on capital – %



Core Group combined operating ratio (COR) – %



We operate in 27 countries and provide insurance products and services in over 130 countries. We are committed to delivering sustainable returns, targeted profitable growth and continuous operational excellence. Our portfolio of businesses is diverse and provides exposure to markets at different stages of development and at different stages in the insurance cycle.

We have a strong reputation for our underwriting and claims expertise. We are focused on continuous operational improvement to enhance operational efficiency, controls and customer experience.

Key to delivering our strategy is embedding a performance management culture and having the right people. We are committed to developing talent and creating an environment

where people are challenged, accountability assigned and performance rewarded.

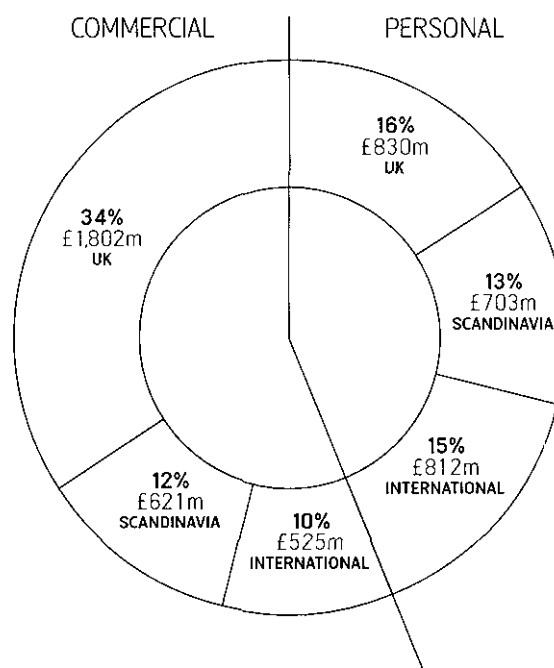
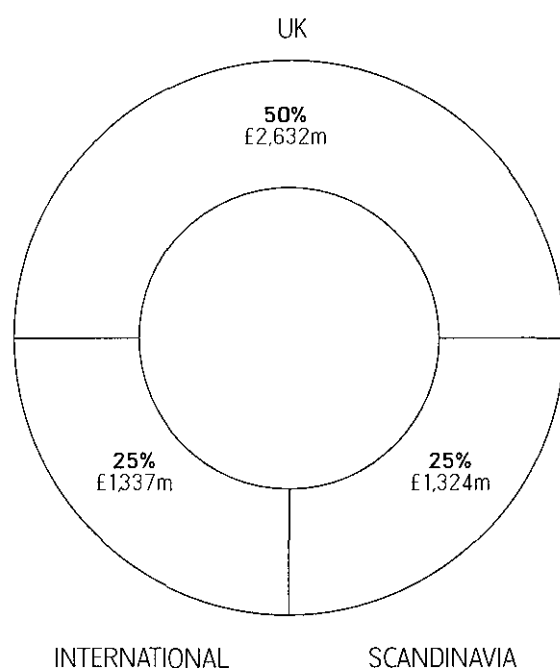
As a result of the momentum generated, the shape and structure of the portfolio of businesses, our focus on core disciplines of underwriting, claims and expense management, the business has performed strongly. The Core Group COR improved in the year by 2 points to 94.1% and the underlying return on capital for the Core Group was 21.6%.

In 2005 we have delivered against our strategic objectives. We are confident in our ability to continue to deliver on our objective of running general insurance businesses with strong market positions delivering sustainable profitable returns.

We have a good balance of premiums and earnings by geography and business line.

Our portfolio is well balanced

Core Group net written premiums



We have strong positions in our chosen markets and segments. Underpinning this is our reputation for providing innovative insurance solutions and good customer service.

In the UK we are ranked number two and three in Commercial and Personal respectively. We have a 12% share of the commercial property segment and insure 40% of FTSE 100 companies. Our UK Personal business has a strong reputation for customer service and has 3.5 million covers in place.

In Scandinavia, our two largest operations, Denmark and Sweden, are ranked third overall in terms of market share. We are number one in Danish marine. Latvia and Lithuania are exciting markets with high growth potential and in these markets we are clear market leaders.

Our International business has operations in 21 countries, including Canada, Ireland, Italy and selected emerging markets in Latin America, Asia and the Middle East. We are focused on building our position in our chosen markets, trades and segments.

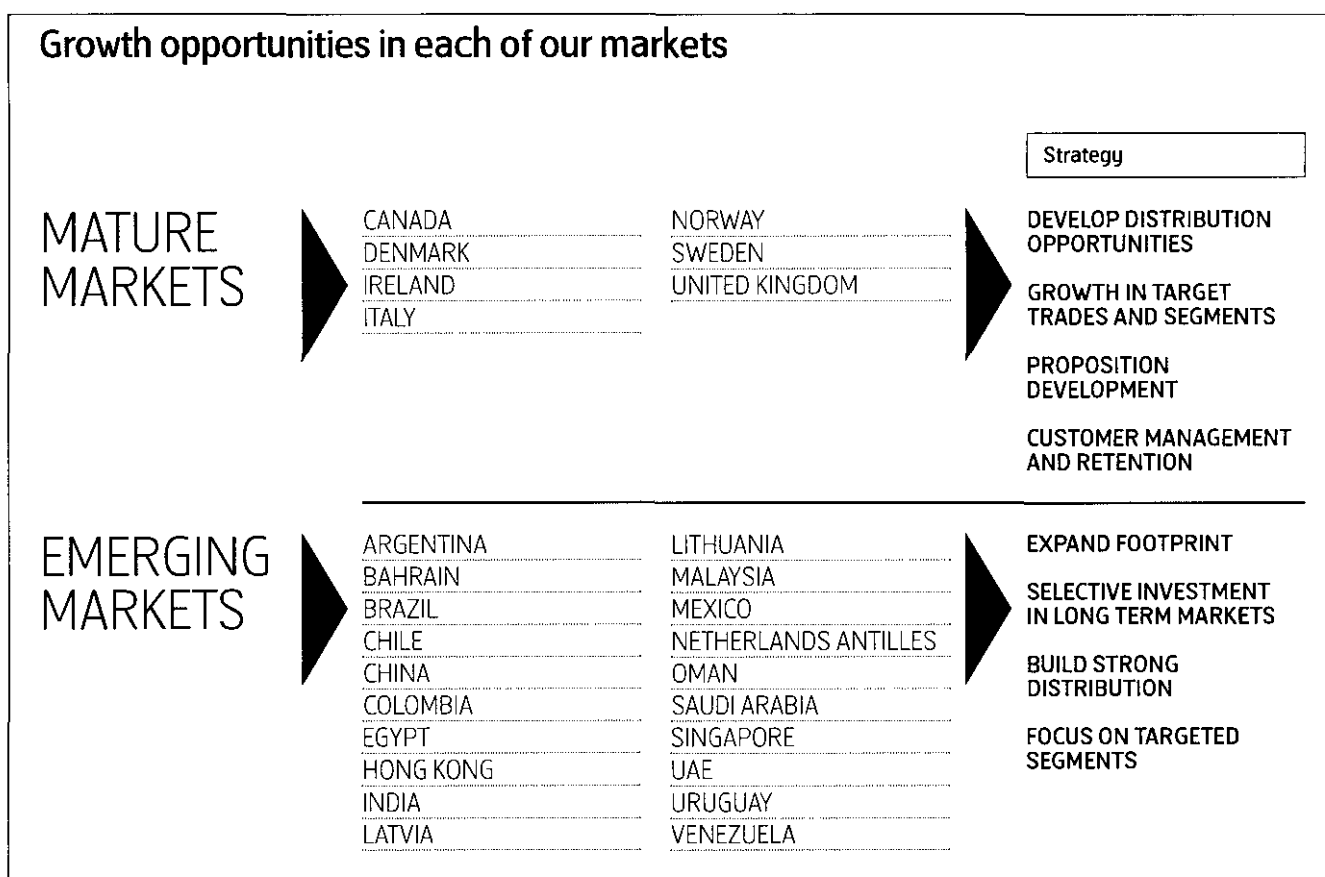
In Canada, Johnson Corporation, our direct business continues to deliver double digit growth. We have also consolidated our leading position in marine through the acquisition of ING's portfolio. We have a leading position in Irish personal household.

The diversity, strength and focus of our business positions us to deliver sustainable earnings with targeted profitable growth.

Royal & SunAlliance today

continued

We have good positions in markets at different stages of development providing us with a range of growth opportunities.



We have businesses in markets at different stages of development presenting a range of strategic options to deliver growth.

Our strategies vary from market to market but there are a number of common themes supporting all of our businesses. These include leveraging Group expertise and focusing on continuous operational improvement.

We are developing our international marine proposition. Through this we are leveraging our technology, product skills, underwriting and claims expertise. We are number one insurer in Canada and Denmark and a leading marine insurer in the UK and Brazil.

One of our strengths is our ability to take successful initiatives from one market to another. The small and medium enterprise (SME) sector is an attractive, growing segment in a number of

markets. In Canada we developed a proposition for the SME sector which we subsequently implemented in the UK and Ireland.

In Denmark we have continued to add to our bancassurance proposition and we have taken this knowledge and applied it to Sweden where the market has yet to develop. Our agreement with FöreningsSparbanken (Swedbank) gives us access to a potential four million customers.

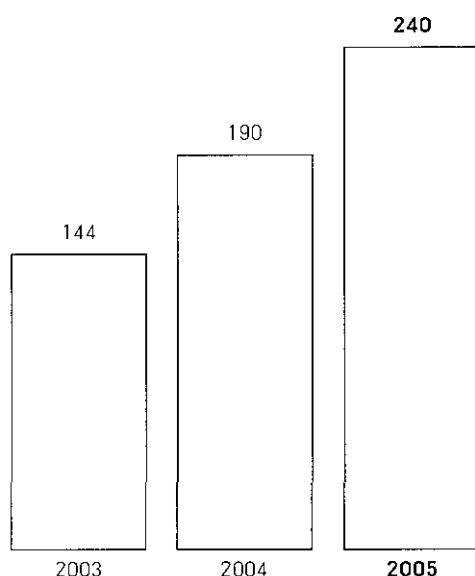
We have been in Chile for 100 years. This year we achieved a market leading position by acquiring the number one Chilean general insurer, Cruz del Sur.

We are focused on building upon the strength of the businesses. Integral to this is our continued focus on the core disciplines of underwriting, claims and expense management.

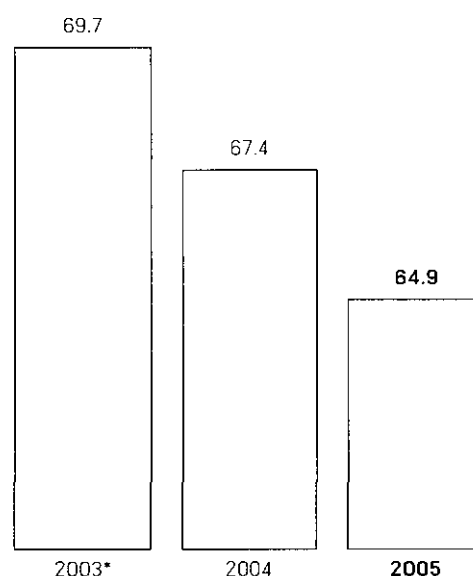
Our continuous focus on our core disciplines of underwriting, claims and expense management is providing us with real competitive advantage.

We are committed to operational excellence

Expense savings – £m



Core Group claims ratio – %



*On a UK GAAP basis

In 2003 we set out a plan to improve our core competencies; underwriting, claims and expense management and deliver annualised expense savings of £270m by the end of 2006. We have made good progress through restructuring the business, implementing new systems and focusing on underwriting, claims and customer service. At the end of 2005 we have delivered £240m of annualised expense savings.

Through the actions we have taken over the last three years we have reduced MORE TH>N's expense ratio by 14 points to 24.1% at the year end.

We have reduced the Core Group's claims ratio by 2.5 points over the year. In Canada and Ireland claims leakage has halved. In the UK we have built a market leading supply chain and have won contracts with two companies to use our supply chain infrastructure.

We are focused on continuous operational excellence and have a range of initiatives to improve efficiency, procedures and develop a culture of accountability. We continue to embed a performance culture. In the last two years we have strengthened the top management team and clearly aligned reward with personal performance for over 80% of employees and are targeting 90% by the end of 2006.

We have developed a Group risk appetite which defines the type and level of risk the Group wants to take. This is underpinned by a disciplined approach towards risk selection and underwriting with clearly defined levels of authority.

UK operating review

Throughout the year we have maintained underwriting discipline and focused on operational excellence.

UK		
£m	2005	2004
General business		
Net written premiums	2,632	2,555
Underwriting result	154	95
Insurance result	475	377
Combined operating ratio (COR)	93.1%	96.3%

2005 has been another very positive year for our UK business. Following the structural changes of recent years, we now have a platform in place to deliver sustainable profitable growth. Maintaining our focus on disciplined technical underwriting, underpinned by continuous operational improvement, we continue to demonstrate our ability to deliver sustained profitability.

Overview of major strategies

In Commercial, we have continued to consolidate our position and have concentrated our efforts on market segments where we can capitalise on our ability to win and retain profitable business. We are well placed to manage through the cycle based on our strong relationships in the marketplace and the flexibility derived from a diversified portfolio.

In Personal, we aim to realise further efficiency improvements and generate profitable growth. Our strategy is to maintain a

competitive, profit led stance on rating and to focus on further operational improvements and cost efficiencies.

Our focus on reducing costs and driving efficiency in all areas of the business continues. We have started to implement a new IT infrastructure and have enhanced our customer service by process improvement and staff training. Development of our performance management culture throughout the UK has led to greater alignment between the performance of our people and the reward and recognition they receive.

We have continued to grow our market leading technical excellence in underwriting and claims, and brought greater alignment to how each of these core competencies serve our businesses. This revised focus allows us to evolve our customer segmentation, propositions and our ability to trade profitably through the market cycle.

Business progress against strategies

The UK business is the largest operating unit within the Group and has produced a strong set of results for the third year in succession, with an overall COR of 93.1% compared with 96.3% in 2004.

Over the last two years, we have reduced our headcount by 18% to 10,500. Our plan to move 1,200 roles offshore continues. We have transferred around 550 roles and expect to transfer the balance by the end of 2006. Customer service has been maintained whilst making these changes.

With 3.5 million small businesses in the UK, the small and medium enterprise market offers an ideal growth opportunity for the UK business. As the second largest player in this sector through our Enterprise brand, we are well placed to meet the insurance needs of these businesses through our direct and broker propositions. In 2006 we will introduce several new products through our direct offering, MORE TH>N® Business and there will be an increased emphasis on this route to market.

Online sales for our direct personal lines proposition, MORE TH>N®, now account for half of all the motor policies we sell, up from around 25% in 2004. Each month in the UK there are over seven million insurance related internet searches and we are taking action to ensure we are well positioned in this market.

We delivered the first phase of our major new IT platform in 2004 and throughout 2005 we continued to implement this across the business. Our claims system is now live in all of our major sites and our new policy administration system (AIS) is live in many of our Commercial offices. Completing the implementation of these systems fits our strategy for process and system rationalisation. This allows us to decommission 10 major legacy systems and accrue further significant cost savings.

Underwriting

We have made good progress in developing market leading capabilities in the pricing and selection of risks.

Within Commercial we have introduced underwriting filters to ensure the business we write properly reflects our strategically defined risk appetite. To augment this, we have introduced new training schemes for key underwriters to ensure adherence to technical pricing across the business.

In Personal we have implemented new rating methodologies across our direct and intermediated motor books. This sophistication has allowed us to confidently re-enter the brand broker market, worth £2.7bn gross written premium (GWP) and forecast to grow to £3.6bn GWP by 2008.

The initial release of AIS delivered improvements for servicing our motor fleet customers. In 2006 the system will be implemented across our business delivering an improved service through end to end processing. This provides a single view of the customer, improves consistency, minimises the administrative burden on underwriters and reduces the time taken to bring new products to market.

Throughout the year we spent considerable effort reviewing and revising our control environment. We have the operating procedures and systems in place to maintain our discipline on underwriting, risk accumulation and risk appetite.

Claims

Fundamental transformation of our claims capabilities, along with a clear focus on actively managing indemnity costs, has played a key role in driving our strong performance. The programme began in 2004 and is on schedule for completion during the second quarter of 2006.

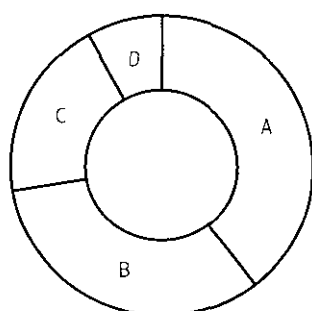
We have focused on identifying the optimum method for managing each claim. Our new claims system is allowing us to restructure our claims handling team and deliver benefits including more effective management of customer claims.

We have led the market in leveraging our significant annual spend to develop active supply chain management solutions. First recognised by Lloyds TSB in 2004, this was further endorsed when Co-operative Insurance Society appointed us as their selected partner for the provision of a household contents and buildings supply chain.

Our claims capabilities provide an important point of differentiation in a competitive market. We deliver a high level of customer satisfaction through our rapid and helpful response to customer claims.

Commercial

Commercial's COR of 91.9% shows a 4.1 point improvement on 2004. The underwriting profit of £115m is up 60%. These results reflect both the quality of our Commercial portfolio and our continued focus on operational excellence. Among a strong set of performances, a number of segments stand out. We have a contract with Motability, who provide mobility solutions for disabled people. They have the largest fleet in Europe and customer numbers have increased this year. In addition customer numbers have increased in Risk Solutions and Marine. At the same time, retention improved by 3 points on 2004 to 85%, despite intense market competition. Property Investors and Marine



Commercial net written premiums

A Property £711m
B Motor £599m
C Casualty £348m
D Other £144m

62%

INCREASE IN
UNDERWRITING
RESULT

UK operating review

continued

have high retention rates reflecting the depth and strength of our relationships with customers and intermediary partners.

With a total market share of 10.1%, Commercial is the second largest insurer in the sector. We have a 12% share of the property segment, a 14% share in motor and 9% in liability. We insure 40% of FTSE 100 companies and are one of the leading carriers of Professional & Financial and Marine risks outside Lloyd's of London.

Commercial is the second largest player in the SME sector. Our direct commercial proposition is sold through the MORE TH>N® Business brand and aimed at the 3.5 million small businesses in the UK with a turnover of under £1 m. It achieved impressive growth during 2005 with policy numbers more than doubling. We also offer our established Enterprise service through brokers and a bespoke service to corporate clients via the intermediated channel.

We have continued to anticipate and respond to the insurance needs of particular segments through understanding our customers. Marine was recognised by winning both the 'Underwriter of the Year' award at the British Insurance Awards, and the 'Risk Management' award at the Insurance Times Awards.

Personal lines

In the Personal business we achieved a COR of 95.6% in 2005 reflecting an improved performance from MORE TH>N® and the intermediated business. Household delivered an impressive COR of 90.4%, with motor achieving a COR of 102.9%.

MORE TH>N® recorded another strong performance with its COR improving to 92.4% and net written premiums up by 11% to £432m. We met our target of a sub 25% expense ratio by the end of 2005.

We continue to be a leading player in our chosen markets. We are the third largest motor and household insurer in the UK with 3.5 million covers in place and a 6.5% market share. Our multi channel distribution model, advanced call centre management expertise and proven ability to 'live' brands provides competitive advantage in this rapidly evolving sector.

During 2005 we have improved the functionality of the MORE TH>N® website and complemented this with targeted marketing to move customers towards using the internet. These changes, as well as a general trend towards internet usage, have resulted in growth of 109% via this channel compared to 2004. We now have around 15,000 visitors each day.

For our partners in the intermediated sector we introduced an integrated household policy system. This has been installed in a number of building societies, enabling them to offer insurance alongside their mortgage propositions.

We also introduced a number of new products into the intermediated market during 2005 including ClearChoice (home) and DriveSelect (motor). ClearChoice is our first home product to be delivered via our electronic business to business platform which helps us deliver value to our customers through competitive, factor based pricing and demonstrates our commitment to this channel.

We have increased our participation in seven leading panels, including AA, Kwik-Fit and Hastings. This was made possible by our improved pricing sophistication that will allow us to deliver competitive prices and acceptable returns from this sector.

The affinity channel, where we manage large groups of customers through a single source, has also been developed further underlining our proven ability to create solutions for our partners and enabling us to grow this side of our business. In 2005 we successfully negotiated deals including Yorkshire Building Society, where we added motor business to the household portfolio we already have with them. During the year we have renewed contracts including Toyota GB where we service their motor insurance account for a fee.

Market and economic conditions

The market has remained competitive in 2005, with downward pressure on rates in a number of classes. Our rating experience was mixed across the portfolio particularly in Commercial. As a leading insurer we are committed to maintaining pricing discipline.

12%

SHARE OF
COMMERCIAL
PROPERTY
SEGMENT

Well positioned to deliver
sustainable profitable growth.

In 2006 we will continue to target new business where we can obtain attractive pricing terms and focus on retaining business.

Understanding our customers, delivering excellent service and building strong relationships in our chosen markets, combined with our market leading technical excellence in underwriting and claims, enables us to continue to manage the cycle effectively. It will see us deliver sustainable, profitable growth while maintaining our underwriting discipline.

The personal lines market is extremely competitive, particularly in motor. This underlines the importance of our ongoing strategy of driving down operating expenses. The good results being achieved by Personal demonstrate how far we have already come in developing our ability to trade profitably through the insurance cycle.

Outlook

The UK business delivered good results. Our key focus for 2006 will be maintaining our strong performance, while continuing our pursuit of operational excellence, ensuring underwriting discipline and targeting sustainable, profitable growth wherever it can be identified.

The completion of our new IT platforms for servicing policies and claims will enable us to enhance our operational effectiveness and improve our customer service and competitive pricing.

The web offers strong prospects for profitable growth. We will continue building on the strong foundations established through the MORE TH>N® brand. In particular, we believe a very significant opportunity exists to shape and lead the SME commercial market. We will therefore be accelerating the growth of MORE TH>N® Business and intend to introduce several new products in 2006 to establish a commanding presence in this rapidly developing segment.

Following the completion of our claims transformation programme during 2006, we will continue to pursue further claims initiatives, including the expansion of our supply chain operation. These, along with a range of initiatives aimed at reducing our operating

expense base, will support our ability to generate attractive returns in what remains a challenging marketplace.

We will continue to enhance the sophistication of our motor and home underwriting to enable us to tailor our rating tables to specific segments of business and types of customers.

We have continued to demonstrate our ability to deliver strong financial returns and the service our customers demand. We believe the proven success of this approach over the past three years is indicative of our ability to deliver sustainable profitable growth.

We have invested significantly in our wholly owned bodyshops. These sites undertake the entire range of motor repairs and in 2005 we opened a new state of the art facility in Birmingham. We have also launched a new motor product for the personal broker market and we provide motor insurance for a range of corporate customers such as Land Rover, Toyota GB and Volvo.

International operating review

A portfolio of businesses in mature and emerging markets focused on delivering sustainable profitable growth.

International

£m	2005	2004
General business		
Net written premiums	1,337	1,186
Underwriting result	63	45
Insurance result	207	173
Combined operating ratio (COR)	94.7%	96.6%

Our International businesses are a balanced portfolio of operations in the mature markets of Canada, Ireland and Italy and selected emerging markets in Latin America, Asia and the Middle East. International delivered excellent results in 2005 with an underwriting profit of £63m and a COR of 94.7%. This reflects our continued focus on maintaining underwriting discipline in a competitive pricing environment.

Overview of major strategies

We continue to focus on securing our position within our chosen countries, market segments and target trades in which we have a competitive advantage, rather than chase market share across all operations. Our approach is to maintain pricing discipline as we target sustainable profitable opportunities. We are continuously raising standards in underwriting and claims, improving our customer management and strengthening our risk and governance environment. We will balance organic

growth with bolt on acquisitions in existing geographies where complementary opportunities are available.

Business progress against strategies

In 2005 there were floods in Canada and India and hurricanes Emily and Wilma. Despite the significant weather events we delivered a 20% increase in the insurance result, demonstrating the strength of the International portfolio.

Our business in Canada delivered a good financial result, driven by both the Johnson Corporation, our personal lines direct operation, and the intermediated business. Johnson's delivered 26% growth and in 2005 signed affinity deals with new sponsorship groups giving access to an additional 600,000 customers in our target professions of education and health. Penetration of these groups is developing strongly with a 25% increase in members insured over the last two years. In September Johnson acquired Morgex Insurance Group, doubling the size of our brokerage in Alberta, providing a platform for further profitable growth.

In the Canadian intermediated business, we continued to accelerate broker appointments, with 147 new brokers added compared with 110 in 2004. In Commercial we acquired the renewal rights to the ING marine portfolio. Overall retention rates in excess of 80% demonstrate our market leading expertise in this segment. Against a background of mandatory rate reductions in motor, the personal intermediated business has made good progress, with high retention levels and strengthening new business trends.

The Group has leading positions in marine in the UK, Canada, Brazil and Denmark. We are leveraging our expertise to develop an International marine proposition. Our position as a leading marine insurer in Brazil demonstrates how this can be achieved. In 2005 the Brazilian marine portfolio grew more than 40%. The marine hull portfolio within the acquisition of Cruz del Sur has been transferred to the UK marine team to benefit from their expertise.

The performance of our business in Ireland was excellent. We are ranked fourth largest in the market and are a leading personal household insurer. In 2005, pricing pressure continued and the claims environment was relatively benign. Our focus was on disciplined underwriting and operational excellence. A project to streamline our processes and reduce inefficiencies generated significant cost benefits enabling us to improve our cost base going forward. As part of this project we are the first general insurer in Ireland to completely outsource our IT services.

Our Italian business continues to grow faster than the market with 25 new agents appointed in 2005. During the year, a new operating model was adopted with new appointments to strengthen the management team and to give an increased focus on risk management and control.

Latin America demonstrated strong levels of growth, both organic and inorganic. In Brazil, our marine portfolio grew in excess of 40% as we strengthened our brand awareness and customer profile in this segment. In recognition of this, our Brazilian operation won awards for 'Best Marine Product' and 'Best Marine Business Performance' in Cobertura, a monthly insurance industry magazine. We significantly increased our presence in the region with the acquisition of Cruz del Sur, the market leader in Chile and La Republica in Argentina.

Latin America has consistently delivered a sub 100 combined operating ratio for the last four years, but in 2005 the COR was 101.4%. This was after absorbing 7.6 points of weather costs which primarily reflect the impact of hurricanes Emily and Wilma. This impact was not significant in terms of the overall International result given the diversification benefits within our portfolio of businesses.

In our Asia and Middle East region we experienced strong growth in motor in UAE and India. We now have distribution agreements with 80 car dealerships through Maruti Suzuki, the largest car manufacturer in India. Through this partnership we have issued more than 100,000 policies. In the Middle East, we are a top five International insurer and see organic growth

opportunities in the markets enjoying economic prosperity. We view India and China as longer term opportunities, with both markets expanding and maturing.

Market and economic conditions

Although geographically diverse, there are a number of common themes across International.

Declining rates were a feature of 2005, whether due to the competitive environment in markets such as Ireland or to mandatory changes in Canada. In 2006 we expect the rating environment, although varied across International, to remain stable. We remain committed to maintaining our pricing discipline and will, if necessary, sacrifice volume for profitability.

The insurance regulatory environment continues to evolve, with strengthened standards of regulation being applied in Italy, parts of the Middle East and Latin America. Having rolled out the Group's comprehensive standards, we are well positioned to respond to regulatory changes and reform.

Other initiatives

In line with the rest of the Group, we have introduced a new performance culture with variable pay elements to ensure our teams are motivated and objectives aligned throughout the operations. We have strengthened the management teams with external hires and are actively promoting internal talent. In Argentina we were voted best company to work for in a survey by Apertura magazine, a leading monthly business magazine. In Brazil our strengths in people management were recognised by Hay Group and ValorCarreira Magazine, an annual HR publication. In India we won the award for 'Most Innovative Recruiting & Staffing Programme' at the first Indian Recruiting and Staffing Best in Class Awards.

Sustainable expense management was a key priority for 2005. We are reaping the benefits of two major change programmes in Canada and Ireland designed to streamline processes. We have outsourced IT services in Ireland and Canada and launched procurement projects to take advantage of bulk buying efficiencies. In 2006 we will roll out key elements of these projects on a smaller scale within the other regions.

13%

INCREASE IN
NET WRITTEN
PREMIUMS

20%

GROWTH
IN INSURANCE
RESULT

International operating review

continued

In Ireland, Brazil and India we have undertaken a full analysis of our client base to help us understand more fully the most profitable clients and the products they are interested in. This work has enabled us to develop retention and win back strategies aimed at our top tier clients, allowing us to differentiate and tailor our proposition to create extra value for our customers.

We have also worked closely with our intermediary brokers and agents to further strengthen our relationships. In Canada, we've continued the roll out of WebBusiness, which allows brokers to process new business and policy changes in their own office, allowing them to compete more effectively with the direct channel. Approximately 90% of processable transactions within the Canadian intermediated personal business are now completed online.

In UAE we won the Insurex Conference E-Business award for effective use of information and communications technology at the point of sale with the broker or client.

In Italy we have a structured training programme to assist agents and brokers in developing their businesses and in Ireland we launched a new key account management team.

These efforts have been vital in allowing us to improve our relationships with brokers and in some territories we have reduced commission rates in response to a falling rate environment.

Acquisitions and disposals

In line with our strategic aim of building strong positions in selected markets to deliver sustainable profitable growth, we acquired Chile's leading general insurer Cruz del Sur and its Argentinean sister company La Republica for £68m in November. This combination creates a clear market leader within Chile with a 22% market share and we see the opportunity for significant value creation as we apply our underwriting model to Cruz del Sur's heavily reinsured portfolio. In Argentina the companies are geographically complementary, allowing us to expand outside Buenos Aires more rapidly.

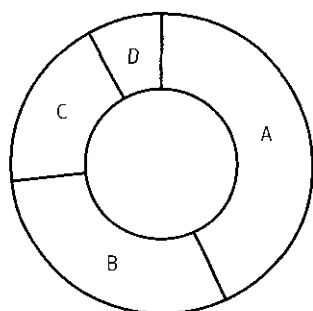
In Canada, Johnson's acquisition of Morgex Insurance Group was the largest of Johnson's 16 broker acquisitions to date. Following the acquisition Johnson is a top five personal insurance provider in Alberta.

We completed the disposals of our Thai and Japanese operations in 2005, bringing to a close the restructuring programme of previous years.

Outlook

We will build upon our current platform by focusing on the markets and segments that offer the best potential for producing sustainable profitable growth. To complement our organic growth strategy we will consider acquisitions of portfolios or businesses in countries where there is a strategic fit with existing operations.

In moving towards a sustainable profitable growth agenda, we will look to balance our increased focus on sales and business development capabilities with continued rigour in our risk selection and control. Successfully combining these activities will ensure we remain a key contributor to the Group's overall performance.



Net written premiums
A Canada £578m
B Europe £406m
C Latin America £249m
D Asia and Middle East £104m

A balanced portfolio with strong positions in our chosen markets and segments.

Scandinavia operating review

We are committed to delivering on our objectives by continuously improving our claims handling and underwriting capabilities.

Scandinavia

£m	2005	2004
General business		
Net written premiums	1,324	1,228
Underwriting result	65	54
Insurance result	180	145
Combined operating ratio (COR)	94.4%	95.6%

In 2005, we continued to focus on our core disciplines and produced very good results with a combined operating ratio of 94.4% and a £65m underwriting profit.

Overview of major strategies

We are the third largest general insurer in the Nordic region comprising Denmark, Sweden, Norway, Latvia and Lithuania. In line with the rest of the Group, our strategy is to focus on markets where we hold positions that enable us to see the positive benefits of the underwriting and pricing actions that we have taken. In both Denmark and Sweden we are the third largest insurer. These businesses are supported by our growing operations in Latvia and Lithuania (Baltics) where we hold market leading positions.

The operational performance improvement programme introduced in 2003 has now moved to business as usual with the commitment of delivering on our targets by continuously

improving our claims handling and underwriting capabilities as well as constantly monitoring and updating our product offering.

We have continued to develop our customer value propositions in personal and developed new propositions for commercial lines. We are building our distribution proposition. In Denmark we have 68 bancassurance agreements with the local banking market including the fifth largest Danish bank SparNord and in Sweden we have recently started selling policies through our partner FöreningsSparbanken (Swedbank).

We now have agreements with three major motor manufacturers which between them account for a quarter of car sales in Sweden and almost 10% in Denmark.

Focusing on the motor sector in Denmark we have jointly developed a vehicle inspection and insurance cover product. The product provides six months of cover for major mechanical components.

Pursuing opportunities for acquisition based growth, led to the acquisition of TopDanmark's marine portfolio which consolidates our number one position in Danish marine.

During the year, we took the next step in driving forward the pan Nordic organisational initiative by realigning our organisation along business lines rather than by geographical regions. The new organisation consists of a number of divisions; Commercial, Personal, Key Accounts, Marine and the Baltics. These business divisions will be serviced by a number of pan Nordic support

We are building on our distribution capabilities. In Denmark we have a successful bancassurance proposition and are applying our skills and knowledge in Sweden, where bancassurance distribution has yet to develop. Through our partner in Sweden, FöreningsSparbanken (Swedbank), we have access to a potential four million customers.

Scandinavia operating review

continued

functions. We will continue to evaluate opportunities for enhancing scale and efficiency in the forthcoming years.

Our employees are key to our success. We are well on our way to moving towards a true performance culture, implementing a performance orientated bonus system for all employees, which is integral to embedding the new culture. We are establishing a more open and challenging culture, which is fairer and offers better promotion prospects with clear and open structures. We believe that this new culture makes us better placed to get the right people for the right jobs. We now have more effective tools to measure leadership performance, thus making it possible for everyone to see their strengths and areas for development. This culture will help us to develop our business.

We are committed to driving the pan Nordic organisation forward but recognise that each country is different and our customer propositions, customer segmentation, pricing models and brands are adapted for each market. As a result, we remain committed to our multibrand strategy in our primary markets where we trade under a variety of brand names: Codan; Trekroner and Privatsikring in Denmark and Trygg-Hansa; Aktsam and Tre Kronor in Sweden. Our main brand names, Codan and Trygg-Hansa, have close to 100% prompted brand awareness.

Business progress against strategies

In Scandinavia, net written premiums of £1,324m were up 8% on 2004 and the underwriting result improved by 20% to £65m. The COR of 94.4% improved by 1.2 points on 2004.

The claims ratio was 74.4%, 2.1 points better than prior year while the expense ratio reflected an increased sales focus and a general strengthening of support functions, including a number of additional regulatory costs. The improvement in our claims ratio reflects the result of the performance improvement programme focusing on more sophisticated pricing models, expansion of rate plans into the part of the commercial book that was previously manually underwritten, as well as continued management action to improve our claims handling and sales efficiencies.

Our Commercial business, with a COR of 85.5%, performed strongly reflecting the benefits of a review of the entire portfolio and increasing premium rates to levels that properly reflect the risk in recent years. In Personal lines, the COR of 102.5% and the Swedish Personal COR of 104.7% reflects the decision to strengthen personal accident reserves. In Denmark the COR for Personal lines was 99.5%.

A number of factors influenced our 8% growth in net written premiums, including improvements in the way in which we structure our reinsurance covers. We achieved rate increases ahead of the market in Swedish Personal Accident, while rate increases across the rest of the portfolio were in line with the market.

We have continued to enhance our concept of dynamic pricing, where prices are based on market factors, price elasticities and technical price. We have also expanded our rate plan based pricing to the part of our commercial book which was previously manually underwritten.

Our customer value propositions have been refined for the Personal market with enhanced value propositions for targeted customer groups, notably families and the over 50s. In Commercial we have introduced customer value propositions aimed at being the best in the market for advisory services. We facilitate Commercial clients' risk management activities with counselling programmes, product offerings, claims adjustment programmes and claims prevention programmes.

In 2005, customer surveys in Denmark and Sweden showed high levels of customer satisfaction. In both Denmark and Sweden, we recorded a net positive inflow of Personal customers in 2005. We believe that the work to improve our value propositions is a major contributor to this increased number of customers.

We will continue to develop and improve our distribution channels in Scandinavia, where most insurance is written direct through call centres and tied agents for both Personal and Commercial insurance. Unlike the position in many other

24%

INCREASE
IN INSURANCE
RESULT

85.5%

COMMERCIAL
BUSINESS
COMBINED
OPERATING RATIO

countries, only a limited proportion of the commercial book is written through brokers.

The markets of Latvia and Lithuania have exciting growth prospects following entry into the European Union in May 2004. In these markets we have gained market share consolidating our number one position. We continue to drive growth and reduce operating costs. Net written premiums are up 26% to £87m and the combined operating ratio was 90.3%. We will maintain our focus on growth within these markets as well as continue to develop the infrastructure by utilising best practice from the other Group operations.

Market and economic conditions

The Scandinavian markets are highly consolidated. In Sweden, the top five players represent 90% of the market and in Denmark 70% of the market. We do not expect significant changes to this level of consolidation, although we did see a limited number of new players enter our markets in 2005, particularly multi nationals in Commercial lines.

In 2005, profitability in Scandinavian markets was good, following the hardening of premium rates in previous years. In Commercial lines, rate levels have increased following several years of low underwriting results. Rates in the Commercial market are under pressure in particular within the Industrial and Transportation segments.

During 2005 we responded proactively to pressure from consumer organisations to offer policies which run for less than one year. We offered products with these characteristics although we have experienced limited demand at this stage.

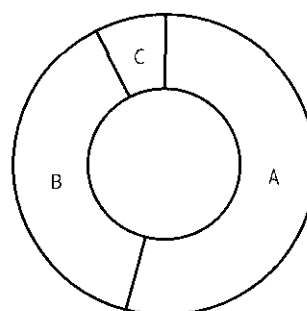
Interest rates in the Scandinavian market remained at low levels and were, against expectations, lower than those at the end of 2004. These low interest rate levels have led to low investment returns and underlined the need for sustainable profitable underwriting results within the industry.

Outlook

We remain committed to improving our core capabilities: pricing, underwriting and claims handling. We believe focusing on our core capabilities will help to mitigate the effect of any softening of the rating environment and maintain our profitability. In addition, we will be looking for further profitable growth opportunities.

In summary, we will maintain our focus on the markets and business lines where we have scale and see evidence of sustainable profitable growth. With the changes we have made in our performance culture and organisational structure, our team is well positioned to deliver on these opportunities.

We are focused on the markets and segments where we can see the benefit of our underwriting and pricing actions.



Net written premiums
A Sweden £720m
B Denmark £506m
C Baltics and Norway £98m

US operating review

2005 has been a productive year with the continued reduction in exposure and infrastructure.

US		
£m	2005	2004
General business		
Underwriting result	(145)	(462)
Insurance result	(29)	(372)

During 2005, we continued our stabilisation and restructuring programme, moving significantly forward with plans to simplify our operations. Highlights included the sale of Nonstandard Auto (NSA), the strengthening of our Risk Based Capital (RBC) ratio, the reduction in regulated insurance entities and domiciliary states and the reduction in losses.

Overview of major strategies

Our major focus during 2005 was structural simplification, building on the successful implementation of our stabilisation plan. The overarching goal of our restructuring is to safeguard assets appropriately and minimise the risk of volatility in the overall operating result of the Group. Derisking the business and eliminating operational uncertainties also allows for greater flexibility in pursuing options for bringing certainty and finality to the US business.

To this end, we have sold our last ongoing business and our net written premiums have decreased by 98% since September 2003.

We cut our insurance result loss to £29m for 2005, down from £372m in 2004 and delivered a £3m profit in the fourth quarter.

Business progress against strategies

Achieving our stabilisation and restructuring strategy continues to be driven by the six critical drivers introduced in late 2003.

Claims management

Our efforts to accelerate the reduction in our claim inventory resulted in a 61% decrease in open claims since December 2003 and liabilities have reduced by \$1.2bn in the year to \$3.4bn at year end. Cost control initiatives included the introduction of a national litigation management strategy designed to control claim litigation costs, and an early resolution initiative that targets claims, where possible, for immediate settlement and resolution.

Expense management

In 2005 we reduced our expense base by \$115m to \$225m in line with our operational size. We also reduced headcount by 1,299 to 860 at the year end.

Transition of resources and assets

We are consolidating the operations whilst ensuring we have a stable, cost effective structure to support our continuing obligations. With the sale of NSA, the remaining US ongoing business is primarily personal insurance. Accordingly, we have filed personal insurance withdrawal plans in several states, with approvals received from four states by the end of February 2006.

Over the last few years, across the Group, we have restructured our portfolio, exited a number of lines of business, more clearly defined our risk appetite and established rigorous underwriting controls. In 2005 there were significant weather events in the Americas. However, through our focus on risk selection and our disciplined approach to underwriting, the Core Group delivered a 42% increase in underwriting profit and a 2 point improvement in the combined operating ratio to 94.1%.

Legal

Through strong management we are focused on the resolution of claims and corporate litigation. Our proactive approach is successfully mitigating risk and positions us for the best possible litigation results.

Investment management

We generated a strong investment result. This can be attributed to duration extensions, interest rate rises and additional income earned from higher coupons on the floating rate portfolio.

Reinsurance recoverables

We aim to maximise the cash available to our operations through aggressive reinsurance collections and cash management. In addition, we are focused on managing and improving our statutory capital position. We collected \$1.3bn in reinsurance balances during 2005, bringing our total collections to almost \$4bn since the beginning of 2003.

Sale of Nonstandard Auto

On 1 November 2005, we sold our remaining ongoing business to Sentry Insurance a Mutual Company. The sale included the transition of more than 600 NSA dedicated employees to Sentry. For the first 10 months of the year, NSA reported an operating profit of \$37m and a COR of 88.8%.

The transaction provided a post tax gain under IFRS of £71m. It also strengthened our Risk Based Capital. At 31 December 2005, the US operation had an RBC ratio of 2.2.

The NSA sale also allowed for continued simplification of our regulatory structure in the US. The operation reduced the number of domiciliary states to two and insurance entities to four, down from 11 and 25 respectively, at the beginning of 2004. This restructuring streamlined the regulatory process, eliminated the costs associated with maintaining numerous legal entities and enhanced our ability to maximise investment return by reducing the number of separate, individual company portfolios.

Governance continued to be a top priority as evidenced by the process controls implemented across the operation, robust

risk assessment and performance management initiatives. Our success in this area was substantiated by internal audits conducted during 2005.

We have continued to closely monitor regulatory and legislative matters in the US, especially the asbestos litigation reform process at the federal level. In February, debate by the senate resulted in Bill 852, the trust fund legislation, being sent back to the committee. As it stands today, it is possible that the focus could shift to a medical bill or another version of asbestos reform. We will continue to monitor developments.

Outlook

During 2006, we will continue the work to identify a solution to the challenges we face in the US. We will maintain our focus on stabilising and restructuring the US organisation in a cost effective and efficient manner, while maintaining an appropriate control environment.

We appointed Edward Muhl to the US Board in January 2006. He brings with him nearly 40 years of insurance industry experience, having served in a regulatory capacity as Superintendent of Insurance, State of New York; Commissioner of Insurance, State of Maryland and President of the NAIC (National Association of Insurance Commissioners).

Achieving stabilisation has not been easy and we still face uncertainty associated with long tail reserves and litigation. On a business as usual basis, we anticipate broadly breaking even at the insurance level in 2006. We continue to focus on driving down claims and expenses and actively explore opportunities to accelerate coming off risk. Our objective is to bring certainty and finality to the US exposure. Execution of this is complex, will take time and will not be a totally smooth ride.

We continue to reduce our exposure and actively explore options to accelerate coming off risk.

61%

REDUCTION
IN OPEN
CLAIMS SINCE
DECEMBER 2003

\$1.2bn

REDUCTION
IN LIABILITIES
IN THE YEAR

Financial review

Chief Financial Officer's report

Through our actions, we have a healthy capital position, a strong balance sheet and a Core Group delivering sustainable performance.

Analysis of result*

	2005 £m	2004 £m	Movement %
Net written premiums	5,400	5,082	6
Underwriting result	118	(277)	—
Investment result ¹	696	591	18
Insurance result	814	314	159
Other activities ²	(116)	(56)	(107)
Operating result	698	258	171
Other movements ³	(210)	(215)	2
Benefit from change in pension scheme design	180	—	—
Profit/(loss) on disposals	197	(109)	—
Discontinued life	—	104	—
Profit before tax⁴	865	38	—
Tax	(260)	(118)	(120)
Profit/(loss) after tax	605	(80)	—
Combined operating ratio			
Ongoing business	93.8%	93.8%	—
Core Group	94.1%	96.1%	+2pts

*For full details please see note 30 – Segment reporting on page 105.

Guide to terms

1. Investment result

Comprises investment income, realised gains, unrealised gains/(losses), impairments, foreign exchange and the unwind of discount.

2. Other activities

The result for other activities comprised a number of elements:

- The operating result from non insurance activities,
- The change in the value of non insurance derivatives,
- Income from associates,
- Central Group expenses,
- Investment expenses and charges.

3. Other movements

Other movements include interest charge on debt, amortisation and reorganisation costs.

4. Profit before tax

Profit before tax is shown on a management basis. Profit before tax on a statutory basis is shown on page 54.

George Culmer Chief Financial Officer

The purpose of this section of the report is to provide an overview of the financial performance of the business in 2005.

Changes in accounting and disclosure

As I mentioned in last year's report, companies are required to report under International Financial Reporting Standards (IFRS) from 1 January 2005 onwards. For Royal & SunAlliance that meant that our 2004 full year accounts were the last to be prepared under UK Generally Accepted Accounting Principles (UK GAAP) and these accounts for 2005 are the first to be prepared under IFRS. All the 2004 numbers included in this report have been restated on an IFRS basis.

While such a significant change in accounting basis can make it harder to understand how a business is really performing, I believe that the move to IFRS, combined with changes in disclosure we have initiated ourselves, will make it easier to see how we are performing.

Further detail on the changes to IFRS are set out in note 1 – First time adoption of International Financial Reporting Standards. However, I have set out below what I see as the key impacts of the conversion to IFRS and the changes in disclosure we have made.

Firstly, in the balance sheet the main change is the treatment of the pension fund deficit. This change is primarily a matter of accounting presentation. Under UK GAAP the pension deficit was previously disclosed solely in a note to the accounts, whereas under IFRS the deficit is now included in the balance sheet. For Royal & SunAlliance the net of tax pension deficit included in the balance sheet at 31 December 2005 was £370m, down from £544m in 2004.

On the income statement the main change is the treatment of the investment return. We have replaced our previous policy, of using the assumed longer term investment return, with showing the actual investment return earned during the period. This is a simple but significant change. Our profits now reflect what we are actually earning from the investment portfolio. As a consequence of this change, our profit after tax will be less volatile and a much more relevant measure of how we have performed in the year.

In addition, as part of the increased disclosure of IFRS we have set out for the first time, loss development tables in note 20 – Insurance contract liabilities. These show how the claims for each financial year since 2001 have matured and show how we are reserving for our liabilities. The tables will be updated on an annual basis and provide an insight into our claims experience. Finally, two downsides to IFRS are firstly that we can no longer provide a five year financial summary as we are not able to show UK GAAP and IFRS numbers in the same table. Secondly, the statutory disclosure does not provide clear insights into our business, hence we have persisted with a management classification of the financials.

It is worth emphasising that the change to IFRS does not change how the business is run. In terms of monitoring our performance, the key measures are much the same under UK GAAP or IFRS and these are set out in the table below:

Key measure	What does it show?
Net written premiums	The amount of business we are writing
Combined operating ratio (COR)	The margin we are making
Operating result	The underlying profitability of our business
Profit after tax	The final, bottom line result for the period

Financial review

continued

If you would like more detail on the changes to IFRS there are two presentations on our website, www.royalsunalliance.com, in the Investor Relations section, that we gave to the market on the conversion to IFRS at the beginning of 2005.

Other disclosures

We now split the result between the Core Group (UK, International, Scandinavia and Group Re) and the US reflecting the way we manage the Group. This was not part of the conversion to IFRS but is how we look at and manage the business and is, I believe, more helpful in understanding the Group's results.

Results overview

2005 was a very strong year of financial performance for the Group. The table at the bottom of this page sets out the key metrics of the Group's financial performance.

Net written premiums

Net written premiums for the year were £5.4bn, up from £5.1bn in 2004.

As expected and highlighted in last year's report, the largest element of growth during 2005 was the recapture of the Munich Re quota share reinsurance arrangement. From 1 January 2005 this was reduced to nil from 8% in 2004 giving an overall benefit of 6%. The strength of the Group's capital position has allowed us to retain these premiums previously reinsured to Munich Re.

In a competitive environment we have also achieved targeted growth in Canada, Latin America, UK Marine, MORE TH>N® and Scandinavia.

Operating result

Set out in the table below is the operating result for 2005 split between its component parts:

	2005 £m	2004 £m	Movement %
Insurance result			
UK	475	377	26
Scandinavia	180	145	24
International	207	173	20
Group Re	(19)	(9)	(111)
Core Group insurance result	843	686	23
US	(29)	(372)	92
Total Group insurance result	814	314	159
Other activities	(116)	(56)	(107)
Operating result	698	258	171

Core Group

The insurance result for the Core Group is up 23% to £843m, representing a 42% increase in the underwriting result and a 16% increase in the investment result, with all regions improving. The split of the Core Group by both premiums and earnings is broadly 50% UK, and 25% each from Scandinavia and International, reflecting the balanced nature of our portfolio. The Core Group delivered an underlying return on equity of 21.6%, 3.9 points better than 2004.

This Core Group result has been achieved against the background of a mixed rating environment and significant weather losses, particularly in International. This result has also been achieved

	Core Group		US		Total	
	2005	2004	2005	2004	2005	2004
Net written premiums	£5.3bn	£5.0bn	£0.1bn	£0.1bn	£5.4bn	£5.1bn
Underwriting result	£263m	£185m	£(145)m	£(462)m	£118m	£(277)m
Insurance result	£843m	£686m	£(29)m	£(372)m	£814m	£314m
Operating result	£743m	£623m	£(45)m	£(365)m	£698m	£258m
Profit/(loss) after tax	£635m	£312m	£(30)m	£(392)m	£605m	£(80)m
Shareholders' funds	£2.3bn	£1.9bn	£0.4bn	£0.4bn	£2.7bn	£2.3bn

whilst we continued to significantly strengthen the Core Group's reserves.

The benefits of our prudent reserving policy and the actions we have taken over the last three years can be seen in both the positive prior year run off and current year underwriting profits.

The investment result of £580m is up 16%, predominantly due to a 12% growth in investment income. This growth reflects the increase in the average invested funds in the Core Group, which are up £1.4bn to £12.6bn, reflecting the positive cashflows and the proceeds of the sale of the Group's life businesses and the issue of the sterling subordinated debt. The yield on this portfolio stayed constant at just under 4%. Realised gains of £109m are broadly in line with prior year and included the disposals of previously occupied Group properties in France and Dublin.

US

There has been a significant reduction in the insurance losses incurred by the US operation from £372m for 2004, to £29m for 2005. The underwriting result has improved by £317m to a loss of £145m as management actions continue to take effect. Investment income in the US has benefited from a pick up in yields from 3.3% to 4.2%.

In the fourth quarter of 2005, the insurance result for the US operation was a profit of £3m. Whilst there are a number of uncertainties within the US operation, on a business as usual basis, we would expect the US insurance result to achieve broadly breakeven during 2006.

The US result included 10 months of profits from the Nonstandard Auto business prior to its sale in November.

Other activities

Other activities predominantly comprise the central Group expenses and the investment expenses and charges. In 2005 the central expenses were £82m compared with £86m in 2004. Both years include approximately £13m relating to the costs of implementing IFRS, Sarbanes Oxley and the Prudential Sourcebook. Whilst we will continue to incur costs relating to these projects we anticipate them reducing from the 2005 levels.

Under IFRS, the movement in non insurance derivatives is also included in Other Activities. The 2004 result included a £75m positive contribution from these contracts. We have since exited the majority of these contracts and the net impact in 2005 is a benefit of £8m.

Profit after tax

Profit after tax of £605m shows a significant improvement over the £80m loss in 2004. This predominantly reflects the improvement in the operating result, a number of disposals and the impact of the change in the pension scheme design.

The table below sets out a reconciliation of operating result to profit after tax:

	2005 £m	2004 £m	Movement %
Operating result	698	258	171
Total interest costs	(107)	(75)	(43)
Amortisation	(17)	(22)	23
Reorganisation costs	(86)	(118)	(27)
Benefit from change in pension scheme design	180	—	—
Profit/(loss) on disposals	197	(109)	—
Discontinued life	—	104	—
Profit before tax*	865	38	—
Taxation	(260)	(118)	(120)
Profit after tax	605	(80)	—

*Profit before tax is shown on a management basis. Profit before tax on a statutory basis is shown on page 54.

Under IFRS, the interest costs on all of the Group's senior and subordinated debt is included below the operating result. The cost of £107m is an increase of £32m over 2004. This predominantly reflects the additional interest paid on the new subordinated debt raised in July 2004 plus the fact that in 2004 this debt and related interest was recognised in equity under International Accounting Standard 32. Following a change in the terms of the debt this has been reclassified and is recognised as debt for 2005.

Amortisation under IFRS is for software assets and goodwill on acquired claims provisions and this charge was £17m in 2005 compared with £22m in 2004.

Financial review

continued

Reorganisation costs relate to the costs of implementing the operating improvement programme and the restructure of the US operation. The charge for 2005 of £86m was £32m lower than 2004 reflecting lower redundancies and premises closure costs.

The profit on disposal of £197m (2004: £(109m)) includes to the disposals of the Japanese operation (£59m), our stake in Rothschilds (£62m) and the Nonstandard Auto business in the US (£71m).

The profit after tax also benefited from a one off credit of £180m relating to the change in the design of the two main UK defined benefit pension schemes. This is explained in more detail in the pension fund section later in this report.

The 2004 profit after tax also reflects the results from our life operations disposed of during the second half of 2004.

And finally, the tax charge of £260m reflects an effective rate of 29% for the Core Group and no tax relief on the US losses.

Financial strength

The overall financial position of the Group continues to be strengthened with further action taken during 2005 on the balance sheet, capital position, pension fund deficit and the Group's credit rating. The following section discusses these actions as well as the Group's investment policy.

Balance sheet

The strength of the Group's balance sheet and capital position has further improved during 2005, capitalising on the good work already done in 2003 and 2004.

Shareholders' funds for the Group has risen by 18% to £2.7bn at 31 December 2005. This reflects a 21% increase in shareholders' funds for the Core Group to £2.3bn, whilst the value of the US business remained stable at £0.4bn.

The improvement in the Core Group shareholders' funds reflects the increase in retained profits and the positive impact of the pension fund changes. We have also strengthened reserves during the year and reserves for the Core Group are now over 200% of net earned premium.

Investment policy

The Group continues to operate a low risk investment policy. In accordance with this policy the structure of the investment portfolio remains dominated by high quality fixed income and cash assets which, when combined with equity and property, are held to provide a broad match to the duration of our insurance liabilities.

Group investments now total £15.6bn. In line with our investment policy, £11.6bn or 74% of this is invested in bonds. Bond holdings are typically of a relatively short term to maturity, with the average duration of the portfolio being just under three years, reflecting the short tail nature of the Group's insurance portfolio. 81% of the fixed interest portfolio was invested in AA grade or better assets and less than 1% is held in non investment grade.

The Group's holding in equities has remained stable for a number of years with approximately £1.7bn or 11% of the Group's investment portfolio invested in equities. We do not envisage any significant change to the Group's investment strategy.

Capital position

As I discussed in last year's report, there were a number of regulatory changes that came into effect from 1 January 2005. We were fully compliant with the FSA's new capital requirements on introduction and have strengthened our position further during the year.

For the Group, compliance with the Insurance Groups Directive (IGD) is one of the main requirements. As at 31 December 2005, the Group had surplus capital of approximately £1.0bn on the IGD basis, an increase of £0.4bn in the year. This surplus gives a coverage ratio of 1.6 times the requirement.

We are comfortable with the level of capital and have sufficient capital to deliver our operational plans.

The other principal capital measure for the Group is the Individual Capital Assessment (ICA). In accordance with the new Prudential requirements we have satisfactorily agreed our ICA with the FSA, which at their request, and in common with the rest of the industry, remains confidential. The ICA is a forward

looking, economic assessment of the capital requirements of the Group based on our assessment of the risks that we are exposed to. The models used to determine the ICA have been integrated into the Group's business processes and are used to enhance the management of the Group.

We continue to push forward with a number of ongoing initiatives targeted at improving balance sheet and capital efficiency. We have successfully renegotiated our senior debt facility on better terms and conditions, shorter duration and at a lower cost. We have also repaid the senior debt in full.

We are streamlining the Group's regulatory structure and reducing legal entities. We are also looking at ways to improve the capital efficiency of some of our discontinued lines of business.

Pension fund

As I have already mentioned, under IFRS the Group has to recognise the pension fund deficit on the balance sheet. At 31 December 2005 the net of tax pension fund deficit has been reduced by £174m to £370m reflecting a number of actions taken by the management team.

Set out below is a table which shows the main movements in the net of tax pension fund deficit during 2005:

£m	Core Group		US	Total
	UK	Other		
As at 1 January 2005	(370)	(23)	(151)	(544)
Market movement, exchange and other	(27)	(5)	(6)	(38)
Scheme design	126	—	—	126
Deficit funding	60	—	26	86
As at 31 December 2005	(211)	(28)	(131)	(370)

In July 2005, we announced some significant changes to our main UK pension schemes. Following discussions with staff and unions, it was agreed that the schemes would be changed from being based on final salary to ones based on average career earnings. The impact of this change was to reduce the UK pension fund deficit by £180m gross of tax (£126m net of tax).

In addition, the Group also replaced its UK deficit funding plan with an accelerated programme. Under this programme, the Group contributed £86m gross of tax (£60m net of tax) in 2005 and has committed to contribute the same amount in each of 2006 and 2007.

Action has also been taken to reduce the impact of future interest rate and inflation movements on the pension fund. The pension funds will, however, remain subject to short term market movements.

Rating agencies

Rating agencies such as Standard & Poor's (S&P), AM Best and Moody's Investor Service provide insurer financial strength ratings for the Group and its principal subsidiaries. These ratings are based on both quantitative and qualitative assessments of the Group's current position and future direction.

During 2005, the ratings from S&P and AM Best remain unchanged at A- (stable) and A- (negative) respectively. In March 2006, Moody's upgraded their outlook for the Group from Baa1 (stable) to Baa1 (positive).

We are committed to returning the Group's rating with all of the major agencies to 'A'.

Details of the Group's ratings can be found in the Investor Relations section under Bond Investor Information on the Group's website www.royalsunalliance.com.

Summary

We have come a long way in the last 24 months. 2005 has been a good year for the Group with strong financial results and a healthy balance sheet and capital position.

The Group has sufficient capital to meet its strategic objectives of sustainable earnings, targeted profitable growth and continuous operational excellence.

Corporate Responsibility

During 2005 we have made good progress and been active in ensuring that we are delivering on our stakeholder commitments.

At Royal & SunAlliance (R&SA), Corporate Responsibility is about how we interact with our stakeholders. During 2005 we have further clarified what this means for us in terms of our Business Principles and how they translate into commitments that relate to our key stakeholder groups: customers, employees, business partners, regulators, shareholders, community and the environment.

Our Principles were revised and updated during the year and provide guidance for employees on general business practice in terms of each stakeholder group. They link to our Group policies, embedding them into business behaviour, and form part of our broader risk and governance framework. Further details on these Principles and a detailed report on our Corporate Responsibility (CR) performance can be found on our website: www.royalsunalliance.com.

Employees

Employees are encouraged to take accountability and responsibility for their own actions in an environment where we promote teamwork and strong leadership. We expect a lot from the people we employ and in return we offer them structured personal development opportunities and reward and recognition linked to performance. Over 80% of employees now have a significant proportion of their pay directly related to their personal performance, up from 15% in 2003. Our target is 90% by the end of 2006.

We seek regular feedback from staff, including an annual global survey which provides an important insight into working at R&SA.

Overall satisfaction improved by 2% in 2005. The results from across the Group show that employees feel we are making strong improvements, particularly in areas such as delivery on business results. Employees also registered a strong improvement in how we deliver for our customers, demonstrating that our focus on putting the customer at the centre of everything we do is becoming embedded.

Customers

Our commitments include communicating openly with customers and providing reliable levels of service, whether it is a new business enquiry, renewal, claim or complaint. We regularly benchmark our customer management performance using an external model. Our main operations are assessed against a cross industry database that contains 260 aspects of best practice in relation to customer management. This process provides opportunities to share best practice across the Group and gives us a better understanding of how we are responding to our customers, enabling us to improve retention of valued customers as well as attracting new ones. During the year our focus on retention has seen Groupwide improvements.

Responding efficiently to claims is critical to providing a high level of customer service, particularly in times of emergency. 2005 provided some challenging opportunities for us to demonstrate how well we can deliver, including the European windstorm in January that led to flooding in the UK and Scandinavia. Our claims excellence extends across the Group. In Scandinavia we have invested in technology to improve the efficiency and transparency

Through our CR programme, we have taken a range of actions on important issues including investment in flood defences and social exclusion.

of our claims handling. We have introduced an innovative online system that sends automatic updates on progress of claims and allows customers to track their claim at any time, day or night. This keeps customers regularly informed at what can be a stressful time for them, while reducing administration costs for the business.

Ensuring complaints are resolved promptly is also key. In the UK, we participate in the annual benchmarking survey on complaints handling conducted by the Association of British Insurers. In 2005 our performance was assessed as upper quartile across all categories. We make use of customer feedback on our processes and products to maintain and improve this performance.

Environment

We are also investing in technology that will help customers to better manage their own risks. A web based service, co funded by R&SA, was launched in December. The tool, EuroTempest, improves our ability to predict windstorms and provide pre-emptive advice to customers. It provides local damage forecasts from windstorms down to postcode level for seven European countries, including the UK, up to five days in advance (<http://et.mssl.ucl.ac.uk>). It complements another tool that we have supported for a number of years, Tropical Storm Risk, which predicts tropical storm activity worldwide.

In the UK, through our Geographical Risk Analysis tool we also have a detailed understanding of flood risk mapping at an individual property level which enables us to set premiums based on the true risk that each home represents. It has also enabled us to take a lead in the broader policy debate on flood issues. In November, we issued a Flood report highlighting our concerns regarding future flood risk in the UK, calling for appropriate spending on flood defences and underlining the need for flood risk to be factored into new build schemes.

In addition to being actively involved in environmental issues through our products and services, we monitor our own direct environmental impacts and seek to improve our performance. Details of our performance and further discussion on environmental issues can be found in our CR report.

Community

In addition to flood risk we are active in a number of other areas. In relation to road safety a new product, Drive for Life, was launched in Canada which provides reduced premiums for young drivers that have undergone safety training in a driving simulator. The training improves their skills and results in fewer accidents.

We are also actively involved in addressing the issue of social exclusion. Insurance offers security and peace of mind and access to affordable insurance is a key issue. In the UK, we have been at the forefront of providing affordable social housing insurance for over 15 years and in 2005 we commissioned a report, 'Widening the Safety Net' to stimulate debate in this area. The report calls for greater access to insurance for socially excluded groups and provides recommendations on how insurers and local partners can work together to widen access. More details on this and other CR initiatives can be found on our website (www.royalsun.com/royalsun/corpres).

We have active community engagement programmes in operation across the Group. Examples include, road safety in Canada, water safety in Sweden, working with the Samaritans in the UK, the Red Cross in Ireland and the provision of tailored products for rural customers in India.

Responsible investment

Our responsibility to stakeholders extends beyond managing day to day business activities and covers management of Company assets. Our UK assets are managed by F&C Asset Management who apply their proprietary 'reo®' methodology (responsible engagement overlay) across our portfolios to encourage companies to manage social, ethical and environmental (SEE) risks. We receive regular feedback on which companies they have engaged with.

We have made progress against our CR objectives but recognise that there is more to do. For a more detailed review of our CR performance and details of our approach going forward, please refer to the separate CR report.

Only five months after floods in Boscastle, a fierce windstorm hit Europe in January. By monitoring the weather we were able to anticipate the worst hit areas and in Carlisle we were the first insurer to have our in house loss adjusters on the ground, proactively contacting customers to provide assistance where needed. In Sweden and Denmark, additional claims personnel were made available to enable us to handle the rise in call volumes which increased by over 1000% at their peak.

Share and shareholder analysis

Royal & SunAlliance is listed on both the London Stock Exchange and the New York Stock Exchange, in each case under the code RSA. On the New York Stock Exchange, the stock is traded in the form of American Depositary Shares (ADSs) each of which represents, in dollar denomination, five ordinary Sterling issue shares.

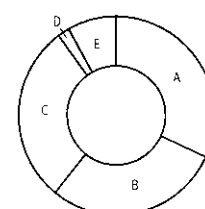
The average total daily trading volume on the London Stock Exchange during 2005 was approximately 27.4m ordinary shares.

The opening market price on 4 January 2005 was 77.5p and closing market price on 30 December 2005 was 125.75p. The highest daily closing price was 126.75p on 29 December 2005 and the lowest daily closing price was 73.5p on 11 May 2005.

Further details of the ordinary and preference shares are found in note 18 on page 81.

Dividend per ordinary share (after adjusting for the 2003 Rights Issue)

	Annual dividend			Change %
	Interim p	Final p	Total p	
2001	7.11	5.81	12.92	(38.5)
2002	3.23	1.62	4.85	(62.5)
2003	1.62	2.90	4.52	(7.5)
2004	1.65	2.96	4.61	2.4
2005	1.69	3.05	4.74	2.8

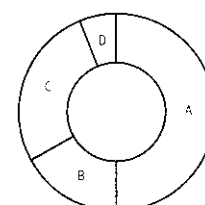


Analysis of UK investors

A Pensions **32%**
B Life **29%**
C Unit Trusts **29%**
D Investment Trusts **2%**
E Others **8%**

Shareholdings by size

Grouping	Shareholders	%	Shares	%
1 – 24,999	55,062	97.46	130.2m	4.44
25,000 – 99,999	801	1.42	36.5m	1.24
100,000 – 499,999	297	0.52	73.9m	2.52
500,000 – 999,999	90	0.16	65.1m	2.22
1,000,000 – 1,999,999	90	0.16	133.2m	4.54
more than 2,000,000	155	0.27	2,496.2m	85.04
Total	56,495	100	2,935.1m	100



Distribution of shares by geography

A UK **50%**
B Europe **17%**
C USA and Canada (incorp ADSs) **27%**
D Asia and Others **6%**

Executive Team

Andy Haste[£] Group CEO
George Culmer[£] Chief Financial Officer
Bridget McIntyre[£] UK Chief Executive
David Paige[£] Group Risk Director
Mark Chambers General Counsel and Group Company Secretary
Jens Erik Christensen Chief Executive, Scandinavia

Tony Latham Group Director, Global Relationships
Simon Lee Chief Executive, International Businesses
Neil Macmillan Group Chief Auditor
Andy Nelson Group Director, Strategic Change & IS
John Tighe President & CEO, Royal & SunAlliance USA
Paul Whittaker Group Human Resources Director

[£] = Executive Director

Board of Directors

John Napier

Andy Haste

George Culmer

Noel Harwerth

Edward Lea

Malcolm Le May

John Maxwell

David Paige

Bridget McIntyre

John Napier^{R,1} Age 63. Director of the Group from January 2003 and Chairman of the Group from March 2003. Chairman of the Nomination Committee from March 2003. Non-executive Chairman of Kelda Group plc (water utility). Former Executive Chairman and Chief Executive of Kelda Group plc. Former Chairman of Booker plc (cash and carry). Former Managing Director of Hays plc (business services) from 1991 to 1998. Former Managing Director of AGB plc (international market research and information services).

Andy Haste^{E,1} Age 44. Director and Group Chief Executive from April 2003. Former Chief Executive of AXA Sun Life plc and director of AXA UK plc (life and pensions). Former President and Chief Executive Officer of Global Consumer Finance Europe at GE Capital UK, Western Europe and Eastern Europe (financial services). Former President of National Westminster Bank's US Consumer Credit Business (retail banking).

George Culmer^{E,1} Age 43. Chief Financial Officer and Director of the Group from May 2004. Previously Head of Capital Management Zurich Financial Services (insurance).

Noel Harwerth^{A,1} Age 58. Director of the Group from March 2004. Director of Corus Group plc, Tube Lines Limited, Metronet Rail SSL Limited and Metronet Rail BCV Limited (transport). Deputy Chairman of Sumitomo Mitsui Banking Corporation Europe Limited (finance). Former Chief Operating Officer of Citibank International plc (finance).

Edward Lea^{A,R,1} Age 64. Director of the Group from July 2003. Chairman of the Group Audit Committee from October 2003. Director Redbourn Group plc (property management and investment). Director of IDC Plugs Limited (electrical services). Director of MacIntyre Care (charity). Previously a director of The British United Provident Association (BUPA).

Malcolm Le May^{R,1} Age 48. Director of the Group from March 2004. President Europe JER Partners Limited (Europe) (property investment). Former Deputy Chief Executive Morley Fund Management (Investment Fund Manager). Former Deputy CEO of ING-Barings (finance).

John Maxwell^{A,R,N,1} Age 61. Director of the Group from July 2003. Chairman of the Remuneration Committee from October 2003. Chairman of DX Services plc (mail). Director of Provident Financial plc (financial services). Director of Homeserve plc (support services). Governor of the Royal Ballet School. Chairman of the Institute of Advanced Motorists. Previously an executive director of Prudential Group plc. Previously Director General (Chief Executive Officer) of The Automobile Association Limited.

David Paige^{E,1} Age 54. Group Risk Director from February 2005. Former Global Finance Transformation Programme Director and former Group Risk & Audit Director Aviva plc (insurance). Former Group Risk Director Zurich Financial Services (insurance). Former Chief Financial Officer of retail business, National Westminster Bank plc (banking).

Bridget McIntyre^E Age 44. UK Chief Executive and Director of the Group from November 2005. Former Director of Sales, Marketing and Underwriting at Norwich Union (insurance).

^E = Executive director

^A = Member of Group Audit Committee

^N = Member of Nomination Committee

^R = Member of Remuneration Committee

¹ = Member of Investment Committee

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Directors' Report

The directors of Royal & Sun Alliance Insurance Group plc present their report and the audited financial statements of the Company for the year ended 31 December 2005.

Principal activity

The Company is the holding company of the Royal & SunAlliance Group of companies (the Group) whose principal activity is the transaction of personal and commercial general insurance business. The Group operates in 27 countries.

Review of the year and future developments

These are outlined in the Chairman's Statement and Group CEO's Review and the Operating Review beginning on page 4. The Group consolidated financial statements are shown on pages 54 to 57.

Dividends

The directors recommend a final dividend of 3.05p per share which, if approved, will be due for payment on 2 June 2006 to holders of ordinary shares on the register at the close of business on 17 March 2006. This, together with the interim dividend of 1.69p per share, will make a total dividend for the year of 4.74p per share.

The preferential dividend at the rate of 3.6875% for the period from 1 October 2005 to 31 March 2006 is to be paid on 3 April 2006 to holders of preference shares on the register at the close of business on 17 March 2006.

Employment policy

The Group's employment policy reflects our belief that motivated and skilled employees are critical to our success.

We promote equal opportunities and diversity across the Group. This involves recruiting, retaining, rewarding and developing people solely on the grounds of ability to do the job, and establishing and promoting a working environment which is free from discrimination.

The Group is committed to preventing discrimination on the grounds of disability. This includes ensuring that all job applicants, including those with a disability, are considered solely on the basis of ability to do the job, and making reasonable adjustments to working environment, working arrangements and working conditions to support disabled employees. We are committed, wherever possible, to supporting the rehabilitation and return to work of employees who become disabled during their career with us.

The Group is committed to fostering a constructive dialogue with independent trade unions wherever they are recognised, ensuring a regular and constructive dialogue on business issues and early consultation on changes affecting the workforce. In the UK, Amicus is formally recognised through a partnership agreement which covers collective consultation and bargaining on behalf of non management employees. The Management Association (TMA) represents managerial employees under a separate consultative agreement. In June 2005, 19 elected delegates from our European businesses attended the annual European Consultative Forum (ECF), which is a cross European body created to enable information sharing and consultation on transnational issues with the European workforce. In 2005, an amended ECF constitution was agreed which introduced streamlined consultation arrangements.

The Group continues to focus on the development of employees in order that they can deliver high levels of performance. In 2005 a particular focus has been the further development of the Executive Development Programme (EDP), a global programme which aims to accelerate the development of our in house executive talent. The EDP has been designed to support those who have the potential to take on Executive Team or direct report to Executive Team roles in the future, thus ensuring that we build a pipeline of strategic leadership capability within the business.

The web based Global Employee Survey was run for the first time in 2004 and repeated in 2005. In 2005, 91% of eligible employees took the opportunity to contribute. Our aim is to consistently seek feedback on the environment we are creating as an employer and to work constructively towards our objective of becoming an employer of choice. Our intention is to repeat this survey annually, to ensure we have a current picture of employees' views and also to track year on year movement in particular areas of priority. In this way, by asking our employees, we measure how the culture of our business is changing. For example, in 2005 we have seen a significant improvement in the proportion of employees who responded positively to the statement 'The better my performance, the better my pay will be'. We believe we can create real competitive advantage by building and maintaining a high performance culture across the Group. As in 2004, we have used the 2005 results to build a Groupwide action plan which requires every manager to identify and work on areas of particular importance to their team.

Our policy is to encourage employee share ownership. Employees from the majority of our global businesses are encouraged to participate in the International Sharesave Plan which is an Inland Revenue approved all employee sharesave scheme.

Employees are kept well informed of the performance and objectives of the Group.

The Group actively encourages employees to become involved in supporting their local communities. Further details are provided in the Corporate Responsibility section of this report on page 32.

Environmental policy

Details of our environmental policy can be found on our website at www.royalsunalliance.com.

Corporate governance

A report on corporate governance appears on pages 39 to 43.

Supplier payment policy

It is the Group's policy to agree appropriate terms and conditions in advance with its suppliers and to make payment in accordance with those terms and conditions, provided that the supplier has complied with them. In most cases, agreements for the supply of goods or services are made under standard terms of contract that lay down payment terms. In the UK these are available on request from UK Purchasing, Leadenhall Court, 1 Leadenhall Street, London EC3V 1PP.

The Company's outstanding indebtedness to trade creditors on 31 December 2005 amounted to £2,719,448 corresponding to 12 days' payment when averaged over the year.

Directors' Report

continued

Share capital

During the year, 2,137,513 ordinary shares of 27.5p each were issued in satisfaction of the exercise of employee share options for a total consideration of £2m, and 20,661,210 ordinary shares of 27.5p each were issued under the Company's scrip dividend scheme for a total consideration of £20m. An authority from the shareholders for the Company to purchase up to 291,236,359 of its own ordinary shares (representing 10% of its issued share capital as at 9 March 2005) remained in force at 31 December 2005.

Substantial share interests

As at 8 March 2006, Brandes Investment Partners LLC and Legal & General Group plc had declared an interest in ordinary shares of 27.5p each in the Company representing 6.7% and 3.2% respectively of the issued ordinary share capital, in accordance with Part VI of the Companies Act 1985.

Directors

Members of the Board of Directors are listed on page 35.

David Paige was appointed to the Board on 16 February 2005.

Bridget McIntyre was appointed to the Board on 2 November 2005.

At the 2006 Annual General Meeting Bridget McIntyre will be eligible for reappointment under Article 110. John Napier and Andy Haste will retire by rotation under Article 106 and, being eligible, offer themselves for re-election.

Related party transactions

Related party transactions are set out in note 34 on page 111.

Charitable and political contributions

The Company and its subsidiaries worldwide made charitable donations of £744,412 during the year. The largest donation of £250,000 was made to the Samaritans Partnership. The Group did not make any donations to European Union (EU) political parties, nor to political parties outside the EU during 2005, and it is not the Group's policy to do so.

Annual General Meeting

The Annual General Meeting will be held at the Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE on Monday 22 May 2006 at 11.00 am.

Enclosed with this report is a letter from the Chairman to shareholders. Attached to the letter is the Notice convening the meeting which will include items of ordinary and special business that are explained in the letter.

Auditors

PricewaterhouseCoopers LLP have confirmed their willingness to continue in office as auditors of the Company and a resolution for their reappointment will be proposed at the Annual General Meeting.

By order of the directors

Mark R Chambers

General Counsel and Group Company Secretary
London

8 March 2006



Corporate Governance

Compliance with the provisions of the Combined Code

The Group complied throughout 2005 with the Principles and Provisions of section 1 of the new Combined Code and with the Schedules except with respect to:

- The appointment of a senior independent director (Provision A.3.3),
- A majority of independent directors on the Nomination Committee (Provision A.4.1).

The required explanation for these exceptions is the significant restructuring of the Board in recent years, the relative size of the Board and the high frequency of meetings. All non-executive directors are encouraged to communicate directly with executive directors outside formal meetings and an active dialogue is maintained by the Board on ongoing issues. The non-executive directors have a unanimous view that the appointment of a senior independent director is not required at this time. Notwithstanding the composition of the Nomination Committee, all non-executive directors would be involved in any process for the appointment of an additional independent director.

Sarbanes Oxley

The Group is required to comply with the Sarbanes Oxley Act 2002 as a result of its listing on the New York Stock Exchange. An internal programme established in 2003 to ensure compliance and to embed controls in the business is nearing completion.

The Group has placed on its website www.royalsunalliance.com a general summary of the significant ways in which the Group's corporate governance differs from that followed by domestic US companies under the New York Stock Exchange's listing rules.

The Board

The Board is responsible for organising and directing the affairs of the Company and the Group in a manner that is in the best interests of the shareholders, meets legal and regulatory requirements and is also consistent with good corporate governance practices. There is a formal document setting out the way in which the Board operates.

The Board is also ultimately responsible to the Financial Services Authority (FSA) for ensuring compliance with the Group's UK regulatory obligations.

The principal matters reserved to the Board include:

- Approval of the Group's long term objectives and commercial strategy,
- Approval of changes to the Group's senior management structure,
- Approval of the Group's overall risk appetite,
- Annual review of the effectiveness of internal control arrangements,
- Approval of the annual operating and capital budgets,
- Changes to the Group's capital structure,
- Approval of the Group's financial results and any significant changes to accounting practices or policies.

The division of responsibilities between John Napier, the Chairman, and Andy Haste, the Group CEO, has been clearly established by way of written role statements, which have been approved by the Board.

The Chairman's main responsibilities are to lead the Board, liaising as necessary with the Group CEO on developments between meetings of the Board, and to ensure that the Group CEO and his executive management team have appropriate objectives and that their performance against those objectives is reviewed.

The Group CEO is responsible to the Board for the executive management of the Group and for liaising with the Chairman and keeping him informed on all material matters.

The Group's Delegated Authority Policy specifies how executive authority is delegated from the Board to the Group CEO and then on to the other executives in the Group. Individual executive licences issued by the Group CEO to each of his direct reports set out their specific limits of authority in terms of entering into financial, underwriting and other business commitments. Each direct report is responsible for ensuring a similar process of delegation is in place within their area of responsibility.

The Articles of Association of the Company require directors to submit themselves for reappointment at the first Annual General Meeting after their appointment and for re-election every three years thereafter. The Board met 12 times during 2005. In addition, there were five occasions when directors met as a Committee of the Board in order to authorise transactions already agreed in principle at Board meetings. On those occasions a quorum of two directors was required.

Directors

Biographical details of all current directors can be found on page 35. The appointments of David Paige and Bridget McIntyre as executive directors, with effect from 16 February 2005 and 2 November 2005 respectively, were announced during the year.

In seeking new directors, the Chairman and the Nomination Committee have had regard to the size of the Board and the balance of executive and non-executive directors as well as of the skills and experience which are already represented and those which would be desirable on the Board going forward.

Attendance at meetings of the Board and the Group Audit, Nomination and Remuneration Committees is shown in the table on page 43.

In 2005 the Board undertook a formal evaluation of its performance and of all of its committees, as well as an appraisal of the Chairman's performance and that of the individual directors. This included the use of a comprehensive questionnaire.

At all times during the year, at least half of the Board was comprised of non-executive directors.

The Chairman meets regularly with the non-executive directors both individually and collectively without the executive directors.

The Board considers that all of the non-executive directors who have served during the year were independent.

The Chairman met the independence criteria in the Combined Code on his appointment in 2003. There have been no changes to his external commitments since then which might affect his responsibilities to the Group. None of the executive directors are on the board of another FTSE 100 company.

Corporate Governance

continued

Non-executive directors are aware that they have to report any change in their circumstances or those of the members of their families that might lead to the Board reconsidering whether they are independent. Directors are also aware that they have to make the Board aware of any conflict of interest they might have in respect of any item of business and absent themselves from consideration of any such matter.

Directors have the right to have their concerns about the running of the Company minuted and documented in a written statement on resignation.

The Company has arranged appropriate insurance cover in respect of legal action against its directors and officers.

Professional development and training

On appointment, new directors are subject to a formal induction programme and receive training and guidance on their duties and responsibilities. Continuing professional development is offered to all directors and the Board is given guidance on developments.

Resources

Directors have access to the services and advice of the General Counsel and Group Company Secretary, and may take additional independent professional advice at the Group's expense in furtherance of their duties.

Corporate Governance Framework

The Group's Corporate Governance Framework describes and prescribes how the Group is directed and managed by setting out the matters reserved for the Board, the terms of reference of Board and management committees, role statements, policies, systems, procedures and controls.

Committees

Details of the chairmen and membership of the Group Audit, Nomination, Remuneration and Investment Committees are set out in the table on page 43 together with details of attendance at meetings.

The Investment Committee meets twice a year, now under the chairmanship of Malcom Le May. All non-executive directors are members of the Committee, which assists the Board in setting the Group's investment strategy and monitors the execution of that strategy and the Group's investment performance.

The Board Risk Committee was chaired by Andy Haste until February 2005. David Paige, the Group Risk Director, assumed the role of Chairman of the Committee with effect from March 2005. This Committee oversees all aspects of risk faced by the Group in accordance with the Board approved risk appetite, which is set out in policies, control limits and other mechanisms in relation to such risks.

The Board Risk Committee, which meets quarterly, comprises the executive directors with other executive management as regular attendees. Its purposes include: defining the Group's risk appetite prior to approval by the Board; approval of policy and minimum standards that are consistent with the appetite; ensuring that risks that are outside the appetite are mitigated in an appropriate manner; and overseeing and challenging the Group's risk management processes. The Committee achieves these objectives by considering reports from risk specialists both internal and external to the Group, and by reviewing Group level risk management information.

Risk management and internal control

The Board has overall responsibility for the Group's systems of risk management and internal control and for reviewing their effectiveness

at least annually. The systems are designed to manage, rather than eliminate, the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material financial misstatement or loss.

Executive management has the responsibility for establishing and implementing appropriate systems and controls in their own areas of remit. The Group Risk Management Framework provides the mechanism through which risk management and control is embedded throughout the Group. Each business is required to follow a consistent process to identify, assess, manage and monitor their key risks. A central risk management function (the Group Risk function) oversees this process and reports progress to the Board Risk Committee and Group Audit Committee.

Group risk appetite

The Group has established a statement of 'Group risk appetite' which sets business volumes for certain higher risk insurance classes, stipulates loss retention limits, reinsurance protection, targets for credit rating and solvency margins, and other appropriate measures. There is a formal escalation process for potential or emerging risks that are outside the risk appetite.

Further work was carried out during 2005 to integrate the capital and risk management frameworks and enable the Group to measure, on a consistent basis, the relative risk of its operations worldwide and to allocate capital on the basis of an assessment of risk and return.

Risk framework

The Group has continued to adopt the risk management model known as the 'three lines of defence' governance model. The framework for the oversight and management of risk is as follows:

- Management – the first line of defence, in setting strategy, performance, measurement, establishment and maintenance of internal control and risk management in the business,
- Risk assessment – the second line, operating a formal risk management framework within which the Group policies and minimum standards are set and objective oversight and challenge of risk management across the Group is achieved. This includes the Board Risk Committee, supported by the Group Risk function and a Groupwide network of regional risk committees,
- Independent assurance – the third line of defence, providing independent and objective assurance of the effectiveness of the Group's systems of internal control established by the first and second lines of defence. This is the Group Audit Committee, supported by Group Internal Audit.

Group risk policy statements

Group risk policy statements set out the minimum standards to be maintained by the Group's operations in order to manage their risks in a way that is consistent with the risk appetite. Business managers are responsible for complying with Group and local risk policies and for managing risk by taking mitigating actions where risks are outside the appetite. The Board Risk Committee's oversight and challenge role includes consideration of risk mitigation.

Policy statements are drafted by Group Risk in consultation with regional business units and approved by the Board Risk Committee.

They are mandatory policies that business units must comply with unless they obtain approval for a variation of or dispensation from a particular requirement. Breaches that are identified by Regions, or through monitoring activity, must be escalated to the appropriate level, with material breaches being reported to the Committee. Processes are in place to keep policies under review in order to reflect changes in circumstances and the risk appetite. Accompanying these policies there are a number of detailed documents setting out best practice in key areas.

Risk categories

Within the Group the risk elements are viewed under the following headings, which broadly correspond to headings used in the Financial Services Authority's Integrated Prudential Sourcebook (PRU):

- Insurance (underwriting and claims) risk,
- Reinsurance risk,
- Operational risk,
- Credit, market and liquidity risk,
- Regulatory risk.

Additional information is provided in note 28.

We also take account of strategy risk and of the contagion risk, whether financial, operational or reputational, faced by individual entities as a result of being members of the Group.

The following details some of the key current practices, tools and other arrangements for each risk category.

Insurance risk

The Group's general insurance activities are primarily concerned with the pricing, acceptance and management of risks arising from our contracts with customers. The management of the underwriting and claims risks uses a number of key tools, including territorial underwriting licences that authorise countries to write certain higher risk classes of business, reviewing the performance and management of all the individual insurance portfolios throughout the Group and the investigation of potential emerging insurance risks. We are continuously improving the oversight, and tools in support of it, in this area to ensure that we remain in control of our insurance business and the risks within it.

Claims development and reserving levels are closely monitored by Reserve Committees. Each Region's Reserve Committee determines a recommended level of outstanding claims reserves, the recommendations of which are determined in accordance with the Group Reserving Policy. The Group Reserve Committee then consider these recommendations before determining the final level of outstanding claims reserves to be carried by each Region and consequently by the Group in aggregate.

Reinsurance risk

The Group's reinsurance strategy and appetite are set and agreed by the Board Risk Committee and published and disseminated via the Group reinsurance policy statement. The Group Reinsurance Credit Committee oversees the implementation of the counterparty credit aspects of this strategy.

A combined Group and UK reinsurance team monitors and controls reinsurance activity throughout the Group, and has responsibility for the purchase of the Group's worldwide programme of treaties.

All major treaty purchases are analysed using various sophisticated modelling tools to ensure that the level of cover purchased is capital efficient and aligned with Group risk appetite and strategy.

Operational risk

Operational risk exists in every facet of the organisation, including those areas that are not viewed as 'operating units'. As such, all areas of the Group and its major outsourcing providers are involved in addressing and controlling operational risk.

The Group uses a suite of risk tools to help manage operational risk using a common categorisation of risk. These tools include Risk and Control Self Assessments, Key Risk Indicators, Scenario Analyses, Incident Management and Loss Data.

Risk and Control Self Assessments are undertaken on a regular basis as part of the Business Risk Assessment Process. This is a Groupwide risk assessment process and has three main elements: high level risk assessments, which review risks from the 'top down'; 'bottom up' risk self assessments; and external events and material change assessments, which assess risks during times of significant change to the organisation, infrastructure and business operating environment.

A series of forward looking key risk indicators are used to assess potential future trends in operational risks, whilst data collected on actual operational risk incidents and 'near misses' captures past experiences. In addition, the use of scenario analyses enables the Group to assess whether certain operational events that have occurred elsewhere could manifest themselves within the Group. When taken together, the tools provide a complementary set of indicators of the Group's operational risk profile.

Credit, market and liquidity risks

The primary sources of credit risk within the Group are investment and treasury activities and reinsurance counterparty risk. Within the investment management and treasury activities, a range of bank counterparty concentration and credit quality limits together with other controls are in place to ensure that exposure is managed within the Group risk appetite. New reinsurance cover is placed with reinsurers that are authorised as Approved Reinsurance Counterparties recommended by the Group Reinsurance Credit Committee under criteria approved by the Board Risk Committee. Target credit profiles and single name limits are set to manage and control the Group's reinsurance credit exposure within the Group's risk appetite. The overall risk appetite for credit risk within all of the Group's activity remains low.

Market risk arises from the Group's investment portfolios. The Global Asset Management Committee is the management committee that oversees the Group's investment strategy under the oversight of the Investment Committee and operating within risk limits set by the Board Risk Committee. During 2005 the Group has introduced enhanced risk analytical techniques in line with the Group's capital model to improve the quantification and understanding of the risk exposures.

Liquidity risk is considered to be a low risk category. Group liquidity is managed by Group Treasury and each operation is required to maintain a minimum level of cash or cash equivalents or highly liquid assets that can be liquidated within a maximum stated period of time. Contingency funding plans are prepared and monitored to ensure that these minimum levels are met even in stress conditions.

Corporate Governance

continued

Regulatory risk

The Group operates in a number of geographical locations with diverse regulatory requirements. Internationally the regulatory environment is becoming more complex and demanding. In response to this the Group continues to strengthen its arrangements for regulatory compliance and to ensure that it maintains open and cooperative relationships with its regulators.

Risk review visits

In addition to setting policy and standards, Group Risk undertakes risk review visits to regional operations to review regional risk management practices. These review visits are tailored to the risk profile for the operation and will consider inter alia insurance, operational, credit, market, liquidity, strategic and emerging risks.

Annual General Meeting (AGM)

The AGM Notice is despatched to shareholders at least 20 working days before the meeting and contains separate resolutions including a resolution to adopt the Annual Report & Accounts. At AGMs, the Chairman of the Group and the chairmen of the Group Audit, Nomination and Remuneration Committees make themselves available to take questions from shareholders.

The Company has arrangements in place with its registrars to ensure that all proxy votes are received and accurately counted. The level of proxies lodged on each resolution, including votes for, against and abstained are published on the Group's website at www.royalsunalliance.com after each AGM.

Directors' responsibilities

The directors are required to ensure that adequate accounting records are maintained so as to disclose at any time, and with reasonable accuracy, the financial position of the Group. They are also responsible for taking reasonable steps to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

They must present financial statements for each financial year which give a true and fair view of the state of affairs of the Company and Group and of the profit or loss for that period. In preparing such financial statements, they are required to:

- Select suitable accounting policies and apply them on a consistent basis using reasonable and prudent judgement,
- State whether or not applicable accounting standards have been followed and explain any material departures,
- Use the going concern basis unless it is inappropriate to do so.

Basis of accounts

The directors have satisfied themselves that the Group has adequate resources to continue in operation for the foreseeable future having given consideration to the uncertainties and contingencies disclosed in the financial statements and have therefore prepared the financial statements on a going concern basis.

Internal controls

The Board reviews annually the effectiveness of the Group's system of internal controls in order to safeguard the Group's assets and shareholders' investment. This system includes governance, financial controls, the risk management framework and operational, regulatory and compliance requirements.

The Board through the Group Audit Committee receives reports from the Group Chief Auditor and his team on the integrity of the control environment and also receives reports from the external auditors based upon their audit work. The Group Audit Committee also receives reports on the Group's arrangements for ensuring regulatory compliance. The Board, through the Board Risk Committee, considers reports from risk specialists both internal and external to the Group, and reviews Group level risk management information.

Each quarter there is a self certification process completed by business managers across the Group to confirm the adequacy of controls and their compliance with Company policies, laws, rules and regulations.

The Board considers that collectively this reporting framework gives it sufficient information upon which to monitor the systems of internal control and to review their effectiveness as required by the Combined Code. The Board therefore considers that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the Group, that it has been in place for 2005 and up to the date of approval of the Annual Report & Accounts, that it is regularly reviewed by the Board and accords with the Turnbull Guidance on the Combined Code.

Report of the Group Audit Committee

Membership

The membership of the Committee and the attendance record of directors in 2005 is shown in the table below. All members of the Committee are independent non-executive directors. Both Edward Lea and John Maxwell have recent and relevant financial experience.

In 2005, the Committee met seven times. The Chairman, Group CEO, Chief Financial Officer, Group Risk Director, Director Regulatory Risk and Compliance and the Group Chief Auditor are regular attendees. Other members of executive management are also invited to attend from time to time.

Principal duties

The Committee's principal duties are as follows:

- To coordinate and have oversight of the Group's financial reporting process,
- To monitor compliance,
- To have oversight of internal and external audit functions,
- To manage the systems of internal controls,
- To review all matters relating to the legal integrity of the Group,
- To provide assurance on the effectiveness of the Group's risk management.

The terms of reference of the Group Audit Committee, which explain its role and the authority delegated to it by the Board of Directors, are available on the Company's website at www.royalsunalliance.com or on request from the General Counsel and Group Company Secretary.

Internal audit

The Group has an internal audit function, whose activities and effectiveness are monitored and reviewed by the Committee. The Committee is responsible for approving the appointment and removal of the Group Chief Auditor, and for ensuring that adequate access to information and resources is given to the holder of that position.

External auditors

The Committee meets regularly with internal and external auditors without management present. The partner of the Group's external auditors who is responsible for the audit is invited to attend all meetings. Each year, the Committee considers the performance of the external auditors prior to a resolution on their reappointment and remuneration at the AGM.

During the year, PricewaterhouseCoopers LLP were, on a number of occasions, engaged as advisors. In order to maintain their independence, such appointments are only made in accordance with a protocol developed by the Board (available on the Company's website). This gives guidance to businesses within the Group on the appropriateness of engaging the Group's external auditors as advisors and sets down the procedures to be followed to authorise such an engagement. The Committee is satisfied that this protocol has been followed and there are no matters that would compromise the independence of the auditors or affect the performance of their statutory duties. PricewaterhouseCoopers LLP have also considered their position and have confirmed their independence to the Company in writing.

The Board has accepted the Committee's recommendation that a resolution be put to the 2006 AGM for the reappointment of PricewaterhouseCoopers LLP as external auditors.

Whistleblowing

It is the Committee's responsibility to keep the procedures laid out in the Group whistleblowing policy under review. This policy deals with employees who wish to raise serious concerns in good faith, and either do not feel comfortable raising the matter with local management or

are not satisfied with the local management response. They can raise their concerns with the Group Chief Auditor, who will either investigate or arrange for an investigation of the matter. Employees are offered such safeguards and support as may be necessary to protect their personal integrity and, where possible, identity.

Report of the Nomination Committee

Membership

The membership of the Committee and the attendance record of directors in 2005 are shown in the table below. The Committee met three times during 2005.

Principal duties

The Committee's principal duties are to review the structure, size and composition of the Board and to evaluate the directors' skills, knowledge and experience. It has access to external recruitment consultants in order to help fill any vacancies. The Committee considers the leadership needs and succession planning of the Board when making decisions on new appointments. Resolutions to reappoint directors at an AGM are not proposed automatically, but are subject to the approval of the Board, taking into account the recommendations of the Committee.

The terms of reference of the Committee, which explains its role and the authority delegated to it by the directors, are available on the Company's website at www.royalsunalliance.com or on request from the General Counsel and Group Company Secretary. The terms and conditions of appointment of the non-executive directors will be available for inspection at the AGM.

Board and board committee membership and attendance in 2005

Directors attending Board and board committees during 2005 was:

	Notes	Board meetings	Board Committee	Group Audit Committee	Investment Committee	Nomination Committee	Remuneration Committee
Total number of meetings in the year	4	12	5	7	2	3	7
George Culmer		12	5	—	1	—	—
Noel Harwerth		12	—	7	2	—	—
Andy Haste		12	5	—	2	—	—
Edward Lea		12	—	7*	2	—	6
Malcolm Le May		7	—	—	2*	—	5
John Maxwell		11	—	6	2	3	6*
Bridget McIntyre	2	2	—	—	—	—	—
John Napier	3	12*	—	4	2	3*	3
David Paige	1	11	—	—	2	—	—

*Chairman of the Board or board committee

Notes

1. David Paige was appointed to the Board on 16 February 2005.
2. Bridget McIntyre was appointed to the Board on 2 November 2005.
3. John Napier attended three meetings of the Remuneration Committee and four meetings of the Group Audit Committee by invitation.
4. In addition to attendance as above, Andy Haste and other executive directors regularly attend, by invitation, meetings of the Group Audit Committee and Remuneration Committee.

By order of the directors

Mark R Chambers

General Counsel and Group Company Secretary

London

8 March 2006

Remuneration Report

The following report by the Remuneration Committee (the Committee) has been approved by the Board for submission to shareholders at the 2006 AGM.

Overview

The emphasis of the Committee's work during 2005 has been on further strengthening the link between performance and reward as part of our strategic drive to reinforce a performance culture across the Group.

A major focus in 2005 has been the review of long term incentive provision, resulting in the development of the 2006 Long Term Incentive Plan (the 2006 Plan). A key element of the 2006 Plan – which shareholders are being asked to approve at the 2006 AGM – will be a stretching performance condition based on a sliding scale which ensures that the highest levels of reward will only be delivered for exceptional performance, measured in terms of both financial results and the returns delivered for shareholders. Overall, the 2006 Plan has been designed to deliver broadly unchanged on target total remuneration for executive directors. Higher levels of remuneration will only be delivered if Company performance is superior or outstanding.

During 2005, the Committee also completed a review of pension provision in the light of changing UK pensions legislation, in particular the Finance Act 2004. In summary, our responses to the changes are:

- We will not compensate executives who are affected by the new taxation limits effective as from 6 April 2006 (A Day),
- We have implemented a communications programme designed to ensure that executives are equipped to plan their own retirement in the context of the new regime,
- We have decided that, if any UK based executive can demonstrate that he or she has accumulated approved pension benefits worth 80% or more of the new Lifetime Allowance, we will consider permitting that executive to take Company pension contributions in the form of a taxable cash allowance, adjusted so that the cash alternative is cost neutral to the Company. No executive director is currently expected to qualify for this cash alternative.

Our policy in respect of pension benefits for executive directors has not changed and is set out below.

The Committee is accountable to shareholders through its annual remuneration report which is voted on at the AGM, and remains committed to reflecting the interests of shareholders and the pursuit of best practice in remuneration policy. The Committee welcomes and values its ongoing dialogue with shareholders on remuneration policy.

The Remuneration Committee

The Committee's responsibilities are set out in its terms of reference which are available to shareholders on request and on the Royal & SunAlliance website www.royalsunalliance.com. These include:

- Determining the terms and conditions and remuneration of the Chairman, and the terms and conditions and remuneration of the executive directors,
- Overseeing the operation of the Company's share based long term incentive schemes, including approving the value and timing of awards and overseeing the operation of performance conditions.

The Committee also considers and advises the Board on the Group's broader remuneration policy in relation to senior executives reporting to the Group CEO (the Executive Team).

Members of the Committee have no personal financial interest, other than as shareholders, in the Committee's decisions and they have no conflicts of interest arising from cross directorships.

In constitution and operation the Committee complies fully with the Combined Code as appended to the Listing Rules of the UK Listing Authority.

Membership

During the year the directors who served on the Committee were: John Maxwell (Chairman), Edward Lea and Malcolm Le May. All of the non-executive directors on the Committee were determined by the Board to be independent. The attendance record of members in 2005 is shown in the table on page 43.

Advisors

In developing remuneration strategy during the year, the Committee obtained its principal advice from New Bridge Street Consultants LLP, who provided no other services to the Company during 2005.

The terms of engagement for the remuneration consultants for 2006 are available to shareholders on request and on the Royal & SunAlliance website www.royalsunalliance.com.

The Group CEO is invited to attend all meetings of the Committee, except when his own remuneration is being discussed, to inform the Committee on company strategy and performance and senior executive pay strategy. The Group Human Resources Director normally attends meetings to provide information on wider remuneration strategy and practice within the Group. The Group Chairman is invited to attend meetings as appropriate.

Remuneration policy principles

The key principles which underpin the Committee's remuneration policy are:

- Total remuneration is set at a level which enables the recruitment, retention and motivation of high quality executive talent,
- There is a strong and visible link between remuneration and performance,
- Executive remuneration and shareholder interests are strongly aligned,
- Incentive arrangements are leveraged so that only exceptional performance attracts the highest level of reward,
- A balance of short and long term performance measures is used, incorporating measures of financial performance, delivery of shareholder value and a robust assessment of personal contribution,
- Remuneration policy and practice is transparent to shareholders.

Elements of remuneration

Remuneration for executive directors in 2006 will consist of five principal elements, of which only base salary is pensionable.

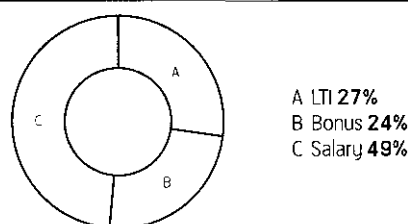
- Base salary,
- Annual performance bonus (delivered as cash and Deferred Shares*),
- Conditional awards of Matching Shares*.

- Conditional awards of Performance Shares*.
- Pension provision and other benefits.
- * Subject to shareholder approval at the 2006 AGM.

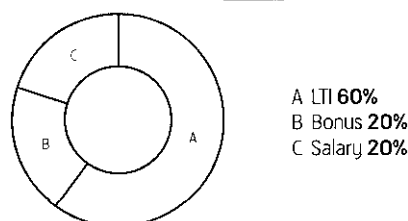
This structure will be replicated for other members of the Executive Team.

The proposed balance between fixed and variable elements of annual direct compensation for executive directors for on target and maximum performance is as follows:

On target



Maximum



For the purposes of the charts, the LTI element shows the present value of the projected gain arising from one year's awards under the 2006 Plan after three years. The valuation incorporates assumptions about share price movements and the Company's performance against conditions, and reflects policy on the scale of initial awards.

Base salary

Base salaries for executive directors and members of the Executive Team are set on appointment with reference to market data. The Committee's policy is to relate base salary to the median level for equivalent roles in similar companies facing similar levels of complexity and challenge in the UK and internationally. In the UK, the comparator group most frequently used is a sample of financial services companies within the FTSE 100. Base salaries are reviewed annually on the basis of market movements and an assessment of the performance of the executive. The 2005 salary review process resulted in the following increases for executive directors:

- Andy Haste, Group CEO, received an increase of 10% taking his base salary to £770,000 as at 31 December 2005.
- George Culmer, Chief Financial Officer, received an increase of 10.5% taking his base salary to £420,000 as at 31 December 2005.
- David Paige, Group Risk Director, joined the Group in February 2005 and received an interim increase of 3% effective 1 August 2005, taking his base salary to £340,000 as at 31 December 2005.
- Bridget McIntyre, UK Chief Executive, joined the Group in November 2005 on a base salary of £350,000; no review of her salary was required during 2005.

Above inflation increases for executive directors in 2005, where given, reflect a strong business year and the strength of individual contributions. The next review date for base salaries is April 2006. Recognising that base salaries are now generally competitive, 2006 increases are expected to be broadly in line with market movements in Boardroom pay.

The following table sets out the base salaries of UK based executives below Board level on a banded basis as at 31 December 2005. No such executive received a base salary in excess of £375,000.

Base salary range	Number of employees
£250,001 and over	2
£200,001 – £250,000	9
£150,001 – £200,000	10

Annual performance bonus

The executive directors and members of the Executive Team participate in an annual performance bonus plan. As in 2005, if stretching business and personal targets are met, participants receive a cash bonus of up to 50% of base salary, and Deferred Shares worth up to 16.5% of base salary. For outstanding performance, a cash bonus of up to 100% of base salary and Deferred Shares worth up to 33% of base salary are achievable. The Deferred Shares will normally vest after three years provided the executive remains in employment with the Company. Total annual bonus potential will therefore be capped at 133% of base salary, as in 2005. Under the 2006 Plan, an award of Matching Shares will be made on a pro rata basis to the Deferred Shares. From 2006, executives will also be offered the opportunity to voluntarily invest up to a further 33% of their cash bonus into Deferred Shares, although the Committee reserves the right to reduce permissible investment below this level.

The majority of the annual bonus is determined by business performance, measured against Combined Operating Ratio (COR) targets for each of the Group's core businesses. Due to the particular nature of the business portfolio in the US, a special suite of metrics has been developed for this business incorporating the underwriting result, the effectiveness of claims management, expense control, and asset and liability management. COR is the preferred measure for our core businesses as it is the single indicator which most fully captures the underlying strength and performance of an insurance business.

The balance of the annual bonus is determined following a structured assessment of each executive's performance against detailed and specific personal objectives. Objectives typically include financial, customer, risk management, compliance, people management and business improvement targets. The Committee reviews and signs off executive directors' objectives early in the financial year. The Group CEO's performance is assessed annually by the Group Chairman and members of the Committee. The Group CEO carries out a similar assessment for each of his direct reports, subject to review and sign off by the Committee in the case of executive directors. Assessments also take account of appropriate leadership style.

Bonuses paid to executive directors in respect of performance year 2005 are included in the table of directors' emoluments on page 49. These reflect the strength of business results in 2005.

Remuneration Report

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UK based executives who are members of the global 'Top 100' group (the Top 100) participate in a bonus plan which is structured in the same way and measured using the same metrics as the plan described above. For outstanding performance a cash bonus of up to 65% of base salary and Deferred Shares worth up to 33% of the cash bonus are achievable.

Long term incentive plans

In 2005, awards of executive share options were made under the Executive Share Option Scheme (ESOS) to executive directors and other senior managers outside the US. Following the 2005 review of long term incentive provision, it is intended that regular awards under the ESOS will be discontinued from 2006 and will be replaced with awards under the 2006 Plan. The ESOS will, however, remain available for use in exceptional circumstances, such as executive recruitment.

In 2005, awards were also made under the Share Matching Plan (the 2004 Plan), which was approved by shareholders at the 2004 AGM. The 2004 Plan was designed to operate for two financial years only; awards granted in 2005 were therefore the final awards under the 2004 Plan.

2006 Long Term Incentive Plan (the 2006 Plan)

The 2006 Plan will be submitted for shareholder approval at the 2006 AGM and will be the primary long term incentive plan, replacing the expired 2004 Plan and executive share options (as outlined above). Full details of the 2006 Plan have been circulated to shareholders in the AGM Notice. The key features of the 2006 Plan and the policies associated with its operation are summarised below.

Performance Shares

Participants may receive a conditional award of shares with the grant level and performance condition determined by the Committee prior to each grant. Executive directors, members of the Executive Team and the Top 100 will be eligible for awards of Performance Shares.

It is intended that, in 2006, awards of Performance Shares to executive directors will be limited to a maximum face value of 100% of base salary, other than in exceptional circumstances. Awards of Performance Shares to members of the Executive Team in 2006 will be limited to a maximum face value of 80% of base salary, other than in exceptional circumstances. Account will be taken of personal performance in determining the scale of the award to each executive. For executives below this level, distribution policy will normally be based on a formula which relates the size of award to performance and potential, as measured through the annual performance appraisal process.

In any year, the face value of Performance Shares granted to any individual will be limited to 150% of base salary in normal circumstances subject to an overriding cap of 250% of base salary in exceptional circumstances such as an executive recruitment.

Performance Shares will vest after three years subject to performance against the performance condition (see below) and provided the individual remains in employment with the Group (other than in exceptional circumstances such as death or retirement at normal retirement age).

Deferred Shares

As described in the annual performance bonus section above, executive directors, members of the Executive Team and the Top 100 may be granted Deferred Shares as part of annual bonus. These Deferred

Shares may not be withdrawn and will normally vest three years from the date of grant subject to continued employment with the Group. In addition, from 2006 executives may invest an additional portion of bonus in Deferred Shares on a voluntary basis. Voluntarily Deferred Shares are not at risk of forfeiture and may be withdrawn at any time (but the right to Matching Shares would lapse on those Deferred Shares withdrawn).

Matching Shares

Executives may receive a conditional award of Matching Shares pro rata to the number of Deferred Shares held. The maximum matching ratio for Matching Shares:Deferred Shares will be 2.5:1, calculated on the gross value of the bonus invested in Deferred Shares. At threshold performance the matching ratio will be 0.625:1. Details of the performance condition proposed for the first grant are provided below.

Executive directors, members of the Executive Team and the Top 100 will be eligible for awards of Matching Shares.

Matching Shares will vest after three years subject to performance against the performance condition (see below) and provided the individual remains in employment with the Group (other than in exceptional circumstances such as death or retirement at normal retirement age).

Awards under the Plan will be funded through a combination of new issue and shares purchased in the market.

Performance conditions

The Committee will determine the performance condition for each grant of Performance Shares and Matching Shares, with performance measured over a single period of three years with no provision to retest. In 2006, grants of Performance Shares and Matching Shares related to non voluntarily Deferred Shares will be subject to a performance condition consisting of a combination of Return on Equity (ROE) and Total Shareholder Return (TSR) targets. These are set out below:

- 50% of the shares comprising the award will vest according to nominal ROE performance. If underlying average annual ROE over three years commencing with the financial year of grant is below 10%, no part of the award subject to the ROE performance condition will vest. If underlying average annual ROE over three years is 10%, 25% of the award will vest. If underlying average annual ROE over three years is 16%, 100% of the award will vest. Vesting will be on a straight line basis in between. Underlying ROE will exclude items of an exceptional nature which in the view of the Committee do not reflect the underlying performance of the business. Underlying ROE will be measured in respect of the Core Group, excluding US operations.
- 50% of the shares comprising the award will vest according to TSR performance against a comparator group of UK and International Financial Services companies. Below median performance, no part of the award subject to the TSR performance condition will vest. At median performance, 25% of the award will vest. At upper quintile (top 20%), 100% of the award will vest. Vesting will be on a straight line basis in between.
- Additionally, before any share subject to the TSR condition vests, the Committee must be satisfied that the Company's TSR performance is reflective of underlying financial performance.

- The comparator group will consist of the following companies: Aegon, AGF, Alleanza, Allianz, Aviva, AXA, Baloise, Fortis, Generali, Legal & General, Munich Re, QBE, Swiss Re and Zurich Financial Services. The Group's TSR will be independently calculated and verified by the Committee for the purposes of the 2006 Plan.

The vesting of Matching Shares related to voluntarily Deferred Shares will be determined solely by the ROE performance condition.

ROE has been selected as the measure of financial performance as it is a key measure of overall business performance which is used internally by the Company and is also visible externally to shareholders.

The TSR performance condition has been designed to provide alignment between executive remuneration and shareholder interests and to ensure that an element of the package is linked directly to share price performance. The comparator group has been selected to ensure that performance is compared fairly against a group of similar companies operating in a similar competitive environment.

The use of ROE and TSR in combination provides a balanced approach to the measurement of Company performance over the longer term.

Equity Incentive Scheme for US Employees

In 2000 shareholders approved an alternative share option scheme for US managers based on US market practice. Grants of options over American Depositary Receipts (ADRs) are made no more than twice a year.

Dilution

Dilution levels for all schemes are held strictly within ABI limits (10% over 10 years for all schemes and 5% for discretionary schemes).

Share ownership guidelines

Strengthened share ownership guidelines were introduced in 2004 for executive directors and members of the Executive Team.

The Group CEO is required to build and maintain a minimum shareholding in the Company equivalent to 150% of base salary. The other executive directors have a target of 100% of base salary and other members of the Executive Team have a target of 50% of base salary. In order to ensure that progress is made towards this target, executives are required to retain shares to a value of 50% of the net of tax gain under all executive schemes until the relevant guideline is attained. This requirement will apply to awards under the 2006 Plan, and will continue to apply to awards under all existing long term incentive plans.

Pension and other benefits

Andy Haste is a member of the SAL Pension Scheme (SAL), a contributory defined benefit occupational pension scheme. In common with all other members of the Royal & SunAlliance defined benefit occupational pension schemes, from 1 January 2006 Andy Haste's future benefits within SAL will accrue on a Career Average Revalued Earnings (CARE) basis rather than on a final salary basis. Royal & SunAlliance has decided to retain a cap within its defined benefits schemes after A Day and, accordingly, Andy Haste's benefit accrual will continue to be calculated by reference to a 'capped' salary (which will be measured each year in line with past practice). In addition to his benefits within SAL, Andy Haste receives an age related taxable cash allowance to enable him to make his own provision for retirement

above the cap. In 2006 he will be paid an allowance of 27% of base salary for this purpose.

Until 31 December 2005, George Culmer participated in a contributory defined contribution occupational pension scheme (the Royal & SunAlliance UK Pension Scheme 2002). From 1 January 2006 this scheme was replaced by the Royal & SunAlliance Stakeholder Pension Plan (the Stakeholder Plan), a contributory defined contribution stakeholder pension scheme. George Culmer became a member of the Stakeholder Plan from 1 January 2006. In 2006 he will receive employer contributions worth 15% of base salary, subject to an employee contribution of 5% of base salary up to Inland Revenue contribution limits as applicable. Additionally, following a review of the market competitiveness of his pension benefits, the Committee decided to provide George Culmer with a taxable cash allowance of 15% of base salary, in order to bring his overall pension provision closer to the market median.

David Paige elected not to join a Royal & SunAlliance pension plan on appointment and instead receives a taxable cash allowance of 17.5% of base salary, in order to enable him to make his own provision for retirement.

Bridget McIntyre joined the Group on 1 November 2005 and was enrolled in the Stakeholder Plan as from 1 January 2006. In 2006 she will receive employer contributions worth 15% of base salary, subject to an employee contribution of 5% of base salary up to Inland Revenue contribution limits as applicable. Additionally, Bridget McIntyre receives a taxable cash allowance of 15% of base salary, in order to bring her overall pension provision closer to the market median.

In addition, the executive directors participate in a number of benefits available to other senior managers including life assurance at the rate of four times base salary, sickness and ill health early retirement benefits and private medical insurance. They also have a choice between a company car and a monthly cash car allowance. In common with other employees, the executive directors are eligible to participate in the Royal & Sun Alliance International Sharesave (SAYE) Plan.

Service contracts

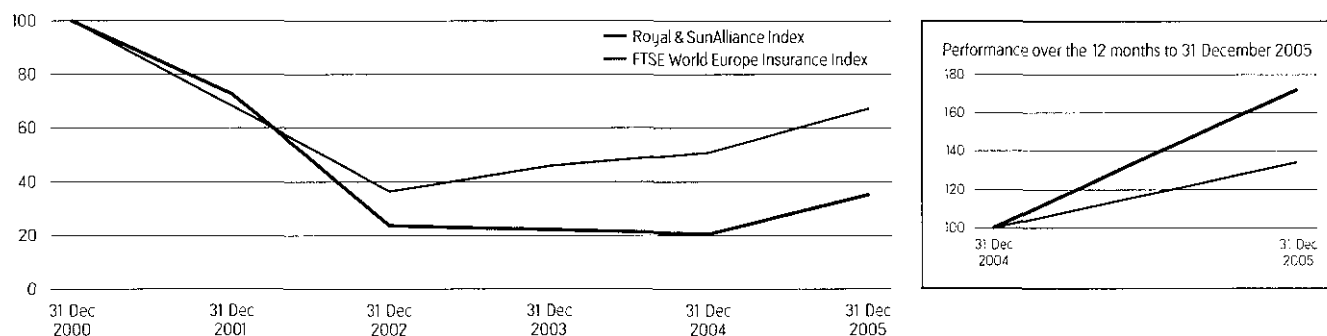
The Committee's policy on service contracts is that they should be subject to a maximum notice period of one year. Generally in the event of termination and in all cases of termination on performance grounds the Committee's policy would be to seek and apply mitigation.

Andy Haste's service contract commenced on 2 April 2003 and he was appointed as a director of the Group on the same date. His contract expires under normal circumstances in January 2024 unless terminated earlier by the Company or by Andy Haste on 12 months' notice. Exceptionally, when he was appointed, the Committee agreed that, in the event of termination other than on grounds of gross misconduct, he would be entitled, within the first three years following his appointment or within two years of a change of control occurring before the third anniversary of his appointment, to liquidated damages equal to one year's base salary, plus the average of any annual bonuses paid during the previous two years and one year's pension contributions and other taxable benefits. This arrangement lapses on 2 April 2006.

Remuneration Report

continued

Total shareholder return for Royal & SunAlliance and FTSE World Europe Insurance Index



George Culmer's service contract commenced on 1 May 2004 and he was appointed as a director of the Group on the same date. David Paige's service contract commenced on 1 February 2005 and he was appointed as a director of the Group on 16 February 2005. Bridget McIntyre's service contract commenced on 1 November 2005 and she was appointed as a director of the Group on 2 November 2005. The service contracts for George Culmer, David Paige and Bridget McIntyre terminate under normal circumstances in October 2024, July 2013 and July 2023 respectively unless terminated earlier by the Company or by the individual on 12 months' notice.

External directorships

Where appropriate, the Group encourages directors and other senior managers to accept, subject to the approval of the Group Chairman and the Group CEO, an invitation to join the Board of another company in a non-executive capacity, recognising the value of such wider experience. In these circumstances, managers are permitted to retain the remuneration from the non-executive appointment. For executive directors and other members of the Executive Team, external appointments are limited to one.

Non-executive directors

All non-executive directors of the Company have letters of appointment which set out the terms and conditions of their appointment. Non-executive directors are not entitled to bonus payments or pension arrangements, nor do they participate in the Group's long term incentive plans.

Under the Group's Articles of Association, the remuneration paid to non-executive directors is determined by the Board, within limits set by shareholders. Prior to 2005, non-executive directors' fees had remained unchanged for five years. In 2005, following a review of market practice for similar roles in FTSE 100 companies, the fee structure for non-executive directors was revised to reflect market movements and also to reflect the increased responsibility and time commitment involved in carrying out non-executive duties, including chairing and participating in Board Committees. The basic fee for a non-executive director was increased from £35,000 to £45,000pa. The additional fee for chairing the Group Audit Committee was increased from £10,000 to £20,000pa and the additional fee for chairing the Remuneration Committee was increased from £10,000 to £12,500pa.

The fee for chairing the Investment Committee was set at £12,500pa. Additionally, a fee of £5,000pa was introduced for any non-executive director sitting on more than one committee but not acting as Chair of any committee. These fee rates will be unchanged for 2006.

The Committee determines the Group Chairman's remuneration. The fee payable to John Napier in respect of his appointment as Chairman of the Company (effective 17 March 2003) was increased effective 1 January 2006 from £250,000 to £325,000pa in order to reflect market movements and also to reflect the complexity and challenge of the role. John Napier's letter of appointment was effective 9 January 2003 and the term of his appointment was initially three years; it has now been extended until 31 December 2008. No further review of John Napier's fees is anticipated during the current term of his appointment. The appointment may be terminated by the Chairman on three months' notice to the Company.

Edward Lea and John Maxwell have letters of appointment effective from 10 July 2003; Noel Harwerth and Malcolm Le May have letters of appointment effective from 30 March 2004. These letters of appointment all request one month's notice should the non-executive director wish to resign.

Historical TSR performance

The main graph above is included in the report of the Committee as a requirement of Schedule 7A to the Companies Act 1985.

The graph shows the TSR of the Group with reference to the FTSE World Europe Insurance Index. The FTSE World Europe Insurance Index comprises the range of European insurance businesses which most closely match our competitor group, and the TSR comparator group selected for 2006 awards under the 2006 Plan. TSR performance relative to the index is shown over the five years from 31 December 2000 to 31 December 2005.

The inset graph shows the TSR of the Group with reference to the same index over the 12 month period ending 31 December 2005.

TSR reflects the change in value of ordinary shares in a company over time, as represented by the evolution of a notional initial investment of £100 in the shares and including any distribution of dividends.

Directors' Emoluments

Remuneration (audited part)

Remuneration for the year ended 31 December was as follows:

	Notes	Base salary and fees £000	Allowances and benefits £000	Bonuses £000	Total 2005 £000	Total 2004 £000
Executive directors	1, 2					
George Culmer	3	410	78	361	849	691
Andy Haste	4	770	245	739	1,754	1,591
Bridget McIntyre (appointed 2 November 2005)	5	58	478	—	536	—
David Paige (appointed 16 February 2005)	6	307	420	190	917	—
Non-executive directors						
Noel Harwerth		50	—	—	50	27
Edward Lea		65	—	—	65	45
Malcolm Le May		58	—	—	58	27
John Maxwell		58	—	—	58	45
John Napier		250	—	—	250	250
Directors who left during 2004						
Bob Ayling		—	—	—	—	21
Julian Hance		—	—	—	—	145
Stephen Hill		—	—	—	—	9
Susan Hooper		—	—	—	—	9

Notes:

1. Directors who were appointed during the year were paid their base salary pro rata.
2. 2005 bonuses were calculated as described in the Remuneration Report on page 45. In 2005 a maximum cash bonus of 100% of salary was achievable.
3. George Culmer received an annual performance bonus of £361,200 in respect of performance year 2005. His allowances include 15% of basic salary as a retirement allowance, paid monthly with effect from 1 April 2005. During 2005 the amount paid was £47,000. He also received car benefits worth £28,000 and medical and life assurance benefits worth £3,000.
4. Andy Haste received an annual performance bonus of £739,200 in respect of performance year 2005. His allowances include an age related percentage of basic salary as a retirement allowance, paid monthly. During 2005 the allowance was 26% and the amount paid was £200,000. He also received car benefits worth £39,000 and medical and life assurance benefits worth £6,000.
5. Bridget McIntyre's salary was for two months of the year, following her appointment in November 2005. She did not receive an annual performance bonus in respect of performance year 2005. Her allowances include 15% of basic salary as a retirement allowance, paid monthly. During 2005, the amount paid was £9,000. Her allowances also include £107,000 as compensation for a bonus lost on leaving her prior employment and £359,000 as compensation for long term incentives lost on leaving her prior employment. She also received car, medical and life assurance benefits worth £3,000.
6. David Paige's salary was for 11 months of the year, following his appointment in February 2005. He received an annual performance bonus of £190,400 in respect of performance year 2005. His allowances include 17.5% of basic salary as a retirement allowance, paid monthly. During 2005, the amount paid was £54,000. His allowances also include £165,000 as compensation for a bonus lost on leaving his prior employment and £185,000 as compensation for long term incentives lost on leaving his prior employment. He also received car benefits worth £13,000 and medical and life assurance benefits worth £3,000.

Directors' Emoluments

continued

Pension benefits (audited part)

Non-executive directors are not entitled to any pension benefits. The pension benefits earned by the executive directors, as members of Group defined benefit schemes, were as follows:

	Change in accrued pension in year £	Total accrued pension at 31 December 2005 £	Transfer value of total accrued pension at 31 December 2005 £	Transfer value of total accrued pension at 31 December 2004 £	Difference in transfer values less members' contribution (note 1) £
Andy Haste	1,864	4,840	48,225	25,254	17,736

Notes:

1. The difference in transfer values reflects the difference between the two transfer values calculated using relevant information on the respective dates and is not necessarily the actuarial increase of the underlying pension.
2. The figures set out in the table above provide information as required by the Directors' Remuneration Report Regulations 2002. The Listing Rules require the change in accrued pension to be shown excluding the effects of inflation and the transfer value of this increase. These figures are shown in the notes below.
3. The accrued pension figures shown are the annual amounts of member's pension payable from normal retirement age. Increases to pensions when in payment are applied in accordance with the relevant scheme rules. On the death of the member leaving a surviving spouse and/or children, spouse's and/or children's pensions are payable in accordance with scheme rules.
4. The benefits shown above in respect of Andy Haste relate to his membership of a defined benefit pension scheme up to the earnings cap.
5. For Andy Haste the increase in his accrued pension during the year, excluding the effects of inflation, was £1,783pa and the transfer value in respect of this less his contributions was £12,531 at 31 December 2005.
6. Andy Haste is required to contribute to the scheme and also has the option of paying Additional Voluntary Contributions (AVCs). Neither voluntary contributions nor the resulting benefits are included in the table.
7. Transfer values have been calculated in accordance with the guidance note GN11 published by the UK Institute of Actuaries and Faculty of Actuaries.
8. The transfer value of the accrued benefits represent the value of assets that the pension scheme would need to transfer to another pension provider on transferring the scheme's liability in respect of Andy Haste's pension benefits. The transfer values do not represent sums payable or due to Andy Haste.

The Company contributions paid in respect of executive directors who are members of Group defined contribution schemes, were as follows:

	Company contributions paid in 2005 £	Company contributions paid in 2004 £
George Culmer	61,500	38,000

George Culmer joined the Group in May 2004; he therefore received contributions in respect of eight months' service in 2004.

Bridget McIntyre joined the Group in November 2005. Because of changes being made to the Group's pension arrangements, no contributions have been paid into the Royal & SunAlliance UK Pension Scheme 2002 in respect of November and December 2005. These contributions will be paid into the Royal & SunAlliance Stakeholder Pension Plan which was set up on 1 January 2006. The contributions paid into the new scheme in 2006 will be reported next year but are expected to include £8,750 in respect of Company contributions payable in respect of November and December 2005.

David Paige is not a member of any Royal & SunAlliance pension scheme.

Directors' Interests

Shareholdings (non audited part)

The interests of directors in ordinary shares of 27.5p each of the Company, as declared and recorded in accordance with the Companies Act 1985, are as follows:

	Notes	Shares held at 31 December 2005	Shares held at 1 January 2005 (or on appointment)
Executive directors			
George Culmer	1	100,819	34,843
Andy Haste	1	666,076	258,910
Bridget McIntyre (appointed 2 November 2005)	1	—	—
David Paige (appointed 16 February 2005)	1	31,167	—
Non-executive directors			
Noel Harwerth	2	34,000	34,000
Edward Lea		241,128	116,128
Malcolm Le May		—	—
John Maxwell		252,044	140,046
John Napier		290,605	275,174

Notes:

1. In addition to the interests shown above, the directors indicated, in common with the employees, had a beneficial interest as at 31 December 2005 in 4,938,894 (2004 3,038,894) ordinary shares of 27.5p each held in the Royal & SunAlliance ESOP Trust No 2.
2. Noel Harwerth's shares are held in the form of 6,800 American Depositary Receipts (ADRs). One ADR represents five ordinary shares.
3. On 8 March 2006, the directors' interests remained unchanged.

Options (audited part)

Movements in option holdings during 2005 were as follows:

	Notes		Options held at 1 January 2005 (or on appointment)	Options granted during the year	Options exercised during the year	Options lapsed during the year	Options held at 31 December 2005
George Culmer	1, 2, 3	ESOS	981,012	1,013,306	—	—	1,994,318
		SAYE	—	12,466	—	—	12,466
Andy Haste	1, 2, 3	ESOS	5,715,705	1,857,728	—	—	7,573,433
		SAYE	16,560	7,298	—	—	23,858
Bridget McIntyre (appointed 2 November 2005)	1, 3	ESOS	—	301,724	—	—	301,724
		SAYE	—	—	—	—	—
David Paige (appointed 16 February 2005)	1, 2, 3	ESOS	—	1,007,796	—	—	1,007,796
		SAYE	—	12,466	—	—	12,466

Options granted following the AGM in May 2003 are potentially exercisable if, at the end of the period of three business years starting with the business year in which the options were granted, the Group has achieved a Return on Capital (ROC) of at least 6% per annum (after inflation and excluding items of an exceptional nature which in the view of the Committee do not reflect the underlying performance of the business) when averaged over the period. One retest is allowed at the end of the fourth business year, but if the performance criterion has not been met over the full four year period, the options lapse. Options granted between September 1998 and May 2003 are also subject to a performance condition that the Group must achieve a ROC of at least 6% (after inflation and excluding items of an exceptional nature which in the view of the Committee do not reflect the underlying performance of the business) when averaged over a consecutive three year period, but if the measure is not satisfied at the end of the third business year following the date of grant, the test can be repeated on an annual basis over the 10 year life of the option. Options granted between October 1996 and September 1998 were subject to a different performance condition linked to TSR. For options to be eligible for exercise, the Group's TSR has to be at or above the median of companies in the FTSE 100 index over a consecutive period of three years, between the year of grant and the completion of the 10 year life of the option. The test is conducted twice per year, at the end of March and September, by independent external specialists. Options granted prior to October 1996 were not subject to performance conditions. None of the terms or conditions of any of the existing options over shares of the Group were varied during the year. Full details of all directors' shareholdings and options to subscribe for shares are recorded in the Group's Register of Directors' Interests which is open to inspection in accordance with the provisions of the Companies Act 1985.

The official closing middle market price at its highest during the year was 126.75p per share and at its lowest was 73.50p per share; on the last dealing day of the year it was 125.75p per share.

Directors' Interests

continued

Options (audited part)

Options held during 2005 in respect of the ordinary shares of the Company as a result of executive and SAYE share option schemes are as follows:

	Notes (or on appointment)	Number of options at 1 January 2005	Number of options at 31 December 2005	Exercise price (pence)	Dates exercisable From	Dates exercisable To
George Culmer	1, 2, 3	481,012	481,012	79.0	14.06.07	13.06.14
		500,000	500,000	76.0	18.11.07	17.11.14
		–	787,500	80.0	08.04.08	07.04.15
		–	225,806	93.0	18.08.08	17.08.15
		–	12,466	75.0	01.12.08	31.05.09
Andy Haste	1, 2, 3	3,052,915	3,052,915	59.0	02.04.06	01.04.13
		1,298,701	1,298,701	92.4	16.10.06	15.10.13
		5,917	5,917	75.0	01.12.08	31.05.09
		443,037	443,037	79.0	14.06.07	13.06.14
		10,643	10,643	59.0	01.12.09	31.05.10
		921,052	921,052	76.0	18.11.07	17.11.14
		–	1,443,750	80.0	08.04.08	07.04.15
		–	413,978	93.0	18.08.08	17.08.15
		–	7,298	75.0	01.12.10	31.05.11
Bridget McIntyre (appointed 2 November 2005)	1, 3	–	301,724	116.0	13.12.08	12.12.15
David Paige (appointed 16 February 2005)	1, 2, 3	–	825,000	80.0	08.04.08	07.04.15
		–	182,796	93.0	18.08.08	17.08.15
		–	12,466	75.0	01.12.08	31.05.09

Notes:

- Options granted to directors on 8 April 2005, 18 August 2005 and 13 December 2005 under the ESOS scheme were granted at exercise prices of 80.0p, 93.0p and 116.0p respectively. These exercise prices were not less than the average of middle market quotations for the shares of the Group on the five business days prior to the date of grant.
- On 13 September 2005, SAYE options were granted at an exercise price of 75.0p.
- All of the above options were granted for nil consideration.

Long term incentive scheme (audited part)

Long term incentive scheme interests held during 2005 in respect of the ordinary shares of the Company are as follows:

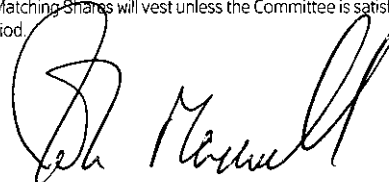
	Notes		Share awards held at 1 January 2005	Share awards granted during 2005	Share awards held at 31 December 2005	Date by which qualifying conditions must be fulfilled
George Culmer	2, 3	Deferred Share awards	–	128,938	128,938	08.04.08
		Matching Share awards	–	386,814	386,814	08.04.08
Andy Haste	2, 3	Deferred Share awards	197,046	265,136	462,182	14.06.07 – 08.04.08
		Matching Share awards	591,138	795,408	1,386,546	14.06.07 – 08.04.08
David Paige	2, 3	Deferred Share awards	–	65,100	65,100	08.04.08
		Matching Share awards	–	195,300	195,300	08.04.08

Notes:

- No other directors of the Company held long term incentive scheme interests during 2005.
- The market price of ordinary shares on 14 June 2004 and 08 June 2005, the dates on which the above long term incentive scheme interests were granted, were 79.25p and 77.62p respectively.
- Matching Share awards are capable of vesting in respect of a maximum of three times the number of Deferred Shares awarded, subject to the achievement of TSR targets over a single two year period. TSR performance is measured relative to other companies specified by the Remuneration Committee. For awards granted in 2004 and 2005, TSR will be measured partly relative to FTSE 100 companies and partly relative to the following financial services comparator group companies: Aegon, Legal & General Group, Allianz Group, Old Mutual, AXA, Prudential, Aviva, RAS, Generali and Zurich Financial Services Group. For 50% of the Matching Share awards, where TSR is measured against the FTSE 100, full vesting will only occur at upper decile performance, vesting will occur in the ratio of shares under Matching Share awards to shares under Deferred Share awards of 2:1 at upper quartile performance and vesting in the ratio 1:1 will occur at median performance. For the other 50% of the Matching Share awards, where TSR is measured against the financial services comparator group, full vesting will occur if TSR is highest in the comparator group, vesting in the ratio 2:1 will occur at upper quartile performance and vesting in the ratio 1:1 will occur at median performance. Matching Share awards will not vest at below median performance. For awards granted in 2004, the targets will be measured over the period from 1 April 2004 to 31 March 2006. For awards granted in 2005, the targets will be measured over the period from 1 April 2005 to 31 March 2007. The relevant TSR figures will be averaged over the three months before the beginning and end of this performance period. Additionally, no Matching Shares will vest unless the Committee is satisfied that there has been a sustained improvement in the underlying performance of the Company over the performance period.

John Maxwell

Chairman of the Remuneration Committee, on behalf of the Board
London
8 March 2006



Independent auditors' report to the members of Royal & Sun Alliance Insurance Group plc

We have audited the consolidated financial statements of Royal & Sun Alliance Insurance Group plc for the year ended 31 December 2005 which comprise the Consolidated Income Statement, the Consolidated Statement of Recognised Income and Expense, the Consolidated Balance Sheet, the Consolidated Cashflow Statement, Estimation techniques, uncertainties and contingencies, Significant accounting policies and the related notes on pages 69 to 113. These consolidated financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the Parent Company financial statements of Royal & Sun Alliance Insurance Group plc for the year ended and on the information in Directors' Emoluments and Directors' Interests that is described as having been audited.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the consolidated financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union are set out in the Directors' Report.

Our responsibility is to audit the consolidated financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the consolidated financial statements give a true and fair view and whether the consolidated financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you if, in our opinion, the Directors' Report is not consistent with the consolidated financial statements, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding director's remuneration and other transactions is not disclosed.

We review whether the Corporate Governance statement reflects the Company's compliance with the nine provisions of the 2003 FRC 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 other information contained in the Annual Report and consider whether it is consistent with the audited consolidated financial statements. The other information comprises only the Highlights, the Key business information, the Chairman's statement, the Group CEO's review, the Royal & SunAlliance today section, the Operating and Financial review, the Corporate Responsibility section, the Share and shareholder analysis, the Directors' Report, the Corporate Governance statement, the Remuneration Report and the unaudited part of Directors' Interests. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the consolidated 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 consolidated financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the consolidated financial statements, and of whether the accounting policies 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 Group financial statements 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 consolidated financial statements.

Opinion

In our opinion:

- The consolidated financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the Group's affairs as at 31 December 2005 and of its profit and cashflows for the year then ended,
- The consolidated financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation.

Michael Cooper
PricewaterhouseCoopers LLP

Chartered Accountants and Registered Auditors
London

8 March 2006

Consolidated Income Statement

for the year ended 31 December 2005

	Notes	2005 £m	2004 £m
Continuing operations			
Income			
Gross written premiums		6,420	6,655
Less: reinsurance premiums		(1,020)	(1,573)
Net written premiums		5,400	5,082
Change in the gross provision for unearned premiums		4	883
Less: change in provision for unearned premiums, reinsurers' share		(22)	(219)
Change in provision for unearned premiums		(18)	664
Net earned premiums		5,382	5,746
Net investment return	2	806	656
Other operating income	4	111	141
Total income		6,299	6,543
Expenses			
Gross claims incurred		(4,451)	(5,816)
Less: claims recoveries from reinsurers		856	1,555
Net claims and benefits	3	(3,595)	(4,261)
Underwriting and policy acquisition costs		(1,738)	(1,816)
Benefit from change of pension scheme design		180	—
		(1,558)	(1,816)
Unwind of discount		(61)	(71)
Other operating expenses	4	(252)	(291)
Total expenses		(5,466)	(6,439)
Results of operating activities		833	104
Finance costs	4	(107)	(75)
Profit/(loss) on disposal of subsidiaries		136	(2)
Net share of profit after tax of associates	11	3	8
Profit before tax on continuing operations		865	35
Income tax expense	5	(260)	(88)
Profit/(loss) for the year from continuing operations		605	(53)
Discontinued operations			
Loss for the year from discontinued operations	36	—	(27)
Profit/(loss) for the year		605	(80)
Attributable to:			
Equity holders of the Parent Company		555	(125)
Minority interests		50	45
		605	(80)
Earnings per share for profit/(loss) from continuing operations attributable to the equity holders of the Parent Company			
Basic	6	18.9p	(4.1)p
Diluted	6	18.7p	(4.1)p
Earnings per share for loss from discontinued operations attributable to the equity holders of the Parent Company			
Basic	6	—	(0.9)p
Diluted	6	—	(0.9)p
Ordinary dividends paid and proposed for the year			
Interim dividend paid (per share)	7	1.69p	1.65p
Final dividend proposed (per share)	7	3.05p	2.96p

The attached notes form an integral part of these consolidated financial statements.

Consolidated Statement of Recognised Income and Expense

for the year ended 31 December 2005

	2005 £m	2004 £m
Exchange gains/(losses)	62	(17)
Fair value (losses)/gains	(35)	21
Pension fund actuarial losses	(53)	(50)
Net losses recognised in equity	(26)	(46)
Profit/(loss) for the year	605	(80)
Total recognised income/(expense) for the year	579	(126)
Attributable to:		
Equity holders of the Parent Company	540	(174)
Minority interests	39	48
	579	(126)

All items are stated net of tax.

The attached notes form an integral part of these consolidated financial statements.

Consolidated Balance Sheet

as at 31 December 2005

	Notes	2005 £m	2004 £m
Assets			
Goodwill and other intangible assets	8	450	322
Property and equipment	9	410	418
Investment property	10	435	417
Investments in associates	11	29	29
Financial assets	12	13,533	13,135
Total investments		13,997	13,581
Reinsurers' share of insurance contract liabilities	13	4,406	4,424
Insurance and reinsurance debtors	14	2,547	2,684
Deferred acquisition costs	15	465	487
Deferred tax assets	23	33	174
Other debtors and other assets	16	636	617
		669	791
Cash and cash equivalents	17	1,617	1,866
		24,561	24,573
Non current assets and assets of operations held for sale	36	36	81
Total assets		24,597	24,654
Equity, reserves and liabilities			
Equity and reserves			
Shareholders' equity		2,743	2,321
Subordinated guaranteed perpetual notes	19	—	444
Minority interests		391	368
Total equity and reserves	18	3,134	3,133
Liabilities			
Loan capital	19	1,071	607
Insurance contract liabilities	20	17,204	17,191
Insurance and reinsurance liabilities	21	475	778
Borrowings	22	251	349
Current tax liabilities	23	55	78
Deferred tax liabilities	23	236	101
Provisions	24	693	914
Other liabilities	25	1,478	1,426
Provisions and other liabilities		2,462	2,519
		21,463	21,444
Liabilities of operations held for sale	36	—	77
Total liabilities		21,463	21,521
Total equity, reserves and liabilities		24,597	24,654

The attached notes form an integral part of these consolidated financial statements.

The financial statements were approved on 8 March 2006 by the Board of Directors and are signed on its behalf by:

George Culmer
Chief Financial Officer



Consolidated Cashflow Statement

for the year ended 31 December 2005

	Notes	2005 £m	2004 £m
Cash generated from continuing operations	33	(462)	(244)
Income tax paid		(65)	(52)
Interest received/(paid)		556	504
Dividends received		2	5
Cashflows from discontinued operations		—	(797)
Loss on disposal of discontinued operations		—	107
Net cashflows from operating activities		31	(477)
Proceeds from sales or maturities of:			
Available for sale investments		10,046	12,179
Investment property		46	23
Property and equipment		13	7
Intangible assets		3	8
Investments in subsidiaries (net of cash disposed of)	32	113	1,005
Investments in associates		5	107
Purchase of:			
Available for sale investments		(10,058)	(15,906)
Investment property		(31)	(42)
Property and equipment		(60)	(111)
Intangible assets		(144)	(123)
Investments in subsidiaries (net of cash acquired)	32	(63)	(12)
Cashflows from discontinued operations		—	940
Net cashflows from investing activities		(130)	(1,925)
Proceeds from issue of share capital		2	—
Purchase of treasury shares		(3)	—
Dividends paid to ordinary shareholders		(116)	(107)
Dividends paid to preference shareholders		(9)	(9)
Interest on subordinated guaranteed perpetual notes		—	(10)
Dividends paid to minority interests		(13)	(12)
Proceeds from issuance of long term borrowings		—	295
Net movement in other borrowings		(86)	(84)
Net cashflows from financing activities		(225)	73
Net decrease in cash and cash equivalents and bank overdrafts		(324)	(2,329)
Cash and cash equivalents and bank overdrafts at beginning of the year		1,864	4,254
Effect of exchange rate changes on cash and cash equivalents		72	(61)
Cash and cash equivalents and bank overdrafts at end of the year	17	1,612	1,864

The attached notes form an integral part of these consolidated financial statements.

Estimation techniques, uncertainties and contingencies

Introduction

One of the purposes of insurance is to enable policyholders to protect themselves against uncertain future events. Insurance companies accept the transfer of uncertainty from policyholders and seek to add value through the aggregation and management of these risks.

The uncertainty inherent in insurance is inevitably reflected in the financial statements of insurance companies. The uncertainty in the financial statements principally arises in respect of the insurance liabilities of the company.

The insurance liabilities of an insurance company include the provision for unearned premiums and unexpired risks and the provision for outstanding claims. Unearned premiums and unexpired risks represent the amount of income set aside by the company to cover the cost of claims that may arise during the unexpired period of risk of insurance policies in force at the Balance Sheet date. Outstanding claims represent the company's estimate of the cost of settlement of claims that have occurred by the Balance Sheet date but have not yet been finally settled.

In addition to the inherent uncertainty of having to make provision for future events, there is also considerable uncertainty as regards the eventual outcome of the claims that have occurred by the Balance Sheet date but remain unsettled. This includes claims that may have occurred but have not yet been notified to the company and those that are not yet apparent to the insured.

As a consequence of this uncertainty, the insurance company needs to apply sophisticated estimation techniques to determine the appropriate provisions.

Estimation techniques

Claims and unexpired risks provisions are determined based upon previous claims experience, knowledge of events and the terms and conditions of the relevant policies and on interpretation of circumstances. Particularly relevant is experience with similar cases and historical claims payment trends. The approach also includes the consideration of the development of loss payment trends, the levels of unpaid claims, legislative changes, judicial decisions and economic conditions.

Where possible the Group adopts multiple techniques to estimate the required level of provisions. This assists in giving greater understanding of the trends inherent in the data being projected. The Group's estimates of losses and loss expenses are reached after a review of several commonly accepted actuarial projection methodologies and a number of different bases to determine these provisions. These include methods based upon the following:

- The development of previously settled claims, where payments to date are extrapolated for each prior year,
- Estimates based upon a projection of claims numbers and average cost,
- Notified claims development, where notified claims to date for each year are extrapolated based upon observed development of earlier years,
- Expected loss ratios.

In addition, the Group uses other methods such as the Bornhuetter-Ferguson method, which combines features of the above methods. The Group also uses bespoke methods for specialist classes of business. In selecting its best estimate, the Group considers the appropriateness of the methods and bases to the individual circumstances of the provision class and underwriting year. The process is designed to select the most appropriate best estimate.

Large claims impacting each relevant business class are generally assessed separately, being measured either at the face value of the loss adjusters' estimates or projected separately in order to allow for the future development of large claims.

Provisions are calculated gross of any reinsurance recoveries. A separate estimate is made of the amounts that will be recoverable from reinsurers based upon the gross provisions and having due regard to collectability.

The claims provisions are subject to close scrutiny both within the Group's business units and at Group Corporate Centre. In addition, for major classes where the risks and uncertainties inherent in the provisions are greatest, regular and ad hoc detailed reviews are undertaken by advisers who are able to draw upon their specialist expertise and a broader knowledge of current industry trends in claims development. As an example, the Group's exposure to asbestos and environmental pollution is examined on this basis. The results of these reviews are considered when establishing the appropriate levels of provisions for outstanding claims and unexpired periods of risk.

It should be emphasised that the estimation techniques for the determination of insurance liabilities involve obtaining corroborative evidence from as wide a range of sources as possible and combining these to form the overall estimate. This technique means that the estimate is inevitably deterministic rather than stochastic. A stochastic valuation approach, whereby a range of possible outcomes is estimated and probabilities assigned thereto, is only possible in a limited number of situations.

The pension assets and pension and post retirement liabilities are calculated in accordance with International Accounting Standard 19 (IAS 19). *The assets, liabilities and Income Statement charge, calculated in accordance with IAS 19, are sensitive to the assumptions made, including inflation, interest rate, investment return and mortality.*

Uncertainties and contingencies

The uncertainty arising under insurance contracts may be characterised under a number of specific headings, such as:

- Uncertainty as to whether an event has occurred which would give rise to a policyholder suffering an insured loss,
- Uncertainty as to the extent of policy coverage and limits applicable,
- Uncertainty as to the amount of insured loss suffered by a policyholder as a result of the event occurring,
- Uncertainty over the timing of a settlement to a policyholder for a loss suffered.

The degree of uncertainty will vary by policy class according to the characteristics of the insured risks and the cost of a claim will be determined by the actual loss suffered by the policyholder.

There may be significant reporting lags between the occurrence of the insured event and the time it is actually reported to the Group. Following the identification and notification of an insured loss, there may still be uncertainty as to the magnitude and timing of the settlement of the claim. There are many factors that will determine the level of uncertainty such as inflation, inconsistent judicial interpretations and court judgments that broaden policy coverage beyond the intent of the original insurance, legislative changes and claims handling procedures.

The establishment of insurance liabilities is an inherently uncertain process and, as a consequence of this uncertainty, the eventual cost

of settlement of outstanding claims and unexpired risks can vary substantially from the initial estimates, particularly for long tail lines of business. The Group seeks to provide appropriate levels of claims provision and provision for unexpired risks taking the known facts and experience into account.

The Group has exposures to risks in each class of business within each operating segment that may develop and that could have a material impact upon the Group's financial position in the period in which the development occurs. The geographical and insurance risk diversity within the Group's portfolio of issued insurance policies make it not possible to predict whether material development will occur and, if it does occur, the location and the timing of such an occurrence. The estimation of insurance liabilities involves the use of judgements and assumptions that are specific to the insurance risks within each territory and the particular type of insurance risk covered. The diversity of the insurance risks results in it not being possible to identify individual judgements and assumptions that are more likely than others to have a material impact on the future development of the insurance liabilities.

The sections below identify a number of specific risks relating to asbestos and environmental claims and to insurance risks remaining within the Group's discontinuing US operations. There may be other classes of risk that are not specifically identified below, which could develop in the future and that could have a material impact on the Group's financial position during the period in which the development occurs.

The Group evaluates the concentration of exposures to individual and cumulative insurance risk and establishes its reinsurance policy to reduce such exposure to levels acceptable to the Group.

Asbestos and environmental claims

The estimation of the provisions for the ultimate cost of claims for asbestos and environmental pollution is subject to a range of uncertainties that is generally greater than those encountered for other classes of insurance business. As a result it is not possible to determine the future development of asbestos and environmental claims with the same degree of reliability as with other types of claims, particularly in periods when theories of law are in flux. Consequently, traditional techniques for estimating claims provisions cannot wholly be relied upon and the Group employs specialised techniques to determine provisions using the extensive knowledge of both internal asbestos and environmental pollution experts and external legal and professional advisors.

Factors contributing to this higher degree of uncertainty include:

- Plaintiffs' expanding theories of liability, compounded by inconsistent court decisions and judicial interpretations,
- A few large claims, accompanied by a very large number of small claims or claims made with no subsequent payment, often driven by intensive advertising by lawyers seeking claimants,
- The tendency for speculative, inflated and/or unsupported claims to be made to insurers, with the aim of securing a settlement on advantageous terms,
- The long delay in reporting claims and exposures, since the onset of illness and disability arising from exposure to harmful conditions may only become apparent many years later (for example, cases of mesothelioma can have a latent period of up to 40 years),
- Inadequate development patterns,

- Difficult issues of allocation of responsibility among potentially responsible parties and insurers,
- Complex technical issues that may give rise to delays in notification arising from unresolved legal issues on policy coverage and the identity of the insureds,
- The tendency for social trends and factors to influence jury verdicts,
- Developments pertaining to the Group's ability to recover reinsurance for claims of this nature.

Further information on specific developments in the US in relation to asbestos and environmental claims is discussed below.

Representations and warranties

In the course of disposal of businesses the Group provides representations and warranties to counterparties in contracts in connection with various transactions and may also provide indemnifications that protect the counterparties to the contracts in the event that certain liabilities arise (covering such matters as tax, property, environmental issues etc). While such representations, warranties and indemnities are essential components of many contractual relationships, they do not represent the underlying purpose for the transaction. These clauses are customary in such contracts and may from time to time lead to us receiving claims from counterparties.

Financial enhancement products

In the UK and US the Group has exposures to financial enhancement products, which provide surety to banks, lending institutions and credit facilities that insure principal and interest repayment on debt securities. The Group no longer writes such business; however, the nature of such contracts is normally that the Group is on risk for more than one year and therefore liabilities remain for an extended period. Further information on financial enhancement products in the US is discussed below.

Litigation, mediation and arbitration

The Group, in common with the insurance industry in general, is subject to litigation, mediation and arbitration, and regulatory and other sectoral inquiries in the normal course of its business. The directors do not believe that any current mediation, arbitration, regulatory or sectoral inquiries and pending or threatened litigation or dispute, as outlined elsewhere in this note, will have a material adverse effect on the Group's financial position, although there can be no assurance that losses resulting from any pending mediation, arbitration, regulatory inquiries and threatened litigation or dispute will not materially affect the Group's financial position or cashflows for any period. Further information on US litigation is discussed below.

Reinsurance

The Group is exposed to disputes on, and defects in, contracts with its reinsurers and the possibility of default by its reinsurers. The Group is also exposed to the credit risk assumed in fronting arrangements. In selecting the reinsurers with whom we do business our strategy is to seek reinsurers with the best combination of credit rating, price and capacity.

We publish internally a list of authorised reinsurers who pass our selection process and which our operations may use for new transactions.

The Group monitors the financial strength of its reinsurers, including those to whom risks are no longer ceded. Allowance is made in the financial position for non recoverability due to reinsurer default by requiring operations to provide, in line with Group standards, having regard to companies on the Group's 'Watch List'. The Watch List is the

Estimation techniques, uncertainties and contingencies

continued

list of companies whom the directors believe will not be able to pay amounts due to the Group in full.

Changes in foreign exchange rates may impact our results

We publish our consolidated financial statements in pounds sterling. Therefore, fluctuations in exchange rates used to translate other currencies, particularly other European currencies and the US dollar, into pounds sterling will impact our reported consolidated financial condition, results of operations and cashflows from period to period. These fluctuations in exchange rates will also impact the pound sterling value of our investments and the return on our investments.

Income and expenses for each Income Statement item are translated at average exchange rates. Balance Sheet assets and liabilities are translated at the closing exchange rates at the Balance Sheet date.

Investment risk

The Group is exposed to credit risk on its invested assets. Credit risk includes the non performance of contractual payment obligations on invested assets and adverse changes in the creditworthiness of invested assets including exposures to issuers or counterparties for bonds, equities, deposits and derivatives. Our insurance investment portfolios are concentrated in listed securities. We use derivative financial instruments to reduce our exposure to adverse fluctuations in interest rates, foreign exchange rates and equity markets. We have strict controls over the use of derivative instruments.

Rating agencies

The ability of the Group to write certain types of insurance business is dependent on the maintenance of the appropriate credit ratings from the rating agencies. The Group has the objective of maintaining single 'A' ratings. At the present time the ratings are 'A-' from S&P and 'A-' from AM Best. Any worsening in the ratings would have an adverse impact on the ability of the Group to write certain types of general insurance business.

Regulatory environment

The regulatory environment is subject to significant change in many of the jurisdictions in which we operate. We continue to monitor the developments and react accordingly. The directors are confident that the Group will continue to meet all future regulatory capital requirements.

In addition the Group is continuing to monitor and respond to consultation on the latest Solvency II proposals, which are intended, in the medium term, to achieve greater harmonisation of approach across European member states to assessing capital resources and requirements.

US operations

In addition to the disclosures above there are a number of specific risks and issues pertaining to our US operations as follows:

Asbestos and environmental claims

In respect of asbestos and environmental claims the position in the US is particularly problematic, as plaintiffs have expanded their focus to defendants beyond the 'traditional' asbestos manufacturers and distributors. This has arisen as a consequence of the increase in the number of insureds seeking bankruptcy protection because of asbestos related litigation and the exhaustion of their policy limits. Plaintiffs, supported by lawyers remunerated on a contingent fee basis, are now seeking to draw in a wide cross section of defendants who previously only had peripheral or secondary involvement in asbestos litigation. This may include companies which have distributed or incorporated asbestos containing parts in their products or operated premises where

asbestos was present. There are also increasing signs of attempts to reopen and reclassify into other insurance coverages previously settled claims, and the filing of claims under the non aggregate premises or operations section of general liability policies. There are also indications that plaintiffs may seek damages by asserting that insurers had a duty to protect the public from the dangers of asbestos.

Federal legislation that would address asbestos related problems, Senate Bill 852, an amended version of Senate Bill 2290 (Fairness in Asbestos Injury Resolution or 'FAIR' Act), was introduced in April 2005 by Senate Judiciary Committee Chair Arlen Specter. The amended bill includes establishing a privately financed trust fund to provide payments to individuals with asbestos related illnesses and removal of asbestos claims from the tort litigation system for the duration of the fund. The proposed bill would remove pending and future cases from the judicial system and place these cases and claims into a no fault trust fund to be administered by the US Department of Labor. It would establish medical criteria to ensure that only people who showed signs of asbestos related illnesses would be entitled to payments from the trust.

However, there are concerns that the bill contains several loopholes which would allow cases to revert to the tort system at various points of the trust fund's life. This would undermine the certainty and finality that insurers and manufacturers/defendants seek.

Given the recent events in the Senate where floor debate ended with Senate Bill 852 sent back to Committee and the heavy opposition that remains for various parties, any prospects of passage of SB 852 in its current form are speculative at best. It is possible that the focus could shift to a medical criteria or another version of asbestos reform.

Against this background and in common with the industry generally, the Group in the US receives notifications and approaches from, and on behalf of, insureds who previously had peripheral or secondary involvement in asbestos litigation indicating that they may be seeking coverage under Group policies. Given the uncertainties outlined above as to the potential of loss suffered, the availability of coverage and the often long delay in reporting these issues it is difficult to predict the outcome of these notifications and approaches. The greatest difficulty is with estimating whether the Group has any liability as many of these are discharged at no cost to the Group or have been settled below the quantum sought, although there can be no certainty that this will always be the case. It is clear that there is unlikely to be any firm direction in case law or legislation which would allow for these issues to be resolved satisfactorily in the near term and no likelihood of the plaintiffs' bar in the US easing its aggressive stance with litigation. Management, therefore, expect that these notifications and approaches will continue to be received for some time to come. One such approach received during 2004 from General Motors Corporation is now the subject of ongoing litigation.

Financial enhancement products

Within the financial enhancement portfolio of Financial Structures Limited, a subsidiary of the US Group, are a variety of financial enhancement product exposures including collateralised debt obligations (CDO), credit enhancement and residual value insurance contracts. These products are no longer written.

During the first quarter 2005 the Group terminated a number of these contracts for a net pre tax gain of \$7m. The fair value of the remaining two contracts was a liability of \$157m at 31 December 2005, unchanged since 31 December 2004.

During February 2006 one of the remaining two contracts was terminated for a net pre tax gain of \$4m. The fair value of the remaining contract at 31 December 2005 was a liability of \$75m.

Litigation

As discussed above, the Group is subject to litigation, mediation and arbitration, and regulatory and other sectoral inquiries in the normal course of its business. This is particularly so in respect of its US operations where there are a number of ongoing litigations. The status of two major US litigations is as follows:

Student Finance Corporation

In early 2002, issues arose in connection with a series of credit risk insurance policies covering loans made to students in various post secondary trade schools, primarily truck driving schools. The original loan portfolio had a face value of approximately \$501m. In mid July 2002, Royal Indemnity Company, a US subsidiary, filed lawsuits in Texas state court, seeking among other things rescission of these policies in response to a systematic pattern of alleged fraud, misrepresentation and cover up by various parties, which among other things concealed the default rate of the loans. Since Royal Indemnity's lawsuits seek rescission of these policies, all the Group's financial accounting entries associated with the transactions have been reversed. The ultimate outcome of the suits is uncertain.

The foregoing rescission actions gave rise to other related lawsuits filed in Delaware by MBIA Insurance Corporation (MBIA) and various banks, seeking to enforce the Royal Indemnity credit risk insurance policies. Plaintiffs in the Delaware actions included Wells Fargo Bank Minnesota, NA (Wells Fargo), in its capacity as trustee of a number of securitisations that were collateralised by student loans, and MBIA which insured the obligations issued through these securitisations. These actions were heard in US District Court, District of Delaware. Plaintiffs in the Delaware actions moved for summary judgement. The Court granted summary judgement to MBIA and Wells Fargo on 30 September 2003.

Calculated through 31 December 2005, the total amount awarded by the foregoing summary judgements was approximately \$386m. Royal Indemnity appealed each of these judgements. On 4 October 2005 the Court of Appeal upheld the District Court's ruling that Royal Indemnity waived its right to rescind its policy obligations based on Student Finance Corporation's fraud and that the policies remain in force. The Court, however, concluded that Royal Indemnity has raised a triable issue as to whether all of the losses claimed by the beneficiaries were covered under those policies. As a result, the Court overturned the summary judgement and returned the case to the District Court to determine coverage and whether the policies cover all of the losses claimed. Royal Indemnity has filed a petition for a rehearing of its appeal.

In April 2005 and October 2005, respectively, PNC Bank and Wilmington Trust, plaintiffs in the Delaware actions, agreed to discontinue their parts of the legal action following agreed settlements.

The ultimate outcome of these lawsuits is necessarily uncertain. In the event Royal Indemnity's lawsuits do not result in complete rescission of all applicable policies, any loss on the loan portfolio will be reduced to the extent of reinsurance available to Royal Indemnity, recoveries from the original borrowers on the defaulted loans, and reserves, if any. Any losses may be further offset by recoveries from other third parties. To that end, Royal Indemnity is actively pursuing recovery actions against certain trucking school entities and professional advisers. However, there can be no assurance that the outcome of these lawsuits, the availability

of reinsurance recoveries, the extent and amount of recoveries from the borrower under the respective loan programmes and/or reserves, if any, among other factors, will be resolved in favour of Royal Indemnity.

Based on current knowledge of the circumstances, legal advice received and the range of other actions available to the Group to manage any insurance exposure, the directors believe that the resolution of the legal proceedings in respect of these credit risk insurance policies will not have a material adverse effect on the Group's financial position.

World Trade Center

The estimated cost of the insurance losses associated with the terrorist action of 11 September 2001 is a gross loss in excess of £1bn, reduced to £280m net of reinsurance. This was an unprecedented event, which still has unresolved issues in respect of both the gross loss and consequent extent of the reinsurance recoveries. The loss estimate has been prepared on the basis of the information currently available as to the magnitude of the claims, including business interruption losses. The final cost may be different from the current estimate due to the uncertainty associated with ongoing appeals and the valuation and allocation process which is currently underway in respect of the Twin Towers complex. Appraisal hearings are scheduled to continue until December 2006. Nevertheless, the directors believe their estimate of the gross and net loss is appropriate based on the information available to them and that there will be no material adverse effect on the Group's financial position.

Restructuring plans

Our US restructuring plans are complex and are subject to particular risks. Although we have reduced the number of lead regulatory states, our US subsidiaries are subject to government regulation in their states of domicile and also in each of the jurisdictions in which they are licensed or authorised to do business. In the US, the conduct of insurance business is regulated at the state level and not by the federal government and our subsidiaries are subject to state supervision of their regulatory capital and surplus positions. At 31 December 2005 our consolidated US regulatory capital and surplus capital position was 2.2 times the NAIC ratio.

Our objective is to reduce or eliminate the Group's exposures in relation to our US business and we continue to review all options.

Significant accounting policies

The principal accounting policies applied in the preparation of the consolidated financial statements are set out below.

Consolidated financial statements

The consolidated financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. The consolidated financial statements are prepared under the historical cost convention as modified by the revaluation of available for sale financial assets, investment property, Group occupied property and financial assets and financial liabilities held for trading (which include all derivative contracts).

Except where otherwise stated, all figures included in the consolidated financial statements are presented in millions of British pounds sterling (£m), rounded to the nearest million.

Adoption of International Financial Reporting Standards

The Group adopted IFRS for the year ended 31 December 2005. Previously the Group's consolidated financial statements were prepared in accordance with applicable UK accounting standards and the Statement of Recommended Practice issued by the Association of British Insurers in November 2003. The previously reported 2004 consolidated financial statements have been restated to comply with IFRS. The impact of the adoption of IFRS, which materially affected the consolidated financial statements, has been reflected within note 1 'First time adoption of IFRS'.

Consolidation

Subsidiaries

Subsidiaries are entities over which the Group has the power to govern the financial and operating policies so as to obtain benefits from its activities, generally accompanying a shareholding of more than one half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are deconsolidated from the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group.

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, including 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, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recognised as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the Income Statement.

Intercompany transactions, balances and unrealised gains on transactions between Group companies are eliminated. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Group.

Associates

Associates are entities over which the Group has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for by the equity method of accounting and are initially recognised at cost.

The Group's shares of its associates' post acquisition profits or losses are recognised in the Income Statement, and its share of post acquisition movements in reserves are recognised in reserves. The cumulative post acquisition movements are adjusted in the carrying amount of the investment. When the Group's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Adjustments are made, where necessary, to conform the accounting policies of associates to ensure consistency with the policies adopted by the Group.

Selection of accounting policies

The Group exercises judgement in selecting each Group accounting policy. The accounting policies of the Group are selected by the directors to present financial statements that they consider provides the most relevant information. For certain accounting policies there are different accounting treatments that could be adopted, each of which would be in compliance with IFRS and would have a significant influence upon the basis on which the financial statements are presented. The bases of selection of the accounting policies for the accounting for financial assets and for the recognition of actuarial gains and losses related to pension obligations are set out below:

- The Group accounting policy is to designate all financial assets that meet the necessary conditions as available for sale financial assets. This designation enables the Group to recognise the investment return earned on such assets in a consistent manner with the internal measures applied to measure the performance of the individual operations.
- The Group accounting policy is to recognise actuarial gains and losses arising from the recognition and funding of the Group's pension obligations in the period in which they arise. This policy has been adopted as it provides the most relevant basis of recognition of such gains and losses.

Translation of foreign currencies

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency).

The results and financial position of those Group entities whose functional currency is not British pounds sterling are translated into British pounds sterling as follows:

- Assets and liabilities for each Balance Sheet presented are translated at the closing exchange rate at the date of that Balance Sheet.
- Income and expenses for each Income Statement are translated at average exchange rates during each period.
- All resulting exchange differences are recognised as a component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments, are taken to equity. When a foreign entity is sold, the cumulative exchange differences relating to that foreign entity are recognised in the Income Statement as part of the gain or loss on sale.

Goodwill arising on the acquisition of a foreign entity is treated as an asset of the foreign entity and the carrying value translated at the closing exchange rate.

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the Income Statement.

Translation differences on non monetary items, such as equities classified as available for sale financial assets, are included in the fair value reserve in equity.

Goodwill and other intangible assets

Goodwill, being the difference between the cost of a business acquisition and the Group's interest in the net fair value of the identifiable assets and liabilities acquired, is initially capitalised in the Balance Sheet at cost and is subsequently recognised at cost less accumulated impairment losses. The cost of the acquisition is the amount of cash paid and the fair value of other purchase consideration given together with associated expenses. Goodwill is subject to an impairment review at least annually. If there are indications of impairment, the recoverable amount is determined. Where the carrying amount is more than the recoverable amount, an impairment is recognised.

When calculating the goodwill arising on an acquisition, claims provisions are discounted to present value. Immediately following the acquisition, the claims provisions are valued at full nominal value. This increase in liabilities is matched by the recognition of an intangible asset arising from acquired claims provisions, representing the present value of future investment income implicit in the claims discount. The intangible asset is amortised over the expected run off period and is tested in the context of the liability adequacy test of insurance liabilities where the balances of intangible assets associated with insurance contracts is deducted from the carrying amount of the insurance liabilities.

Expenditure that increases the future economic benefits arising from computer software in excess of its standard of performance assessed immediately before the expenditure was made, is recognised as an intangible asset and amortised using the straight line method over a period of three to five years.

Property and equipment

Property and equipment comprise Group occupied land and buildings, fixtures, fittings and equipment (including computer hardware and motor vehicles). These assets are depreciated over periods not exceeding their estimated useful life after taking into account residual values.

Group occupied property is stated at fair value, less subsequent depreciation for buildings. All other assets are stated at depreciated cost. Fair value movements are recorded in equity.

Fair value is based on current prices in an active market for similar property in the same location and condition and subject to similar contractual terms of ownership. Valuations are performed by external professionally qualified valuation surveyors on at least an annual basis, with reference to current market conditions.

All other classes are stated at cost less accumulated depreciation. Cost includes expenditure that is directly attributable to the acquisition of the items. Subsequent costs are included in the asset only when it is probable that future economic benefits associated to the item will flow to the Group and the cost can be measured reliably.

Land is not depreciated. Depreciation on all other items is calculated on the straight line method to write down the cost of such assets to their residual value over their estimated useful lives as follows:

Group occupied buildings	normally 30 years
Fixtures and fittings	10 years
Motor vehicles	4 years
Equipment	3-5 years

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the Balance Sheet date.

An asset's carrying amount is written down to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

Increases in the carrying amount arising on the revaluation of Group occupied property are credited to revaluation surplus in equity. Decreases that offset the previous increases of the same asset are charged against revaluation surplus directly in equity, other decreases are charged to the Income Statement. Each year the difference between depreciation based on the fair value of the asset charged to the Income Statement and depreciation based on the assets original cost is transferred from revaluation surplus to retained earnings.

Investment property

Investment property, comprising freehold and leasehold land and buildings, is held for long term rental yields and is not occupied by the Group.

Investment property is recorded at fair value, measured by independent professionally qualified valuers, who hold a recognised and relevant professional qualification and have recent experience in the location and category of the investment property being valued, on an annual basis or more frequently and by internal valuers for interim periods, with reference to current market conditions. Related unrealised gains and unrealised losses or changes thereof are recognised in investment income.

Financial assets

A financial asset is initially recognised, on the date the Group commits to purchase the asset, at fair value plus, in the case of all financial assets not classified as at fair value through the Income Statement, transaction costs that are directly attributable to its acquisition. A financial asset is derecognised when the rights to receive cashflows from the investment have expired or have been transferred and the Group has also transferred substantially the risks and rewards of ownership of the asset.

Significant accounting policies

continued

On initial recognition, the financial assets are categorised into the following categories: financial assets at fair value through the Income Statement, loans and receivables, held to maturity financial assets and available for sale financial assets. The classification depends on the purpose for which the investments were acquired. Management determines the classification of its investments at initial recognition.

The Group designates its financial assets as available for sale financial assets on initial recognition of a financial asset. On subsequent measurement, investments are measured at fair value with changes in fair value recognised in equity. Where the cumulative changes recognised in equity represent an unrealised loss the individual asset or group of assets is reviewed to test whether an indication of impairment exists.

For securities whose fair values are readily determined and where there is objective evidence that such an asset is impaired, including a significant or prolonged decline in the fair value below cost, the unrealised loss charged to equity is reclassified to the Income Statement.

If the fair value of a previously impaired debt security increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, the impairment loss is reversed and the reversal recognised in the Income Statement. Impairment losses on equity investments are not reversed.

Investment income is recognised in the Income Statement. Dividends on equity investments are recognised on the date at which the investment is priced 'ex dividend'. Interest income is recognised using the effective interest method. Unrealised gains and losses on available for sale investments are recognised directly in equity, except for impairment losses and foreign exchange gains and losses on monetary items (which are recognised in the Income Statement). On derecognition of an investment, the cumulative gain or loss previously recognised in equity is recognised in the Income Statement.

Derivative financial instruments

Derivatives are recognised in the Balance Sheet on a trade date basis and are carried at fair value. Derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative. The method of recognising the resulting gain or loss depends on whether the derivative is designated as a hedging instrument and the nature of the item being hedged.

Hedging

Transactions are classified as hedging transactions when the following conditions for hedge accounting are met:

- There is a formal designation and documentation of the hedging relationship and the Group's risk management objective and strategy for undertaking the hedge,
- The hedge is expected to be highly effective in achieving offsetting changes in fair value or cashflows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship,

- The effectiveness of the hedge can be reliably measured,
- For cashflow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cashflows that could ultimately affect profit or loss,
- The hedge is assessed on an ongoing basis and determined to have been highly effective.

Where loan capital is designated as the hedging instrument against the net investment in foreign entities, the effective portion of the hedge is recognised in equity; the gain or loss relating to the ineffective portion is recognised immediately in the Income Statement. Gains and losses accumulated in equity are included in the Income Statement when the underlying hedged item is derecognised.

Estimation of the fair value of financial assets and liabilities

The methods and assumptions used by the Group in estimating the fair value of financial assets and liabilities are:

- For fixed maturity securities, fair values are generally based upon quoted market prices. Where market prices are not readily available, fair values are estimated using either values obtained from quoted market prices of comparable securities or estimated by discounting expected future cashflows using a current market rate applicable to the yield, credit quality and maturity of the investment,
- For equity securities fair values are based upon quoted market prices,
- If the market for a financial asset is not active, the Group establishes fair value by using valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cashflow analysis and option pricing models,
- For mortgage loans on real estate and collateral loans, fair values are estimated using discounted cashflow calculations based upon prevailing market rates,
- For cash, short term investments, commercial paper, other assets, liabilities and accruals carrying amounts approximate to fair values,
- For notes, bonds and loans payable, fair values are determined by reference to quoted market prices or estimated using discounted cashflow calculations based upon prevailing market rates. Loan capital is carried at amortised cost and when this is different from fair value this is shown in the relevant note. Fair value in this case is based on discounted future cashflows. For borrowings that carry a variable rate of interest (other than loan capital), carrying values approximate to fair values,
- For derivatives, fair values are generally based upon quoted market prices.

Insurance contracts

Product classification

Insurance contracts are those contracts that transfer significant insurance risk at the inception of the contract. Insurance risk is transferred when the Group agrees to compensate a policyholder if a specified uncertain

future event (other than a change in a financial variable) adversely affects the policyholder. Any contracts not meeting the definition of an insurance contract under IFRS are classified as investment contracts or derivative contracts, as appropriate.

Recognition of income

Premiums written are accounted for in the period in which the contract is entered into and include estimates where the amounts are not determined at the Balance Sheet date. Premiums written exclude taxes and duties levied on premiums and directly related expenses eg commissions. Premiums are earned as revenue over the period of the contract and are calculated principally on a daily pro rata basis.

Acquisition costs

Acquisition costs comprise the direct and indirect costs of obtaining and processing new insurance business. These costs are recognised as a deferred acquisition cost asset and amortised on the same basis as the related premiums are earned.

Insurance liabilities

The provision for unearned premium represents the portion of the premiums written relating to periods of insurance coverage subsequent to the Balance Sheet date.

The provisions for claims outstanding, whether reported or not, comprises the estimated cost of claims incurred but not settled at the Balance Sheet date. It includes related expenses and a deduction for the expected value of salvage and other recoveries. The provision is determined using the best information available of claims settlement patterns, forecast inflation and settlement of claims.

The provisions for claims outstanding, and related reinsurance recoveries, are discounted where there is a particularly long period from incident to claims settlement and where there exists a suitable claims payment pattern from which to calculate the discount. In defining those claims with a long period from incident to claims settlement, those categories of claims where the average period of settlement is six years or more from the Balance Sheet date, has been used as a guide. The discount rate used is based upon an investment return expected to be earned by assets, which are appropriate in magnitude and nature to cover the provisions for claims outstanding being discounted, during the period necessary for the payment of such claims.

The provisions for claims outstanding relating to long term permanent disability claims in the US, Canada and Scandinavia are determined using recognised actuarial methods.

Differences between the estimated cost and subsequent settlement of claims are recognised in the Income Statement in the year in which they are settled or in which the provisions for claims outstanding are re-estimated.

At each Balance Sheet date an assessment is made of whether the provisions for unearned premiums are adequate. A separate provision is made, based on information available at the Balance Sheet date, for any estimated future underwriting losses relating to unexpired risks.

The provision is calculated after taking into account future investment income that is expected to be earned from the assets backing the provisions for unearned premiums (net of deferred acquisition costs). The unexpired risk provision is assessed in aggregate for business classes which, in the opinion of the directors, are managed together.

Reinsurance ceded

Premiums payable in respect of reinsurance ceded, are recognised in the period in which the reinsurance contract is entered into and include estimates where the amounts are not determined at the Balance Sheet date. Premiums are expensed over the period of the reinsurance contract, calculated principally on a daily pro rata basis.

A reinsurance asset, (reinsurers' share of insurance liabilities) is recognised to reflect the amount estimated to be recoverable under the reinsurance contracts in respect of the outstanding claims reported under insurance liabilities. The amount recoverable from reinsurers is initially valued on the same basis as the underlying claims provision. The amount recoverable is reduced when there is an event arising after the initial recognition that provides objective evidence that the Group may not receive all amounts due under the contract and the event has a reliably measurable impact on the expected amount that will be recovered from the reinsurer.

The reinsurers' shares of each unexpired risk provision is recognised on the same basis.

Annuities purchased by the Group to make payments under structured settlement arrangements are accounted for as reinsurance ceded if the Group remains liable for the settlement in the event of default by the annuity provider. Any gain or loss arising on the purchase of an annuity is recognised in the Income Statement at the date of purchase.

Cash and cash equivalents

Cash and cash equivalents are short term, highly liquid investments that are subject to insignificant changes in value and are readily convertible into known amounts of cash. Cash equivalents comprise financial assets with less than three months maturity from the date of acquisition.

Treasury shares

Treasury shares are deducted from equity. No gain or loss is recognised on the purchase, sale, issue or cancellation of the treasury shares. Any consideration paid or received is recognised directly in equity.

Loan capital

Loan capital comprises subordinated bonds which are stated at the consideration received less transaction costs. Subsequently, it is measured at amortised cost using the effective interest rate method.

Taxation

Taxation in the Income Statement is based on profits and income for the year as determined in accordance with the relevant tax legislation, together with adjustments to provisions for prior years. UK tax in respect of overseas subsidiaries and principal associated undertakings is recognised as an expense in the year in which the profits arise, except where the remittance of earnings can be controlled

Significant accounting policies

continued

and it is probable that remittance will not take place in the foreseeable future, in which case UK tax is based on dividends received.

Deferred tax is provided in full using the liability method on temporary differences arising between the tax bases of assets and liabilities and the carrying amounts in the financial statements. However, if the deferred tax arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss, it is not accounted for. Deferred tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the Balance Sheet date and are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which these temporary differences can be utilised.

Employee benefits

Pension obligations

Group companies operate various pension schemes. The schemes are generally funded through payments to trustee administered funds, determined by periodic actuarial calculations. The Group has both defined contribution and defined benefit schemes. A defined contribution scheme is a pension scheme under which the Group pays fixed contributions into a separate entity. A defined benefit scheme is a pension scheme that defines an amount of pension benefit that an employee will receive on retirement, usually dependent on one or more factors such as age, years of service and salary.

Post retirement benefits (including pension schemes and post retirement health schemes)

Contributions to defined contribution pension schemes are charged in the period in which the employment services qualifying for the benefit are provided. The Group has no further payment obligations once the contributions have been paid.

The amounts charged (or credited where relevant) in the Income Statement relating to post retirement benefits in respect of defined benefit schemes are as follows:

- The current service cost,
- The past service costs for additional benefits granted in the current or earlier periods,
- The interest cost for the period,
- *The impact of any curtailments or settlements during the period,*
- The expected return on scheme assets (where relevant).

The current service cost in respect of defined benefit schemes comprises the present value of the additional benefits attributable to employees' services provided during the period.

The present value of defined benefit obligations and the present values of additional benefits accruing during the period are calculated using the Projected Unit Credit Method.

Past service costs arise where additional benefits are granted. The cost of providing additional benefits is recognised on a straight line basis over the *remaining period of service until such benefits vest*. The cost of providing additional benefits that vest on their introduction are recognised immediately.

The calculation of the present value of accrued benefits includes an actuarial assumption of future interest rates, which is used to discount the expected ultimate cost of providing the benefits. The discount rate is determined at each Balance Sheet date by reference to current market yields on high quality corporate bonds identified to match the currency and estimated term of the obligations. The interest cost for the period is calculated by multiplying the discount rate determined at the start of the period by the defined benefit obligations during the period.

The change in the present value of the defined benefit obligation and the changes in the fair value of scheme assets resulting from any curtailments and settlements of scheme liabilities during the period are recognised in the Income Statement. Additionally, any previously unrecognised past service costs related to these liabilities are recognised in the gains or losses on settlement and curtailment.

The expected return on scheme assets is calculated using market expectations, at the beginning of the period, of the investment returns on scheme assets over the entire life of the related obligations.

Actuarial gains and losses arise from changes to actuarial assumptions when revaluing future benefits and from actual experience in respect of scheme liabilities and investment performance of scheme assets being different from previous assumptions. Actuarial gains and losses are recognised as a component of equity.

The value recognised in the Balance Sheet for each individual post retirement scheme is calculated as follows:

- The present value of defined benefit obligation of the scheme at the Balance Sheet date,
- Minus any past service cost not yet recognised,
- Minus the fair value at the Balance Sheet date of the scheme assets out of which the obligations are to be settled directly.

Termination benefits

Termination benefits are payable when employment is terminated before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Group recognises termination benefits when it is demonstrably committed to either: *terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal; or providing termination benefits as a result of an offer made to encourage voluntary redundancy*. Benefits falling due more than 12 months after the Balance Sheet date are discounted to present value.

Share based payment

The value of the employee share options and other equity settled share based payments is calculated at fair value at the grant date using appropriate and recognised option pricing models. The value

of liabilities in respect of cash settled share based payment transactions are based upon the fair value of the awards at the Balance Sheet date.

Vesting conditions, other than those based upon market conditions, are not taken into account when estimating the fair value of such awards but are taken into account by adjusting the number of equity instruments included in the ultimate measurement of the transaction amount. The value of the awards are recognised as an expense on a systematic basis over the period during which the employment services are provided. The proceeds received net of any transaction costs are credited to share capital (nominal value) and share premium when the options are exercised.

Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is more likely than not that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated.

Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole. A provision is recognised even if the likelihood of an outflow with respect to any one item included in the same class of obligations may be small.

Dividends to equity holders

The final dividend is recognised as a liability when approved at the Annual General Meeting. The interim dividend is recognised as a liability when announced.

Leases

Rental income from operating leases is recognised on a straight line basis over the term of the lease. Payments made under operating leases are charged on a straight line basis over the term of the lease.

Non current assets and operations held for sale and discontinued operations

Non current assets and operations are classified as held for sale if their carrying amount is to be recovered principally through a sale transaction rather than through continuing use. Such assets are measured at the lower of carrying amount and fair value less costs to sell and are classified separately from other assets in the Balance Sheet. Assets and liabilities are not netted. Discontinued operations are presented on the face of the Income Statement as a single amount comprising the total of the net profit or loss of discontinued operations and the after tax gain or loss recognised on the sale or the measurement to fair value less costs to sell of the net assets constituting the discontinued operations. In the period where an operation is presented for the first time as discontinued, the Income Statement for the comparative prior period presented is restated to present that operation as discontinued.

Accounting policies of discontinued life operations

The Group disposed of its life insurance businesses during 2004. The accounting policies specific to these life insurance businesses and applied in addition to the policies stated above in the measurement of assets and liabilities of the life insurance business and its results to the date of disposal are set out below:

Recognition of income

Premiums and annuity considerations arising from insurance contracts are accounted for when due. Premiums are shown before deduction of commission and are gross of any taxes or duties levied with premiums.

For single premium contracts, premiums are recorded as income when due with any excess profit deferred and recognised in income in a constant relationship to the insurance in force or, for annuities, the amount of expected benefit payments.

Investment contracts

Amounts collected for investment contracts, which principally involve the transfer of financial risk such as long term savings contracts are accounted for using deposit accounting, under which the amounts collected are credited directly to the Balance Sheet as an adjustment to the liability to the policyholder. Where a contract contains both financial and insurance risk, the proportion of any premium relating to the insurance risk element of the contract is accounted for through income and the remaining financial risk element is accounted for using deposit accounting.

Revenues from investment contracts consist of charges assessed for mortality, fees for contract administration, surrenders and withdrawals and investment income earned on contract balances. Contract charges and fees revenues are recognised in the year they are assessed unless they relate to services to be provided in future years. Such deferred revenue is recognised as the service is provided.

Insurance contracts and investment contracts with Discretionary Participation Features

The Group sold certain contracts where the contract holders have a contingent interest in the excess of the value of specific Group assets over the value of specific Group liabilities. This interest derives from contractual rights to receive from this excess, additional benefits, the timing and the amount of which are at the discretion of the Group. The allocation of the excess between shareholders and contract holders is not determined at the Balance Sheet. This excess at the Balance Sheet date is recognised as an additional liability. Changes in the fair value of this liability is recognised in the Income Statement.

Deferred acquisition costs (DAC)

For long term insurance business, principally life insurance and annuity contracts, DAC is amortised over the year in which the costs are expected to be recovered out of estimated margins in matching revenues from the related policies. The rate of amortisation is consistent with the pattern of estimated margins.

Insurance and financial liabilities in respect of Unit Linked contracts

The liabilities arising under Unit Linked contracts are measured at a value determined by the value of the underlying assets in the investment fund established by the Group. Changes in the fair value of these liabilities are recognised in the Income Statement.

Financial assets

The Group holds financial assets in specific funds backing the liabilities arising from insurance and investment contracts where the contract

Significant accounting policies

continued

holders are entitled to participate in the investment performance of the fund. On initial recognition, the Group designates such investments as financial assets at fair value through the Income Statement and measures each financial asset at fair value. After initial recognition, the financial assets are remeasured at fair value with changes in the fair value recognised in the Income Statement.

Current and non current distinction

Assets are classified as current when expected to be realised within the Group's normal operating cycle of one year. Liabilities are classified as current when expected to be settled within the Group's normal operating cycle of one year. All other assets and liabilities are classified as non current.

The Group's consolidated Balance Sheet is not presented using a current/non current classification. However, the following balances are generally classified as current: cash and cash equivalents; deferred acquisition costs; and insurance and reinsurance debtors.

The following balances are generally classified as non current: goodwill and other intangible assets; property and equipment; investment property; investment in associates; financial assets; deferred tax assets; loan capital; and deferred tax liabilities.

The remaining balances are of a mixed nature. The current and non current portions of such balances have been set out in the respective notes.

Recently issued accounting pronouncements adopted early by the Group

On 16 December 2004, the International Accounting Standards Board (IASB) issued an amendment to International Accounting Standard (IAS) 19 'Employee Benefits Actuarial Gains and Losses, Group Plan and Disclosures'. Before this amendment, IAS 19 required actuarial gains and losses to be recognised in the Income Statement. For the Group, the other significant changes introduced by the amendment relate to additional disclosures. The amendment has been adopted by the EU and is effective for periods beginning 1 January 2006. The Group believes that the amendment provides a more relevant basis of recognition of actuarial gains and losses and has adopted the amendment from the date of transition to IFRS.

Recently issued accounting pronouncements not yet adopted by the Group

Below are listed the developments that are relevant in the future to the Group's future financial reporting. The Group does not anticipate that any of these developments will have a material impact on the Group's financial condition or results of its operations.

On 14 April 2005, the IASB issued an Amendment to IAS 39 'Financial Instruments: Recognition and Measurement – Cashflow Hedge Accounting of Forecast Intragroup Transactions'. The Amendment allows the foreign currency risk of a highly probable forecast intragroup transaction to qualify as a hedged item in consolidated financial statements. The Amendment has been adopted by the EU and is effective for periods beginning 1 January 2006.

On 16 June 2005, the IASB issued an Amendment to IAS 39 'Financial Instruments: Recognition and Measurement – The Fair Value Option'. The Amendment addresses concerns that the fair value option might be used inappropriately. The Amendment has been adopted by the EU and is effective for periods beginning 1 January 2006.

On 18 August 2005, the IASB issued an Amendment to IAS 39 'Financial Instruments: Recognition and Measurement – Financial Guarantee Contracts'. The Amendment is intended to ensure that the issuer of financial guarantee contracts includes the resulting liabilities in its Balance Sheet. The Amendment defines a financial guarantee contract as a 'contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument'. The Amendment has been adopted by the EU and is effective for periods beginning 1 January 2006.

On 18 August 2005, the IASB issued IFRS 7 'Financial Instruments: Disclosures' and a complementary Amendment to IAS 1 'Presentation of Financial Statements – Capital Disclosures'. IFRS 7 requires disclosures about the significance of financial instruments for an entity's financial position and performance. These disclosures incorporate many of the requirements previously in IAS 32. IFRS 7 also requires information about the extent to which the Group is exposed to risks arising from financial instruments, and a description of management's objectives, policies and processes for managing those risks. The Amendment to IAS 1 introduces requirements for disclosures about an entity's capital. IFRS 7 and the Amendment to IAS 1 have been adopted by the EU and are effective for periods beginning 1 January 2007.

On 15 December 2005, the IASB issued a limited Amendment to IAS 21 'The Effects of Changes in Foreign Exchange Rates'. The Amendment clarifies the requirements of IAS 21 regarding an entity's investment in foreign operations. The limited Amendment to IAS 21 has not yet been adopted by the EU.

Notes to the financial statements

1. First time adoption of International Financial Reporting Standards

The Group's financial statements for the year ended 31 December 2005 are the first annual financial statements that comply with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU).

The Group has applied IFRS 1 'First Time Adoption of International Financial Reporting Standards', in preparing these consolidated financial statements. The Group's transition date is 1 January 2004 and an opening IFRS Balance Sheet has been prepared at that date.

IFRS 1 allows some exemptions from full retrospective application of certain standards. In preparing these consolidated financial statements in accordance with IFRS 1, the Group has applied the mandatory exceptions and certain of the optional exemptions from full retrospective application of IFRS.

The Group has applied the provisions in IFRS 4 'Insurance Contracts', which leaves existing accounting policies for insurance contracts unchanged.

The Group has elected to apply the following optional exemptions from full retrospective application:

Business combinations exemption

The Group has applied the business combinations exemption in IFRS 1. It has not restated business combinations that took place prior to the 1 January 2004 transition date.

Cumulative translation differences exemption

The Group has elected to set the previously accumulated cumulative translation differences to zero at 1 January 2004. This exemption has been applied to all subsidiaries in accordance with IFRS 1.

Designation of financial assets and financial liabilities exemption

The Group reclassified various securities as available for sale investments with fair value movements recognised in equity.

The Group has applied the following mandatory exceptions from retrospective application:

Derecognition of financial assets and liabilities exception

Financial assets and liabilities derecognised before 1 January 2004 are not rerecognised under IFRS.

Hedge accounting exception

The Group has applied hedge accounting from 1 January 2004 only if the hedge relationship meets all the hedge accounting criteria under IAS 39 'Financial Instruments: Recognition and Measurement'.

Estimates exception

Estimates under IFRS at 1 January 2004 are consistent with estimates made for the same date under UK Generally Accepted Accounting Principles (UK GAAP).

The Group has also chosen to adopt IFRS 5 'Non Current Assets Held for Sale and Discontinued Operations', early. The 2004 financial statements have been prepared in accordance with the relevant requirements.

Reconciliations between IFRS and UK GAAP

The following reconciliations provide a quantification of the effect of the transition to IFRS on both the Income Statement for the year ended 31 December 2004 and Balance Sheets as at 31 December 2004 and 1 January 2004.

Explanations of the adjustments are set out below.

	Notes	£m
Loss for the year ended 31 December 2004 as reported under UK GAAP		(109)
Adjusted for:		
Discontinued life	a	10
Insurance contracts reclassified to financial instruments	b	42
Investment return	c	(69)
Equalisation provisions	d	37
Internal software costs capitalised	e	21
Foreign exchange	f	(32)
Reversal of amortisation of goodwill	g	11
Loan capital interest	h	3
Subordinated guaranteed perpetual notes	i	14
Deferred tax	j	(8)
Loss for the year ended 31 December 2004 as reported under IFRS		(80)

Notes to the financial statements

continued

1. First time adoption of International Financial Reporting Standards continued

Equity at 31 December 2004 and 1 January 2004

	Notes	31 December 2004 £m	1 January 2004 £m
Total equity and reserves as reported under UK GAAP		3,039	3,332
Adjusted for:			
Discontinued life	a	—	9
Insurance contracts reclassified to financial instruments	b	(93)	(147)
Equalisation provisions	d	356	319
Internal software costs capitalised	e	39	18
Reversal of amortisation of goodwill	g	11	—
Subordinated guaranteed perpetual notes	i	444	—
Deferred tax	j	31	34
Pensions	k	(759)	(681)
Dividends	l	86	83
Other	m	(21)	4
Total equity and reserves as reported under IFRS		3,133	2,971

Explanations

a) Discontinued life

Adjustments relating to discontinued life operations primarily relate to contracts reclassified to investments, valuation differences taken to funds for future appropriations and mid to bid adjustments. This caused an increase in the life profit of £10m for the year ended 31 December 2004. The impact on equity was to increase shareholder funds by £9m at 1 January 2004. There was no adjustment at 31 December 2004 as the life operations were disposed of during the year. All other adjustments below relate to continuing business.

b) Insurance contracts reclassified to financial instruments

Under IFRS, insurance contracts that do not contain an element of insurance risk are either classified as investment contracts if considered as such or as derivatives. Derivative contracts are marked to market on the Balance Sheet with the movement in the fair value taken through the Income Statement. At 31 December 2004 the impact of reclassifying certain contracts previously classified as insurance contracts was to increase the pre tax profit for the year by £42m and decrease equity and reserves by £93m pre tax.

c) Investment return

Under UK GAAP, investment income comprises dividend income from equities, income on bonds based on accrued interest, rental income on properties, interest accrued on deposits and realised and unrealised gains and losses on investments.

Under IFRS, investment return comprises dividend income from equities, income from bonds, rental income and unrealised gains from properties, realised gains and losses and associated impairment charges. Income on bonds is based on the effective interest rate method whereby any discount or premium is amortised over the life of the security. Unrealised movements, other than those relating to investment property, are taken directly to equity. Under IFRS, available for sale securities are tested for impairment and impairment losses are recognised in the Income Statement. The impact of the change in treatment of the investment return was to decrease the pre tax profit for the year ended 31 December 2004 by £69m.

d) Equalisation provisions

Under UK GAAP, equalisation provisions are established for future catastrophe and other unusual losses. Under IFRS, such losses are not provided for until incurred. The adjustment reflects the reversal of the equalisation provisions which resulted in an increase of £37m in the pre tax profit for the year ended 31 December 2004 and a pre tax increase of £356m in the equity at 31 December 2004.

e) Internal software costs capitalised

Under UK GAAP, the costs of software development are predominantly expensed as incurred. Under IFRS, these costs are capitalised and amortised over the useful life of the software, normally being three years. The impact is an increase of £21m in the pre tax profit for the year ended 31 December 2004 and a pre tax increase of £39m in the equity and reserves at 31 December 2004.

f) Foreign exchange

Under UK GAAP, income and expenses of foreign entities are translated using the closing exchange rate. Under IFRS, income and expenses are translated at the average rate of exchange.

On debt securities and other interest bearing available for sale investments, the changes in fair value due to foreign exchange movements are recognised in the Income Statement. The impact of this adjustment is to decrease the pre tax profit for the year ended 31 December 2004 by £32m.

g) Reversal of amortisation of goodwill

Amortisation of goodwill is not permitted under IFRS. This adjustment of £11m represents the reversal of goodwill amortised under UK GAAP during the year ended 31 December 2004.

1. First time adoption of International Financial Reporting Standards continued

h) Loan capital interest

Under UK GAAP, the financial statements reflect an accrual or prepayment for the interest accrued on derivatives hedging loan capital interest. Under IFRS, this accrual or prepayment is reversed and the fair value of the derivative contracts is reflected in the financial statements. At 31 December 2004 the impact was an increase in the pre tax profit for the year of £3m.

i) Subordinated guaranteed perpetual notes

Under UK GAAP, the subordinated guaranteed perpetual notes issued during 2004 are classified as a liability. As described in note 19, IFRS requires the perpetual notes to be classified as equity and the interest payments to be recognised directly in equity. The impact of this adjustment is to increase the pre tax profit for the year by £14m and to increase equity and reserves by £444m.

j) Deferred tax

Deferred tax is recognised under UK GAAP on all timing differences, whereas under IFRS deferred tax is recognised on temporary differences. Further, under UK GAAP, deferred tax balances are discounted whereas under IFRS, no allowance is made for the time value of money in calculating for the deferred tax provisions. The adjustments relate to both the change in basis in the calculation of deferred tax and the deferred tax impact of other IFRS adjustments made that affect the loss for the period. The impact of changes to deferred tax is to increase the loss for the year ended 31 December 2004 by £8m and to increase equity and reserves by £31m at that date.

k) Pensions

Under UK GAAP, the cost of providing pension benefits was accounted for over the employees' working lives on a systematic basis as advised by qualified actuaries. Under IFRS the Income Statement charge comprises the current service cost, past service cost, interest cost, the impact of any curtailment or settlements in the period and the expected return on plan assets. There was no material impact on the loss for the year ended 31 December 2004.

Under UK GAAP, the accrual or prepayment included on the Balance Sheet represents the difference between the expenses charged in the Income Statement and the cash paid into the scheme. Under IFRS, the full pension asset or deficit is carried on the Balance Sheet. The impact of this adjustment at 31 December 2004 is a pre tax decrease in equity and reserves of £759m.

l) Dividends

Under UK GAAP, all dividends relating to an accounting period that are proposed up to the date of the approval of the financial statements by the Board of Directors are accrued in that accounting period. Under IFRS, only dividends approved during the year are accrued. The adjustment reflects the impact of reversing the proposed dividends, which at 31 December 2004 was £86m.

m) Other

Other includes the impact of adjustments relating to the determination of the fair value of an asset using bid price (mid market price under UK GAAP) and other miscellaneous adjustments.

Cashflow reconciliation for year ended 31 December 2004

The Group's consolidated Cashflow Statements are presented in accordance with IAS 7 'Cashflow Statements'. The statements present substantially the same information as that required under UK GAAP as required by UK Financial Reporting Standard 1, as revised, with the exception that the UK GAAP Cashflow Statements and related notes excludes the cashflows of the Group's life insurance funds. Under IFRS these cashflows are required to be presented. These are presented as discontinued activities.

Under UK GAAP, the Group's cash comprises cash at bank. Under IFRS, cash and cash equivalents include cash and short term investments with original maturities of three months or less. In addition, under UK GAAP, cashflows are presented for operating activities, returns on investments and servicing of finance, taxation, capital expenditure and financial investment, acquisitions and disposals, equity dividends paid, management of liquid resources and financing. IFRS requires the classification of cashflows as resulting from operating, investing and financing activities. Cashflows from capital expenditure and financial investment, acquisitions and disposals, shown separately under UK GAAP, are included as part of the investing activities under IFRS. The payment of dividends to shareholders is included as a financing activity under IFRS.

Notes to the financial statements

continued

2. Net investment return

A summary of the gross investment income, net realised and net unrealised gains/(losses) included in the Income Statement is given below.

	Investment income		Net realised gains/(losses)		Net unrealised gains/(losses)		Impairments		Total investment return	
	2005 £m	2004 £m	2005 £m	2004 £m	2005 £m	2004 £m	2005 £m	2004 £m	2005 £m	2004 £m
Investment property	11	18	43	38	27	9	—	—	81	65
Equity securities	59	58	128	21	—	—	(5)	(16)	182	63
Debt securities	454	389	35	48	—	—	—	—	489	437
Other investments:										
Loans secured by mortgages	2	5	—	—	—	—	—	—	2	5
Other loans	4	3	—	—	—	—	—	—	4	3
Other	12	19	5	6	—	—	—	—	17	25
Deposits, cash and cash equivalents	61	59	—	—	—	—	—	—	61	59
Derivatives	—	—	(21)	—	(9)	(1)	—	—	(30)	(1)
Net investment return	603	551	190	113	18	8	(5)	(16)	806	656

Unrealised capital gains and losses recognised directly in equity for available for sale assets.

	Net unrealised gains/(losses)		Net realised gains transferred to Income Statement		Impairments transferred to Income Statement		Net movement recognised in equity	
	2005 £m	2004 £m	2005 £m	2004 £m	2005 £m	2004 £m	2005 £m	2004 £m
Equity securities	186	56	(128)	(21)	5	16	63	51
Debt securities	(48)	11	(35)	(48)	—	—	(83)	(37)
Other	9	7	(5)	(6)	—	—	4	1
Total	147	74	(168)	(75)	5	16	(16)	15

Investment property income

Rental income during the year amounted to **£11m** (2004: £25m). Direct operating expenses (including repairs and maintenance) arising from investment properties were not material in 2005 and 2004.

3. Net claims and benefits

	2005 £m	2004 £m
Gross claims paid	5,225	6,004
Gross changes in insurance contract liabilities for claims	(774)	(188)
Reinsurance recoveries on loss and loss expenses paid	(1,251)	(1,608)
Reinsurers' share of change in insurance contract liabilities for claims	395	53
Net claims and benefits	3,595	4,261

4. Profit before tax

The following items have been included in arriving at the profit before tax:

Other operating income

	2005 £m	2004 £m
Other income	103	66
Net gains on derivatives	8	75
Other operating income	111	141

4. Profit before tax continued

Other operating expenses

	2005 £m	2004 £m
Administration and other expenses	102	99
Reorganisation expenses	86	118
Investment expenses and charges	46	58
Amortisation and impairment of intangible assets	17	22
Foreign exchange losses/(gains)	1	(6)
Other operating expenses	252	291

The operating lease payments recognised as an expense during the year were **£65m** (2004: £74m).

Finance costs

	2005 £m	2004 £m
Interest expense on loan capital	79	53
Other loan interest	26	21
Other finance costs	2	1
Finance costs	107	75

Auditors' remuneration

	2005 £000	2004 £000
Audit of Group Accounts		
PricewaterhouseCoopers LLP	3,234	2,515
Other	–	308
	3,234	2,823
Other statutory audit		
PricewaterhouseCoopers LLP	757	1,035
Other	44	47
	801	1,082
	4,035	3,905

Remuneration for audit includes **£16,000** (2004: £16,000) in respect of the Parent Company.

Non audit fees of **£3,548,000** (2004: £2,803,000) in the UK during the year were payable to PricewaterhouseCoopers LLP. Of these **£2,010,000** (2004: £1,267,000) were for assurance services, **£299,000** (2004: £482,000) were for tax advisory services and **£1,239,000** (2004: £1,054,000) were for other non audit services.

Directors' emoluments

The aggregate emoluments of the directors, including amounts received from subsidiaries, were as follows:

	2005 £000	2004 £000
Emoluments of executive directors	4,056	2,427
Fees and other payments to non-executive directors	481	433
	4,537	2,860

A pension payment of **£22,953** (2004: £22,650) was paid by a subsidiary to a former director in respect of services other than as a director.

Details of directors' remuneration and pension benefits, including that of the highest paid director (Andy Haste), are included in the Directors' Emoluments. Details of directors' interests in the Parent Company are shown in the Directors' Interests.

Notes to the financial statements

continued

4. Profit before tax continued

Employee information

Staff costs for all employees comprise:

	2005 £m	2004 £m
Wages and salaries	668	669
Social security costs	50	52
Pension costs	(93)	130
Share based payments to directors and employees	9	4
	634	855

Pension costs in 2005 include a one off benefit of **£180m** due to the change in pension scheme design.

The average number of employees of the Group during the year was as follows:

	2005 Number	2004 Number
UK	10,781	11,870
Scandinavia	6,709	7,298
International	6,036	6,365
US	1,766	2,822
	25,292	28,355

5. Income tax expense

The tax amounts charged in the Income Statement are as follows:

	2005 £m	2004 £m
Current tax	(17)	115
Deferred tax	277	(27)
Taxation attributable to the Group	260	88
Share of taxation attributable to associates	—	4

UK corporation tax is calculated at **30%** (2004: 30%) of the estimated assessable profit for the year. Since the Group operates around the world, it is subject to income taxes in many different tax jurisdictions. Taxation for other jurisdictions is calculated at the rates prevailing in those jurisdictions. Of the above taxation attributable to the Group **£176m** (2004: £34m) relates to UK corporation tax and **£84m** (2004: £54m) to overseas taxation.

	2005 £m	2004 £m
Profit before tax	865	35
Tax at the UK rate of 30% (2004: 30%)	260	10
Tax effect of:		
Income not taxable	(41)	(44)
Expenses not deductible for tax purposes	13	37
Tax losses not recognised	25	120
Adjustment for prior year provisions	18	(24)
Different tax rates of subsidiaries operating in other jurisdictions	(15)	(11)
Income tax expense	260	88

6. Earnings per share attributable to the equity holders of the Parent Company

The earnings per ordinary share is calculated by reference to the profit/(loss) attributable to the equity shareholders and the weighted average of shares in issue during the year.

Basic

Basic earnings per share is calculated by dividing the profit/(loss) attributable to equity holders of the Parent Company by the weighted average number of ordinary shares in issue during the period, excluding ordinary shares purchased by the Parent Company and held as treasury shares.

	Continuing operations		Discontinued operations	
	2005 £m	2004 £m	2005 £m	2004 £m
Profit/(loss) attributable to equity holders of the Parent Company	555	(98)	—	(27)
Less: Interest on subordinated guaranteed perpetual notes (net of tax)	—	(10)	—	—
Less: Cumulative preference dividends	(9)	(9)	—	—
Profit/(loss) for the calculation of earnings per share	546	(117)	—	(27)
Weighted average number of ordinary shares in issue (thousands)	2,896,059	2,872,090	2,896,059	2,872,090
Basic earnings per share (p)	18.9	(4.1)	—	(0.9)

Diluted

Diluted earnings per share is calculated by adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares. The Parent Company has only one category, share options, of dilutive potential ordinary shares.

The calculation is performed for the share options to determine the number of shares that could have been acquired at fair value (determined as the average annual market share price of the Parent Company's shares) based on the monetary value of the subscription rights attached to outstanding share options. The number of shares calculated as above is compared with the number of shares that would have been issued assuming the exercise of the share options.

	Continuing operations		Discontinued operations	
	2005 £m	2004 £m	2005 £m	2004 £m
Profit/(loss) for the calculation of earnings per share	546	(117)	—	(27)
Weighted average number of ordinary shares in issue (thousands)	2,896,059	2,872,090	2,896,059	2,872,090
Adjustments for share options (thousands)	17,445	—	17,445	—
Weighted average number of ordinary shares for diluted earnings per share (thousands)	2,913,504	2,872,090	2,913,504	2,872,090
Diluted earnings per share (p)	18.7	(4.1)	—	(0.9)

The number of contingently issuable shares that could potentially dilute basic earnings per share in the future, but were not included in the calculation of diluted earnings per share because they are antidilutive for the period, are nil (2004: 8.2million).

7. Dividends

	2005 p	2004 p	2005 £m	2004 £m
Ordinary dividend:				
Final paid in respect of prior year	2.96	2.90	86	83
Interim paid in respect of current year	1.69	1.65	49	47
			135	130
Preference dividend			9	9
			144	139

At the Annual General Meeting (AGM) on 22 May 2006, a dividend in respect of 2005 of **3.05p** per share amounting to a total dividend of **£89m** is to be proposed. The dividend will be paid and accounted for in shareholders' equity as an appropriation of retained earnings in the year ending 31 December 2006.

The trustees of the Royal & SunAlliance ESOP Trust and the Royal & SunAlliance ESOP Trust No 2 waived their entitlement to dividends which reduced the total dividend paid by **£1m** (2004: £1m).

Notes to the financial statements

continued

8. Goodwill and other intangible assets

	Goodwill £m	Intangible asset arising from acquired claims provisions £m	Software development £m	Other £m	Total £m
Gross carrying amount at 1 January 2005	708	208	212	56	1,184
Accumulated amortisation at 1 January 2005	—	(150)	(85)	(34)	(269)
Accumulated impairment at 1 January 2005	(593)	—	—	—	(593)
Net carrying amount at 1 January 2005	115	58	127	22	322
Exchange adjustments	2	1	—	4	7
Additions and transfers	38	—	122	22	182
Disposals and transfers	(3)	—	(2)	—	(5)
Amortisation	—	(12)	(39)	(5)	(56)
Impairment losses recognised	—	—	—	—	—
Gross carrying amount at 31 December 2005	745	209	332	82	1,368
Accumulated amortisation at 31 December 2005	—	(162)	(124)	(39)	(325)
Accumulated impairment at 31 December 2005	(593)	—	—	—	(593)
Net book amount at 31 December 2005	152	47	208	43	450

	Goodwill £m	Intangible asset arising from acquired claims provisions £m	Software development £m	Other £m	Total £m
Gross carrying amount at 1 January 2004	708	206	102	50	1,066
Accumulated amortisation at 1 January 2004	—	(134)	(64)	(28)	(226)
Accumulated impairment at 1 January 2004	(590)	—	—	—	(590)
Net carrying amount at 1 January 2004	118	72	38	22	250
Exchange adjustments	—	2	—	1	3
Additions and transfers	2	—	117	6	125
Disposals and transfers	(2)	—	(7)	(1)	(10)
Amortisation	—	(16)	(21)	(6)	(43)
Impairment losses recognised	(3)	—	—	—	(3)
Gross carrying amount at 31 December 2004	708	208	212	56	1,184
Accumulated amortisation at 31 December 2004	—	(150)	(85)	(34)	(269)
Accumulated impairment at 31 December 2004	(593)	—	—	—	(593)
Net book amount at 31 December 2004	115	58	127	22	322

9. Property and equipment

	Group occupied property – land and buildings £m	Equipment £m	Total £m
Cost/valuation			
At 1 January 2005	319	366	685
Additions	3	58	61
Acquisition/(disposal) of subsidiaries	1	(1)	–
Disposals	–	(85)	(85)
Transfer to assets held for sale	(33)	(17)	(50)
Revaluation adjustments	13	–	13
Exchange adjustment	(2)	8	6
At 31 December 2005	301	329	630
Accumulated depreciation			
At 1 January 2005	–	267	267
Depreciation charge	5	32	37
Depreciation on disposals	–	(69)	(69)
Disposal of subsidiaries	–	(1)	(1)
Transfer to assets held for sale	–	(12)	(12)
Revaluation adjustment	(5)	–	(5)
Exchange adjustment	–	3	3
At 31 December 2005	–	220	220
Net book amount at 31 December 2005	301	109	410

	Group occupied property – land and buildings £m	Equipment £m	Total £m
Cost/valuation			
At 1 January 2004	338	407	745
Additions	25	32	57
Acquisition/(disposal) of subsidiaries	–	(4)	(4)
Disposals	(18)	(67)	(85)
Transfers to investment property	(14)	–	(14)
Revaluation adjustments	(10)	–	(10)
Exchange adjustment	(2)	(2)	(4)
At 31 December 2004	319	366	685
Accumulated depreciation			
At 1 January 2004	–	287	287
Depreciation charge	6	33	39
Depreciation on disposals	–	(50)	(50)
Acquisition/(disposal) of subsidiaries	–	(3)	(3)
Revaluation adjustment	(6)	–	(6)
At 31 December 2004	–	267	267
Net book amount at 31 December 2004	319	99	418

The Group occupied property was revalued on 31 December 2005 by independent valuers.

Depreciation and impairment expense of **£37m** (2004: £39m) has been charged to underwriting and policy acquisition costs.

The carrying amount of Group occupied property that would have been recognised had the assets been carried under the cost model at 31 December 2005 was **£260m** (2004: £283m).

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10. Investment property

Investment property consists of the following:

	2005 £m	2004 £m
Land and buildings:		
Freehold and long leasehold	431	412
Short leasehold	4	5
Total land and buildings	435	417

Movement in the carrying value of investment property is detailed below:

	2005 £m	2004 £m
Investment property at 1 January	417	353
Additions from subsequent expenditure	10	1
Transfer from property and equipment	—	14
Sales and purchases	(2)	33
Fair value gains	12	16
Exchange adjustment	(2)	—
Investment property at 31 December	435	417

11. Investments in associates

The Group has the following investments in associates:

	Country	Ordinary shareholding
Royal & Sun Alliance Insurance (Malaysia) Bhd	Malaysia	45.0%
Royal Sundaram Alliance Insurance Company Ltd	India	26.0%
Syn Mun Kong Public Company Ltd	Thailand	20.0%

Summarised below are the assets, liabilities, revenue and profit and loss of the companies above. During 2004 the Group disposed of its 37.5% interest in Mutual & Federal Insurance Company Limited, a South African undertaking, and accordingly it is excluded from the table below.

	2005 £m	2004 £m
Total assets	185	165
Total liabilities	121	105
Total revenue	128	113
Goodwill on acquisition	5	5
Profit for the year after tax	6	6

The Group's share of net assets and profit and loss are accounted for under the equity method.

12. Financial assets

	2005 £m	2004 £m
Equity securities	1,683	1,657
Debt securities	11,609	11,158
Other financial assets	146	137
Short term investments	95	183
Total financial assets – available for sale	13,533	13,135

At the period end, the Group had pledged **£2,503m** (2004: £2,368m) of financial assets as collateral for liabilities or contingent liabilities and had accepted **£1,802m** (2004: £1,900m) collateral that could be sold or pledged.

13. Reinsurers' share of insurance contract liabilities

	2005 £m	2004 £m
Reinsurers' share of provision for unearned premiums	298	266
Reinsurers' share of provisions for loss and loss adjustment expenses	4,108	4,158
Total reinsurers' share of insurance contract liabilities	4,406	4,424

The following changes have occurred in the reinsurers' share of the provision for unearned premiums during the year.

	2005 £m	2004 £m
Reinsurers' share of provision for unearned premiums at 1 January	266	493
Premiums ceded to reinsurers	1,020	1,573
Reinsurers' share of premiums earned	(1,042)	(1,792)
Changes in reinsurance asset	(22)	(219)
Reinsurers' share of portfolio transfers and acquisitions	35	(2)
Exchange adjustment	19	(6)
Reinsurers' share of provision for unearned premiums at 31 December	298	266

The following changes have occurred in the reinsurers' share of insurance contract liabilities for loss and loss adjustment expenses during the year.

	2005 £m	2004 £m
Reinsurers' share of provisions for loss and loss adjustment expenses at 1 January	4,158	4,484
Reinsurers' share of total claims incurred	856	1,555
Total reinsurance recoveries received	(1,251)	(1,608)
Reinsurers' share of portfolio transfers and acquisitions	21	(14)
Exchange adjustment	318	(276)
Other movements	6	17
Reinsurers' share of provisions for loss and loss adjustment expenses at 31 December	4,108	4,158
To be settled within 12 months	1,690	1,605
To be settled after 12 months	2,418	2,553

14. Insurance and reinsurance debtors

	2005 £m	2004 £m
Insurance debtors comprise:		
Due from policyholders	851	853
Due from intermediaries	1,127	1,014
Total insurance debtors	1,978	1,867
Reinsurance debtors	569	817
Total insurance and reinsurance debtors	2,547	2,684

All insurance and reinsurance debtors are recoverable within 12 months.

15. Deferred acquisition costs

	2005 £m	2004 £m
Deferred acquisition costs at 1 January	487	698
Exchange adjustment	13	(4)
Acquisition costs deferred during the year	738	630
Amortisation charged during the year	(769)	(831)
Charge to Income Statement in the year	(31)	(201)
Disposal of assets	(3)	(4)
Other	(1)	(2)
Deferred acquisition costs at 31 December	465	487

The Group records acquisition costs recovered from reinsurers as a deduction from deferred acquisition costs.

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16. Other debtors and other assets

	2005 £m	2004 £m
Derivative assets	31	30
Tax recoverable	40	6
Outstanding investment sales	3	5
Other debtors	329	357
Accrued interest and rent	155	135
Prepayments	78	84
Total other debtors and other assets	636	617
To be settled within 12 months	501	473
To be settled after 12 months	135	144

17. Cash and cash equivalents

	2005 £m	2004 £m
Cash and cash equivalents and bank overdrafts (as reported within the Cashflow Statement)	1,612	1,864
Add: bank overdrafts	5	17
Less: balances attributable to operations held for sale	—	(15)
Total cash and cash equivalents	1,617	1,866

The interest bearing financial assets and financial liabilities included in cash and cash equivalents had an effective interest rate of **4.09%** (2004: 3.06%) and had an average maturity of **30 days** (2004: 13 days).

18. Equity and reserves

Changes in equity

Changes in equity for the year ended 31 December 2005

	Ordinary share capital £m	Ordinary share premium £m	Treasury shares £m	Preference shares £m	Revaluation reserves £m	Capital redemption reserve £m	Translation reserve £m	Retained earnings £m	Share- holders' funds £m	Sub- ordinated guaranteed perpetual notes £m	Minority interest £m	Total equity £m
Balance at 1 January	801	790	(54)	125	479	8	(19)	191	2,321	444	368	3,133
Total recognised income/ (expense) for the year	—	—	—	—	(31)	—	69	502	540	—	39	579
Dividends – paid (note 7)	—	—	—	—	—	—	—	(144)	(144)	—	(16)	(160)
Issued by scrip	5	13	—	—	—	—	—	—	18	—	—	18
Issued for cash	1	1	—	—	—	—	—	—	2	—	—	2
Treasury share purchase	—	—	(3)	—	—	—	—	—	(3)	—	—	(3)
Depreciation transfer	—	—	—	—	(16)	—	—	16	—	—	—	—
Share options	—	—	—	—	—	—	—	9	9	—	—	9
Reclassification to loan capital (note 19)	—	—	—	—	—	—	—	—	—	(444)	—	(444)
Minority interests (disposal of subsidiaries)	—	—	—	—	—	—	—	—	—	—	—	—
Balance at 31 December	807	804	(57)	125	432	8	50	574	2,743	—	391	3,134

18. Equity and reserves continued

Changes in equity for the year ended 31 December 2004

	Ordinary share capital £m	Ordinary share premium £m	Treasury shares £m	Preference shares £m	Revaluation reserves £m	Capital redemption reserve £m	Translation reserve £m	Retained earnings £m	Share- holders' funds £m	Subordinated guaranteed perpetual notes £m	Minority interest £m	Total equity £m
Balance at 1 January	792	775	(54)	125	526	8	—	444	2,616	—	355	2,971
Total recognised income/ (expense) for the year	—	—	—	—	(47)	—	(19)	(108)	(174)	—	48	(126)
Dividends – paid (note 7)	—	—	—	—	—	—	—	(139)	(139)	—	(12)	(151)
Issued by scrip	9	15	—	—	—	—	—	—	24	—	—	24
Share options	—	—	—	—	—	—	—	4	4	—	—	4
Issue of subordinated guaranteed perpetual notes (note 19)	—	—	—	—	—	—	—	—	—	444	—	444
Interest on subordinated guaranteed perpetual notes net of tax (note 19)	—	—	—	—	—	—	—	(10)	(10)	—	—	(10)
Minority interests (disposal of subsidiaries)	—	—	—	—	—	—	—	—	—	—	(23)	(23)
Balance at 31 December	801	790	(54)	125	479	8	(19)	191	2,321	444	368	3,133

Ordinary and preference shares

During the year **2,137,513** (2004: 449,832) ordinary shares were issued on the exercise of employee share options for a cash consideration of **£2m** (2004: £0.3m). The Parent Company also issued **20,661,210** (2004: 31,669,408) ordinary shares during the year under the scrip scheme approved by the shareholders at the 2005 AGM. The total nominal value of ordinary shares issued during the year was **£6m** (2004: £9m).

	2005 £m	2004 £m
Authorised		
3,923,636,364 ordinary shares of 27.5p each (2004: 3,923,636,364 ordinary shares of 27.5p each)	1,079	1,079
300,000,000 preference shares of £1 each (2004: 300,000,000 preference shares of £1 each)	300	300
Issued and fully paid		
2,935,117,294 ordinary shares of 27.5p each (2004: 2,912,318,571 ordinary shares of 27.5p each)	807	801
125,000,000 preference shares of £1 each (2004: 125,000,000 preference shares of £1 each)	125	125
	932	926

The preference shares carry a right to a fixed cumulative preferential dividend of 7.375% per annum, payable in half yearly instalments, and are not redeemable. On a return of capital on a winding up (liquidation), the holders are entitled, in priority to holders of all shares of the Parent Company, to receive out of the surplus assets of the Parent Company any arrears and accruals of the dividend together with the greater of the price at which the gross yield on 3.5% War Loan or such Government Stock as may be agreed (but not exceeding twice the nominal amount of the preference share) and the nominal amount of the share together with any premium paid on issue. The holders of preference shares have the right to vote at a general meeting of the Group only if at the date of the notice of the meeting the dividend payable on the share is in arrears or otherwise on a resolution to vary the rights attaching to the preference shares.

The Royal & SunAlliance ESOP Trust holds ordinary shares in the Parent Company, which may subsequently be transferred to employees (other than the executive directors). At 31 December 2005, the Trust held **19,182,272** ordinary shares (2004: 12,369,290) in the Parent Company with a nominal value of **£5m** (2004: £3m) and a mid market value, based on the market value of the Parent Company's shares at the close of business on 30 December 2005 as shown in the Official List of the London Stock Exchange, of **£24m** (2004: £10m).

The Royal & SunAlliance ESOP Trust No 2 holds ordinary shares in the Parent Company, which may subsequently be transferred to employees including executive directors. At 31 December 2005 the trust held **4,938,894** ordinary shares (2004: 3,038,894) in the Parent Company with a nominal value of **£1m** (2004: £1m) and a market value, based on the mid market value of the Company's share at the close of business on 30 December 2005 as shown in the Official List of the London Stock Exchange, of **£6m** (2004: £2m).

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19. Loan capital

	2005 £m	2004 £m
Subordinated guaranteed US\$ bonds	285	255
Subordinated guaranteed Euro bonds	341	352
Total dated loan capital	626	607
Subordinated guaranteed perpetual notes	445	–
Total loan capital	1,071	607
Subordinated guaranteed perpetual notes classified as equity	–	444

The subordinated guaranteed US\$ bonds (\$500m) have a redemption date of 15 October 2029. The rate of interest payable on the US\$ bonds is 8.95%.

The subordinated guaranteed Euro bonds (€500m) have a redemption date of 15 October 2019. €200m of the Euro bonds bear interest at a fixed rate of 6.875% until 15 October 2009 and a floating rate thereafter. €300m of the Euro bonds bear interest at a floating rate from the date of issue. The Parent Company has the option to repay the Euro bonds on specific dates from 15 October 2009.

Subordinated guaranteed perpetual notes of £450m (£444m net of discount and fees) were issued on 23 July 2004. The notes pay an annual coupon of 8.50% with an option to call the notes, or if not called for the coupon rate to be reset, on 8 December 2014 and every five years thereafter.

IFRS requires perpetual debt to be classified as equity where the issuer has no contractual obligation to deliver cash (or another financial asset) to another party. Once classified as equity the subsequent interest payments (and related income tax benefits) are recognised directly in equity. Under the original terms of the loan agreement the Company had an option to defer interest payments indefinitely, provided no dividend was declared or distribution paid in respect to any class of share capital since the most recent AGM. Accordingly, the interest payments for the year ended 31 December 2004 of £14m (net of tax £10m) were recognised directly in equity.

During the year ended 31 December 2005, the loan agreement was amended such that the subordinated guaranteed perpetual notes became a financial liability.

The bonds and the notes are contractually subordinated to all other creditors of the Parent Company such that in the event of a winding up or of bankruptcy, they are to be repaid only after the claims of all other creditors have been met.

The fair value of the dated loan capital and subordinated guaranteed perpetual notes at 31 December 2005 was **£1,271m** (2004: £1,206m).

20. Insurance contract liabilities

	2005 £m	2004 £m
Provision for unearned premiums	3,001	2,903
Provision for losses and loss adjustment expenses	14,203	14,288
Total gross insurance contract liabilities	17,204	17,191

Provision for unearned premiums

The following changes have occurred in the provision for unearned premiums during the year:

	2005 £m	2004 £m
Provision for unearned premiums at 1 January	2,903	3,863
Premiums written	6,420	6,655
Less: premiums earned	(6,424)	(7,538)
Changes in provision for unearned premiums	(4)	(883)
Gross portfolio transfers and acquisitions	41	(55)
Exchange adjustment	61	(10)
Other movements	–	(12)
Provision for unearned premiums at 31 December	3,001	2,903

20. Insurance contract liabilities continued

Provisions for losses and loss adjustment expenses

	2005 £m	2004 £m
Provision for losses and loss adjustment expenses at 1 January	14,288	14,923
Claim losses and expenses incurred	4,451	5,816
Total claims payments made in the year, net of recoveries	(5,225)	(6,004)
Gross portfolio transfers and acquisitions	(15)	(150)
Exchange adjustment	637	(385)
Other movements	67	88
Provision for losses and loss adjustment expenses at 31 December	14,203	14,288
To be settled within 12 months	7,616	8,202
To be settled after 12 months	6,587	6,086

Assumptions

The total value of outstanding claims provisions less related reinsurance recoveries before discounting amounted to **£10,843m** (2004: £10,852m).

Claims on certain classes of business have been discounted as follows:

		Discount rate		Average number of years to settlement	
	Category	2005 %	2004 %	2005 Years	2004 Years
UK	Asbestos and environmental	5.00	5.00	13	14
Scandinavia	Disability	3.57	3.14	12	11
US	Asbestos and environmental	5.00	5.00	9	9
	Disability	5.00	5.00	15	15
Canada	Asbestos and environmental	5.00	5.00	6	6

In determining the average number of years to ultimate claims settlement, estimates have been made based on the underlying claims settlement patterns.

Claims development tables

The tables below present changes in the historical general insurance provisions that were established in 2001 and the general insurance provisions arising in each subsequent accident year. The tables are presented at current year cumulative average exchange rates and have been adjusted for operations disposed of.

The top triangle of the tables presents the estimated provision for ultimate incurred losses and loss adjustment expenses at the end of each accident year as at each Balance Sheet date.

The lower (paid) triangle of the tables presents the amounts paid against those provisions in each subsequent accounting period.

The estimated provision for ultimate incurred losses changes as more information becomes known about the actual losses for which the initial provisions were set up and as the rate of exchange changes. The 2005 redundancy/(deficiency) presents the claims development of earlier accident years incurred in the current accounting period. The redundancy/(deficiency) is equal to the current estimate of cumulative claims less the cumulative claims paid.

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20. Insurance contract liabilities continued**Consolidated claims development table – gross of reinsurance**

	2001 and prior £m	2002 £m	2003 £m	2004 £m	2005 £m	Total £m
Estimate of cumulative claims						
At end of accident year	14,262	4,209	4,252	2,998	2,742	
One year later	15,603	4,099	3,934	2,579		
Two years later	16,969	4,306	3,891			
Three years later	17,445	4,370				
Four years later	17,994					
Claims paid						
One year later	4,763	1,621	1,458	952		
Two years later	2,699	733	581			
Three years later	2,085	504				
Four years later	1,493					
Cumulative claims paid	11,040	2,858	2,039	952		
2005 redundancy/(deficiency)						
Core Group	(352)	53	84	234		19
US	(197)	(117)	(41)	185		(170)
	(549)	(64)	43	419		(151)
Reconciliation to the Balance Sheet						
Current year provision before discounting	6,954	1,512	1,852	1,627	2,742	14,687
Exchange adjustment to closing rates						384
Discounting						(868)
Present value recognised in the Balance Sheet						14,203

Consolidated claims development table – net of reinsurance

	2001 and prior £m	2002 £m	2003 £m	2004 £m	2005 £m	Total £m
Estimate of cumulative claims						
At end of accident year	10,056	3,076	2,996	2,422	2,194	
One year later	10,666	2,925	2,746	2,090		
Two years later	11,308	2,972	2,626			
Three years later	11,830	3,118				
Four years later	12,034					
Claims paid						
One year later	3,283	1,198	993	709		
Two years later	1,803	450	365			
Three years later	1,347	436				
Four years later	873					
Cumulative claims paid	7,306	2,084	1,358	709		
2005 redundancy/(deficiency)						
Core Group	(108)	21	85	153		151
US	(96)	(167)	35	179		(49)
	(204)	(146)	120	332		102
Reconciliation to the Balance Sheet						
Current year provision before discounting	4,728	1,034	1,268	1,381	2,194	10,605
Exchange adjustment to closing rates						238
Discounting						(748)
Present value recognised in the Balance Sheet						10,095

In 2005 there has been net positive development of £151m for the Group excluding the US reflecting the favourable experience in the 2002 to 2005 accident years, partially offset by some general reserve strengthening in the 2001 and prior accident years.

US reserves show a significant reduction as the Group continues to settle claims proactively. The split between accident years has been distorted by the treatment of general litigation provisions where the provisions held and any settlements made may be reported in different accident years.

21. Insurance and reinsurance liabilities

	2005 £m	2004 £m
Direct insurance creditors	196	302
Reinsurance creditors	279	476
Total insurance and reinsurance liabilities	475	778
To be settled within 12 months	458	739
To be settled after 12 months	17	39

22. Borrowings

	2005 £m	2004 £m
Secured debenture loans	10	10
Amounts owed to credit institutions – unsecured:		
Under committed credit facilities	233	317
Other	8	22
Total borrowings	251	349

Borrowings at 31 December were repayable as follows:

	2005 £m	2004 £m
One year or less	242	104
After one year and within two years	1	236
After two years and within three years	1	2
After three years and within four years	1	1
After four years and within five years	2	1
After five years	4	5
Total borrowings	251	349

Loans from credit institutions of **£233m** at 31 December 2005 (2004: £317m) under committed credit facilities have been classified by reference to the earliest date on which repayment may be demanded by the lender. At 31 December 2005 total committed credit facilities available to the Group were **£233m** (2004: £317m), of which **£233m** (2004: £84m) expire within one year and **£nil** (2004: £233m) expire within one to two years. £400m (2004: £400m) was originally committed under a deal comprising a £150m revolving facility and £250m amortising loan which expires in October 2006. This facility currently bears interest at 125 basis points over LIBOR and there is a commitment fee charged at 50% of the applicable margin of any unused portion of the facility. The facility is subject to cross default conditions. A new facility was entered into by the Group on 7 March 2006.

At 31 December 2005 and 2004 the Group had in place a one billion US dollar Euro commercial paper program. There were no amounts outstanding at 31 December 2005 (2004: £nil).

The weighted average interest rate on short term borrowings at 31 December 2005 was **5.79%** (2004: 6.17%).

At 31 December 2005 interest payable on amounts repayable within five years was **£20m** (2004: £25m) and after five years **£1m** (2004: £1m).

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23. Current and deferred tax

Current tax liability

	2005 £m	2004 £m
To be settled within 12 months	33	57
To be settled after 12 months	22	21
	55	78

Deferred tax

	2005 £m	2004 £m
Deferred tax assets	33	174
Deferred tax liabilities	(236)	(101)
Net deferred tax position at 31 December	(203)	73

The movement for the year in the Group's net deferred tax position was as follows:

	2005 £m	2004 £m
Net deferred tax position at 1 January	73	(45)
(Charge)/credit to the Income Statement for the year	(277)	27
(Charge)/credit to equity for the year	(9)	5
Net liability disposed of on disposal of subsidiary	—	86
Exchange adjustment	10	—
Net deferred tax position at 31 December	(203)	73

The following are the major deferred tax liabilities and assets recognised by the Group and their movements during the year:

Deferred tax liabilities

	Claims equalisation reserves £m	Revaluation of investments £m	Other temporary differences £m	Total £m
Deferred tax liabilities at 1 January 2004	85	106	10	201
Charge/(credit) to the Income Statement for the year	12	(16)	33	29
Charge/(credit) to equity for the year	—	(5)	—	(5)
Disposals	—	—	(124)	(124)
Deferred tax liabilities at 31 December 2004	97	85	(81)	101
Charge to the Income Statement for the year	7	5	98	110
Charge to equity for the year	—	28	5	33
Disposals	—	—	—	—
Exchange adjustment	—	—	(8)	(8)
Deferred tax liabilities at 31 December 2005	104	118	14	236

23. Current and deferred tax continued

Deferred tax assets

	Retirement benefit obligations £m	Other temporary differences £m	Total £m
Deferred tax assets at 1 January 2004	161	(6)	155
Charge to the Income Statement for the year	9	47	56
Disposals	—	(37)	(37)
Exchange adjustment	—	—	—
Deferred tax assets at 31 December 2004	170	4	174
Charge to the Income Statement for the year	(91)	(76)	(167)
Charge to equity for the year	24	—	24
Exchange adjustment	—	2	2
Deferred tax assets at 31 December 2005	103	(70)	33

The deferred income tax (charged)/credited to equity is as follows:

	2005 £m	2004 £m
Fair value reserves in shareholders' equity		
Available for sale financial assets	(28)	5
Group occupied property	5	—
Retirement benefit obligations	24	—

The aggregate current tax relating to items that were charged or credited to equity is **£21m** (2004: £nil).

At the Balance Sheet date, the Group had unused tax losses of **£1,812m** (2004: £1,324m) available for offset against future profits. A deferred tax asset has been recognised in respect of **£4m** (2004: £14m) of these losses. No deferred tax asset has been recognised in respect of the remaining **£1,808m** (2004: £1,328m) due to the unpredictability of future profit streams. Included in unrecognised tax losses are losses of **£1,086m** (2004: £723m) which will expire between 2007 and 2024. Other losses may be carried forward indefinitely.

24. Provisions

	Reorganisation provisions £m	Pensions and post retirement benefits £m	Other provisions £m	Total £m
Provisions at 1 January 2005	74	714	126	914
Exchange adjustment	5	21	3	29
Credited/(charged)	101	(47)	88	142
Utilised	(138)	(35)	(42)	(215)
Released	(3)	(180)	(2)	(185)
Acquisition/(disposal) of subsidiary undertaking	9	—	(1)	8
Provisions at 31 December 2005	48	473	172	693

Reorganisation provisions comprise costs relating to reorganisations mainly within the US and UK businesses. These provisions primarily comprise severance and property costs and are part of a programme to achieve business improvement and expense savings, to be substantially achieved by year end 2006.

Other provisions include various litigation provisions of **£4m** (2004: £4m), the payment of which is dependent upon legal processes. In addition, there are provisions of **£54m** (2004: £66m) held relating to vacant property leases, dilapidations and refurbishments, the costs relating to which will be borne across the period over which the leases expire, which is up to 20 years.

Of the above **£468m** is due to be settled outside of 12 months (2004: £699m).

See note 26 for further information regarding the pensions and post retirement benefits provision.

Notes to the financial statements

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25. Other liabilities

	2005 £m	2004 £m
Deposits received from reinsurers	347	290
Derivative trading liabilities	130	125
Other creditors	624	643
Accruals and deferred income	377	368
Total other liabilities	1,478	1,426
To be settled within 12 months	994	880
To be settled after 12 months	484	546

26. Retirement benefit obligations

The Group operates defined contribution pension schemes, funded and unfunded defined benefit pension schemes, and has other post retirement obligations.

Defined contribution pension schemes

Contributions of **£28m** (2004: £31m) were made to defined contribution schemes across the Group, including **£24m** (2004: £27m) in respect of schemes in Denmark and Sweden. The defined contribution schemes in Denmark and Sweden are fully funded and are administered, as with all the overseas schemes, in accordance with local law and practice.

Defined benefit pension schemes and other post retirement benefits

The major defined benefit pension schemes are located in the UK and US. The assets of these schemes are held mainly in separate trustee administered funds. In April 2002, the primary UK defined benefit schemes were effectively closed to new entrants following the introduction of a new, primarily defined contribution, scheme (the 2002 Scheme). However, due to a small defined benefit underpin, the 2002 Scheme is still disclosed under IAS 19 as a defined benefit scheme.

In 2005, following discussions with the Trustees and consultation with the members, the UK defined benefit schemes were altered from providing benefits on a final salary basis to benefits on a revalued average salary basis with effect from 1 January 2006. Under the new benefit formula, the accrued benefits of current active members are based on salaries at the date of change and will increase in line with inflation each year (limited to 5% in any year) up to their retirement date. Benefits earned in future years will be based on salaries in that year and similarly will be revalued up to retirement. As a result of the changes, the projected benefit obligations of the schemes are reduced from the date of change. The figures shown in the tables below reflect that reduction at the Balance Sheet date and the one off benefit of £180m arising from the reduction is recorded in the Income Statement in 2005.

In addition to these changes, the 2002 Scheme (which was the scheme to which new UK employees have been admitted since the closure of the defined benefit schemes to new members) has been closed to further accrual from 1 January 2006. It has been replaced by a stakeholder arrangement and members of the 2002 Scheme and future new employees in the UK will accrue future benefits on a defined contribution basis under the stakeholder plan.

For the two main UK defined benefit schemes, the level of contributions in 2005 were **23%** and **21%** of pensionable salaries (2004: 23% and 20%). Additional contributions totalling **£86m** (2004: £43m) were made to the schemes, in accordance with the plan to reduce their deficits.

The major defined benefit schemes are subject to regular valuation using the projected unit method which is the basis of the pension cost in the consolidated Income Statement. Independent, qualified actuaries carry out valuations of the major defined benefit schemes for the purposes of assessing pension costs.

The Group also provides post retirement healthcare benefits to certain current and retired US and Canadian employees. The benefits are not pre funded. Life insurance benefits, which provide varying levels of coverage, are provided at no cost to retirees. Healthcare benefits, which also provide varying levels of coverage, require retiree contributions in certain instances. Benefits are generally payable for life. The estimated discounted present values of the unfunded accumulated obligations are calculated in accordance with the advice of independent, qualified actuaries.

26. Retirement benefit obligations continued

Movement in deficit during the year:

	2005 £m	2004 £m
Deficit at 1 January	713	705
Total pension (credit)/expense	(121)	99
Employer contribution	(215)	(150)
Actuarial loss	74	70
Exchange adjustment	21	(11)
Deficit at 31 December	472	713
Unrecognised past service cost	1	1
Pension and post retirement liability on Balance Sheet	473	714
Deferred tax in respect of net pension and post retirement liability	(103)	(170)
Net liability on Balance Sheet	370	544

The amounts recognised in the Income Statement are as follows:

	2005				2004
	UK £m	US £m	Other £m	Total £m	Total £m
Current service cost	64	4	6	74	80
Interest cost	221	23	12	256	246
Expected return on scheme assets	(226)	(19)	(12)	(257)	(241)
Past service cost/(benefit)	4	(11)	1	(6)	22
Gains on curtailment	(182)	(6)	—	(188)	(8)
Total (included in staff costs)	(119)	(9)	7	(121)	99

The actuarial loss recognised in equity is as follows:

	2005				2004
	UK £m	US £m	Other £m	Total £m	Total £m
Actual return on scheme assets	652	16	23	691	386
Less: expected return on scheme assets	(226)	(19)	(12)	(257)	(241)
Actual return on assets in excess of expected	426	(3)	11	434	145
Experience (losses)/gains on liabilities	(66)	(1)	17	(50)	87
Change in actuarial assumptions	(429)	(1)	(28)	(458)	(302)
Actuarial losses on pension benefits	(69)	(5)	—	(74)	(70)

	2005				2004
	UK %	US %	Other %	Total %	Total %
Gains/(losses) between expected and actual return as a percentage of scheme assets	11.2	(1.2)	6.7	10.3	3.5
Experience (losses)/gains as a percentage of scheme liabilities	(1.5)	(0.3)	8.6	(1.0)	1.8
Total actuarial loss to be recognised in Statement of Recognised Income and Expense as a percentage of scheme liabilities	(1.1)	(1.3)	—	(1.1)	(1.3)

The accumulated actuarial losses since 1 January 2004 are **£144m** (2004: £70m).

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continued

26. Retirement benefit obligations continued

	2005				2004
	UK £m	US £m	Other £m	Total £m	Total £m
Present value of funded obligations	4,763	377	194	5,334	4,844
Present value of unfunded obligations	12	41	52	105	95
Present value of obligations	4,775	418	246	5,439	4,939
Equities	2,141	159	106	2,406	2,076
Bonds	1,947	122	99	2,168	1,831
Cash	124	6	2	132	103
Property	261	—	—	261	216
Total assets in the schemes	4,473	287	207	4,967	4,226
Net deficit	302	131	39	472	713
Unrecognised past service credit	—	—	1	1	1
Net liability on Balance Sheet	302	131	40	473	714
Analysed:					
Defined benefit pension schemes	302	112	12	426	659
Other post retirement benefits	—	19	28	47	55
Net liability on Balance Sheet	302	131	40	473	714
To be settled within 12 months	86	—	—	86	97
To be settled after 12 months	216	131	40	387	617

The following is a reconciliation of the Group's retirement benefit obligation:

	2005 £m	2004 £m
Retirement benefit obligation at 1 January	4,939	4,633
Current service costs	74	80
Past service (benefits)/costs	(6)	22
Interest costs	256	246
Contributions by scheme participants	10	4
Actuarial loss on obligations	508	215
Gain on curtailments	(188)	(8)
Benefits paid	(229)	(227)
Exchange rate adjustment	75	(26)
Retirement benefit obligation at 31 December	5,439	4,939

The following is a reconciliation of the Group's pension scheme assets:

	2005 £m	2004 £m
Pension scheme assets at 1 January	4,226	3,928
Expected return on scheme assets	257	241
Actual return on assets in excess of expected	434	145
Contributions by the employer	215	150
Contributions by scheme participants	10	4
Benefits paid	(229)	(227)
Exchange rate adjustment	54	(15)
Pension scheme assets at 31 December	4,967	4,226

26. Retirement benefit obligations continued

The principal actuarial assumptions used were as follows:

	UK		US		Other	
	2005 %	2004 %	2005 %	2004 %	2005 %	2004 %
Assumptions used in calculation of retirement benefit obligation:						
Discount rate	4.7	5.2	5.8	5.8	5.0	6.0
Annual rate of general inflation	2.5	2.5	2.5	2.5	2.0	2.0
Annual rate of increase in salaries	4.0	4.0	3.7	4.8	4.1	4.0
Annual rate of increase in pensions	2.5	2.5	—	—	2.0	2.0
Assumptions used in calculation of Income Statement credit/charge in year:						
Discount rate	5.2	5.4	5.8	6.0	6.0	6.5
Expected return on:						
Equities	7.3	7.3	9.0	9.0	8.0	9.5
Bonds	4.5	4.8	6.0	6.0	5.5	6.0
Other	6.1	6.3	2.0	2.0	3.5	3.0

The weighted average expected return on assets across the Group for 2005 was **6.1%** (2004: 6.3%). The assumptions made for the expected return on assets have been derived by considering best estimates for the expected long term real rates of return from the main asset classes and from rates of return assumed elsewhere within the operation of the business.

The mortality assumptions are set following investigations of the main schemes' recent experience by the scheme actuaries for their funding valuations. The last such valuations were carried out in 2004 and the next ones are due in 2006. Following the last investigations, the mortality assumptions adopted used the PMA92 and PFA92 mortality tables for males and females respectively, with age ratings to reflect the schemes' recent experience compared with that expected under these tables.

Reductions in future mortality rates were allowed for using the 'medium cohort' projection and using the projected mortality rates applicable to calendar year 2012 for current pensioners and 2030 for future pensioners. The weighted average assumptions imply that a current pensioner aged 60 has an expected future lifetime of 24.7 years (males) and 26.8 years (females) and a future pensioner aged 60 has a future lifetime of 26.1 years (males) and 28.1 years (females).

The valuation of liabilities for post retirement benefits in the US assumes a pre 65 premium inflation rate of **8%** decreasing to **5%** by 2012 (2004: 9% decreasing to 5% by 2011) and a post 65 premium inflation rate of **10%** decreasing to **5%** by 2014 (2004: 11% decreasing to 5% by 2013). The valuation of liabilities for post retirement liabilities in Canada assumes **10%** decreasing to **5%** in 10 years for drugs (2004: 8% decreasing to 5% in nine years) and **4%** (2004: 4%) for hospitals and **3%** (2004: 3%) for other.

The effect of an increase of one percentage point and the effect of a decrease of one percentage point in the assumed medical cost trend rates on the following is set out below:

	1% increase		1% decrease	
	2005 £m	2004 £m	2005 £m	2004 £m
Aggregate of the current service cost and interest components of net periodic post employment medical costs	0.3	0.5	0.3	0.3
Accumulated post employment benefit obligation for medical costs	3.1	4.1	2.5	3.5

27. Share based payment

The Group has four types of share based payment plans which are settled in the form of ordinary shares: the Executive Share Option Scheme; the Equity Incentive Scheme for US Employees; the International Sharesave Plan; and the Share Matching Plan. Dilution levels for all schemes are held strictly within ABI limits.

In addition, in the US there are a number of cash settled share based payment plans.

The total employment cost recorded in the Income Statement for all plans was **£9m** in 2005 (2004: £4m). These costs include the costs associated with plans which are settled in the form of ordinary shares for awards that have been granted after 7 November 2002. The value of equity settled awards granted prior to this date have been excluded in accordance with the transitional provisions contained in IFRS 2 'Share Based Payment'.

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27. Share based payment continued

Executive Share Option Scheme and Equity Incentive Scheme for US Employees

The Group operates an Executive Share Option Scheme and an Equity Incentive Scheme for US Employees, which provide options to purchase ordinary shares to officers and other key employees at prices not less than the fair value of the ordinary shares at the date of grant. The exercise of awards made under the Equity Incentive Scheme for US Employees can be accelerated dependent on the performance of the US subsidiary to between one and three years.

The performance conditions in respect of awards under the Executive Share Option Scheme are described in the footnote to the options table (audited part) on page 51. The exercise price of all options is the fair value of the ordinary shares on the date of grant. All options expire 10 years after the date of the grant.

Additional information with respect to the plans at 31 December is as follows:

	2005		2004	
	Shares	Price*	Shares	Price*
Options outstanding at 1 January	72,044,516	214.35	66,570,939	300.30
Granted	28,126,364	84.79	18,457,304	77.45
Exercised	(16,190)	84.12	—	—
Forfeited	(18,814,826)	300.87	(12,574,471)	304.65
Expired	(710,012)	261.29	(409,256)	233.18
Options outstanding at 31 December	80,629,852	148.58	72,044,516	214.35
Options exercisable at year end	17,140,769	336.66	1,913,345	320.40

*Price refers to weighted average exercise price in sterling (pence).

The following share options under the Executive Share Option Scheme and Equity Incentive Scheme for US Employees are outstanding or exercisable at 31 December:

Options outstanding

Range of exercise prices	2005			2004		
	Number of shares	Weighted average remaining contractual life (years)	Weighted average exercise price*	Number of shares	Weighted average remaining contractual life (years)	Weighted average exercise price*
50.1 – 100.0	55,844,164	8.83	81.90	29,668,584	9.28	79.71
100.1 – 150.0	4,949,924	7.58	114.01	5,753,895	8.42	113.88
200.1 – 250.0	4,788,459	6.19	234.23	9,559,027	7.19	234.23
250.1 – 300.0	2,113,806	4.21	280.01	3,755,531	4.30	276.13
300.1 – 350.0	289,828	1.88	336.09	1,816,439	5.69	319.60
350.1 – 400.0	6,327,895	4.84	380.46	9,997,737	5.89	381.02
400.1 – 450.0	6,315,776	3.46	415.42	11,493,303	4.58	413.86
	80,629,852	7.72	148.58	72,044,516	7.36	214.35

*Price refers to weighted average exercise price in sterling (pence).

Options exercisable

Range of exercise prices	2005		2004	
	Number of shares	Weighted average exercise price*	Number of shares	Weighted average exercise price*
50.1 – 100.0	707,260	90.79	36,752	85.11
100.1 – 150.0	34,905	113.88	18,210	113.88
200.1 – 250.0	3,537,959	234.23	111,495	234.23
250.1 – 300.0	2,113,806	280.01	710,012	261.29
300.1 – 350.0	289,828	336.09	—	—
350.1 – 400.0	4,141,235	376.89	777,813	367.94
400.1 – 450.0	6,315,776	415.42	259,063	424.67
	17,140,769	336.66	1,913,345	320.40

*Price refers to weighted average exercise price in sterling (pence).

27. Share based payment continued

Under the schemes, the weighted average estimated fair value per option granted by the Company during 2005 was **27.42p** (2004: 26.07p). The fair value of the share options granted under the plans during 2005 was **£8m** (2004: £5m). The value of the awards is charged in the Income Statement over the vesting period.

Fair values for the options granted under the schemes were estimated as of the date of grant using the Black Scholes pricing model with the following weighted average assumptions: dividend yields of **5.0%** (2004: 6.0%); expected volatilities of **50%** (2004: 55%); risk free interest rates of **4.4%** (2004: 4.8%); expected terms of five years for Executive Share Option Scheme grants made prior to the 2003 AGM, four years for Executive Share Option Scheme grants made after the 2003 AGM and four years for grants made under the Equity Incentive Scheme for US Employees; and the assumption that all performance criteria are expected to be met. An estimate based on past experience is made of the number of forfeitures during the vesting period due to employees leaving the Group. The actual share price at 31 December 2005 was **125.75p** (2004: 77.5p).

International Sharesave Plan

Under the Group's International Sharesave Plan (savings related) eligible employees can receive options to purchase ordinary shares at a price equal to 80% of the fair value of the ordinary shares on the date of grant. All options vest either three or five years from the grant date and expire six months after vesting. The number of shares available for purchase from the plan by each participant is limited to the whole number of shares purchasable from the aggregate value of the individual's savings contract upon maturity. An individual's maximum monthly contribution to all current savings contracts is £250.

Additional information with respect to the Group's International Sharesave Plan at 31 December is as follows:

	2005		2004	
	Shares	Price*	Shares	Price*
Options outstanding at 1 January	52,761,469	81.29	40,148,839	107.76
Granted	16,628,956	76.95	23,305,933	59.27
Exercised	(2,169,748)	66.38	(459,237)	67.57
Forfeited	(5,596,314)	78.45	(8,482,007)	98.14
Expired	(1,486,820)	320.42	(1,752,059)	317.07
Options outstanding at 31 December	60,137,543	74.98	52,761,469	81.29
Options exercisable at year end	1,966,919	153.67	1,280,687	326.39

*Price refers to weighted average exercise price in sterling (pence).

The following share options under the International Sharesave Plan are outstanding or exercisable as of 31 December:

Options outstanding

Range of exercise prices	2005			2004		
	Number of shares	Weighted average remaining contractual life (years)	Weighted average exercise price*	Number of shares	Weighted average remaining contractual life (years)	Weighted average exercise price*
50.1 – 100.0	58,565,114	2.95	68.83	49,444,038	3.41	65.88
200.1 – 250.0	134,287	1.09	250.00	162,772	2.09	250.00
250.1 – 300.0	577,671	–	292.00	899,296	0.66	290.00
300.1 – 350.0	715,047	0.75	313.76	2,105,655	0.69	321.43
350.1 – 400.0	145,424	–	354.00	149,708	0.83	354.00
	60,137,543	2.89	74.98	52,761,469	3.24	81.29

*Price refers to weighted average exercise price in sterling (pence).

Options exercisable

Range of exercise prices	2005		2004	
	Number of shares	Weighted average exercise price*	Number of shares	Weighted average exercise price*
50.1 – 100.0	1,243,824	66.00	–	–
200.1 – 250.0	–	–	–	–
250.1 – 300.0	577,671	292.00	–	–
300.1 – 350.0	–	–	1,280,687	326.39
350.1 – 400.0	145,424	354.00	–	–
	1,966,919	153.67	1,280,687	326.39

*Price refers to weighted average exercise price in sterling (pence).

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27. Share based payment continued

Under the International Sharesave Plan, the weighted average estimated fair value per option granted by the Company during 2005 was **36.62p** (2004: 28.09p). The fair value of share options granted under the International Sharesave Plan during 2005 was **£6m** (2004: £6m). The value of the awards is charged in the Income Statement over the vesting period.

Fair values for the options granted under the International Sharesave Plan were estimated as of the date of grant using the Black Scholes pricing model with the following weighted average assumptions: dividend yields of **5.0%** (2004: 6.0%); expected volatilities of **50%** (2004: 55%); risk free interest rates of **4.2%** (2004: 4.8%); and expected terms equal to the vesting terms of three or five years. An estimate based on past experience is made of the number of forfeitures during the vesting period due to employees leaving the Group. The actual share price at 31 December 2005 was **125.75p** (2004: 77.5p).

Share Matching Plan

The Group's Share Matching Plan for executive directors and other selected executives was adopted following approval obtained at the 2004 AGM. Awards were made during 2004 and 2005 and the awards granted in 2005 were the final awards under the plan.

The performance conditions in respect of awards under the Share Matching Plan are described in the footnote to the options table (audited part) on page 52. Under the plan, Deferred Share awards granted are held in trust for three years and are normally forfeited upon an employee leaving the Group. No further performance conditions apply.

Participants may also receive Matching Share awards up to a maximum of three times the number of Deferred Shares awarded. Matching Share awards are subject to the achievement of total shareholder return targets over a single two year period, with performance measured by comparison against other UK listed companies. Matching Share awards vest with the Deferred Share awards on the third anniversary of the date of grant to the extent that the performance conditions have been met.

Further information on the Share Matching Plan may be found in the footnote to the long term incentive scheme table (audited part) on page 52.

Additional information with respect to Deferred and Matching Share awards at 31 December is as follows:

	2005		2004	
	Shares	Price*	Shares	Price*
Outstanding Deferred Share awards at 1 January	1,559,056	—	—	—
Granted	2,704,444	—	1,593,302	—
Exercised	(25,374)	—	—	—
Forfeited	(162,958)	—	(34,246)	—
Outstanding Deferred Share awards at 31 December	4,075,168	—	1,559,056	—
Potential Matching Share awards	12,225,504	—	4,677,168	—
Total potential share awards outstanding at 31 December	16,300,672	—	6,236,224	—

*Price refers to weighted average exercise price in sterling (pence).

Under the Share Matching Plan, the fair values of each Deferred Share award granted by the Company during 2005 was **71.40p** (2004: 66.24p) and the fair value of each potential Matching Share award was **23.80p** (2004: 22.08p). The total fair value of the awards granted under the plan during 2005 was **£4m** (2004: £2m).

The fair value of the Deferred Share awards was calculated based upon the ordinary share price at grant date after deducting from it the estimated value of the dividends that will not be received during the vesting period. The fair value of the potential Matching Share awards was estimated by calculating the expected value arising from modelling the awards that would arise under different performance scenarios.

Other share based payments

In the US, there are plans under which awards have been granted to certain employees in the form of cash settled share based awards. Under these plans, if the vesting conditions are satisfied, cash awards are made based upon the underlying performance of the Company's ordinary shares. Awards were made in 1999 and 2001 under old schemes and during 2004 and 2005 on terms that provide the same potential benefits as the Share Matching Plan. The liability in respect of these plans at 31 December 2005 was **£1m** (2004: £nil). The intrinsic value of awards that had vested at 31 December 2005 was **£nil** (2004: £nil).

28. Management of risks

As an insurance company, the Group is fundamentally concerned with the management of risk. This note summarises these risks and the way the Group manages them.

As set out in the Corporate Governance report, the Group's Board defines the risk appetite of the organisation.

The Group employs a comprehensive risk management framework to identify, assess, manage and monitor the risks arising as a result of operating the business. The framework includes a comprehensive suite of risk policies, procedures, measurement and monitoring techniques and a series of stress tests and scenario analyses to ensure that the Group's exposures do not exceed risk appetite.

The Group is exposed to financial risk through its financial assets, financial liabilities (investment contracts and borrowings), reinsurance assets and insurance liabilities. In particular the key financial risk is that the proceeds from the realisation of its financial assets are not sufficient to fund the obligations arising from its insurance and investment contracts.

The Group manages its financial assets within a framework that has been developed to seek to ensure the ability to meet its obligations under insurance and investment contracts. A key principle behind this process is to hold assets that provide a broad match against the liabilities arising from insurance and investment contracts.

Risks arise within the investment portfolio from the inappropriate matching of cash and fixed interest assets against liabilities by duration (eg inflation and reinvestment risk). However, the relatively short duration of a general insurance portfolio together with the Group's strategy of broadly matching assets and liabilities by duration provides mitigation against these risks. The Group reviews the duration of its liabilities and asset portfolios to ensure that they remain broadly matched. Regional investment directives limit permissible duration ranges within the individual portfolios. These directives also include objectives for liquidity, asset sector concentration and credit quality.

The components of risk credit, market, liquidity and insurance and reinsurance risks are addressed below:

Credit risk

The Board Risk Committee (BRC) is responsible for ensuring that the Board approved Group credit risk appetite is not exceeded.

In defining its risk appetite the Group draws a distinction between credit risks incurred as a result of offsetting insurance risks or operating in the insurance market (eg reinsurance credit risks and insurance operations credit risks) for which risk tolerances and target profiles are identified, and credit risks incurred for the purposes of generating a return (eg invested assets credit risk) for which strict exposure limits are set.

The Group controls its credit exposures according to a series of Group credit risk policies that reflects the individual considerations of the risk categories. These policies are supported by a series of procedures (eg counterparty assessment processes) and limits (eg investment and bank counterparty limits), which are designed to ensure that the Group's risk appetite is not exceeded.

Reinsurance counterparties are subject to a rigorous internal assessment process on an ongoing basis to ensure that their creditworthiness continues to be satisfactory. Collateral is taken to mitigate exposures where appropriate to the size or credit quality of the exposure. Further discussion on credit risk arising from reinsurance ceded is discussed within the section below on reinsurance risk.

Insurance operations credit risks are incurred on a devolved basis with regional operations undertaking the responsibility for assessing and monitoring the creditworthiness of their counterparties (eg brokers and policyholders). Local credit committees are responsible for ensuring these exposures are within the risk appetite of the local operations within the overall financial control framework. Exposure monitoring and reporting is embedded throughout the organisation with aggregate credit positions reported at Group level. Invested assets credit risk is discussed in more detail below. The Group's maximum exposure to credit risk can be set out as follows:

	2005 Maximum credit risk (carrying value) £m	2004 Maximum credit risk (carrying value) £m
Cash and cash equivalents	1,617	1,866
Debt securities	11,609	11,158
Other financial assets	146	137
Short term investments	95	183
Derivative assets	31	30
Insurance debtors	1,978	1,867
Reinsurance debtors	569	817
Reinsurers' share of insurance contract liabilities	4,406	4,424

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28. Management of risks continued

The Group's investments comprise a broad range of financial investments issued principally in the UK, US and Scandinavia. The mix of investments and their carrying values which include fixed maturities and equity securities is set out below.

Analysis of debt securities

The credit profile of the Group's fixed income portfolios reflects the Group's commitment to matching its liabilities with investment rated liquid instruments for the protection of the policyholder.

	2005		2004	
	£m	%	£m	%
By country/region				
UK	3,000	26	2,454	22
US	2,714	23	3,272	29
Scandinavia	2,906	25	3,142	28
International	2,989	26	2,290	21
Total	11,609	100	11,158	100
By industry				
Banks	1,959	17	652	6
Insurance	71	1	107	1
Manufacturing	222	2	156	1
Utilities	224	2	186	2
Retail	88	1	101	1
Government securities	5,527	47	6,736	60
Mortgage backed securities	2,100	18	1,598	14
Telecommunications	88	1	84	1
Services	179	1	494	4
Other	1,151	10	1,044	10
Total	11,609	100	11,158	100

Credit profile of Group fixed income portfolio (note 1):

	2005		2004	
	£m	%	£m	%
AAA (note 2)	6,786	58	7,198	65
AA	2,608	23	2,297	21
A	1,665	14	1,242	11
BBB	450	4	341	3
<BBB	100	1	80	—
Total	11,609	100	11,158	100

Notes

1. The ratings set out above are assigned by Standard & Poor's.

2. Includes UK government guaranteed fixed income securities that are not rated.

28. Management of risks continued

Analysis of equity securities

The Group's equity portfolio is diversified as follows across sectors:

	2005		2004	
	£m	%	£m	%
By country/region				
UK	1,077	64	1,017	61
US	82	5	95	6
Scandinavia	11	1	17	1
International	513	30	528	32
Total	1,683	100	1,657	100
By industry				
Banks	217	13	360	22
Pharmaceuticals	80	5	77	5
Insurance	82	5	69	4
Manufacturing	83	5	62	4
Utilities	101	6	104	6
Construction	22	1	30	2
Mining	183	11	142	9
Retail	52	3	65	4
Telecommunications	70	4	86	5
Services	155	9	201	12
Other	638	38	461	27
Total	1,683	100	1,657	100

Maturity periods or contractual repricing

The following table summarises the contractual repricing or maturity dates (whichever is earlier) for financial assets and financial liabilities, that are subject to fixed and variable interest rates. Equity instruments are not subject to interest rate risk.

	Less than one year £m	One to two years £m	Two to three years £m	Three to four years £m	Four to five years £m	Greater than five years £m	Total £m
2005							
Financial assets							
Cash and cash equivalents	1,617	—	—	—	—	—	1,617
Debt securities	2,615	2,147	1,734	1,520	999	2,594	11,609
Other financial assets	104	1	—	8	1	32	146
Short term investments	95	—	—	—	—	—	95
Derivative assets	13	5	5	2	2	4	31
Total	4,444	2,153	1,739	1,530	1,002	2,630	13,498
Financial liabilities							
Borrowings:							
Secured debenture loans	1	1	1	1	2	4	10
Amounts owed to credit institutions – unsecured:							
Under committed credit facilities	233	—	—	—	—	—	233
Other	8	—	—	—	—	—	8
Subordinated guaranteed US\$ bonds	—	—	—	—	—	285	285
Subordinated guaranteed Euro bonds	—	—	—	—	—	341	341
Subordinated guaranteed perpetual notes	—	—	—	—	—	445	445
Derivative trading liabilities	20	—	—	—	11	99	130
Total	262	1	1	1	13	1,174	1,452

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28. Management of risks continued

	Less than one year £m	One to two years £m	Two to three years £m	Three to four years £m	Four to five years £m	Greater than five years £m	Total £m
2004							
Financial assets							
Cash and cash equivalents	1,866	—	—	—	—	—	1,866
Debt securities	3,056	1,989	1,903	1,230	959	2,021	11,158
Other financial assets	97	—	3	7	30	—	137
Short term investments	183	—	—	—	—	—	183
Derivative assets	12	4	3	3	2	6	30
Total	5,214	1,993	1,909	1,240	991	2,027	13,374
Financial liabilities							
Borrowings:							
Secured debenture loans	1	1	1	1	1	5	10
Amounts owed to credit institutions – unsecured:							
Under committed credit facilities	84	233	—	—	—	—	317
Other	19	2	1	—	—	—	22
Subordinated guaranteed US\$ bonds	—	—	—	—	—	255	255
Subordinated guaranteed Euro bonds	—	—	—	—	—	352	352
Subordinated guaranteed perpetual notes	—	—	—	—	—	444	444
Derivative trading liabilities	9	23	—	—	—	93	125
Total	113	259	2	1	1	1,149	1,525

Market risk

The Group is exposed to the risk of potential losses from adverse movements in market rates and prices as follows:

- Interest rate risk,
- Equity price risk,
- Property price risk,
- Foreign currency exchange risk,
- Derivatives.

The investment risk policy governs the Group's exposure to market risks. Exposures are controlled by the setting of investment limits in line with the Group's risk appetite.

The Group Investment Committee (GIC), on behalf of the Group Board, is responsible for reviewing and approving the investment strategy for the Group's investment portfolios. It provides approval for all major changes of the Group's investment strategy and, in particular, approves any substantive changes to the balance of the Group's funds between the major asset classes. Importantly the GIC also approves the terms of reference of the Group's main operational investment committee, the Group Asset Management Committee (GAMC). The BRC issues GAMC with risk limits.

Interest rate risk

The fair value of the Group's portfolio of fixed income securities is inversely correlated to changes in the market interest rates. Thus if interest rates fall the fair value of the portfolio would tend to rise and vice versa as set out in the sensitivity analysis.

Equity price risk

The Group's portfolio of equity securities is subject to equity risk arising from changes in market price. Thus if the value of equities rise so will the fair value of its portfolio and vice versa as set out in the sensitivity analysis.

The Group sets appropriate risk limits to ensure that no significant concentrations to individual companies or sectors arise. The Group takes a long term view in selecting stocks and looks to build value over a sustained period of time rather than churning the portfolio looking for short term gains from its equity holdings.

The Group makes use of derivative products as appropriate to protect the portfolio from losses outside of risk appetite.

The Group does not have material holdings of unquoted equities.

28. Management of risks continued

Property price risk

The Group's portfolio of properties is subject to property price risk arising from changes in the market value of properties. Thus if the value of property falls so will the fair value of the portfolio as set out in the sensitivity analysis.

A number of the Group's property holdings are Group occupied and therefore appear as property and equipment within the reported accounts. The Group's investment in investment property is recorded as such and is invested in as part of an efficient portfolio management strategy.

Foreign currency exchange risk

The Group operates in 28 countries. Accordingly, its net assets are subject to foreign currency exchange rate movements. The Group's primary foreign currency exposures are to the US dollar, Canadian dollar, Danish kroner, Swedish krona and Euro. If the value of the British pound strengthens then the value of non British pound net assets will decline when translated into British pounds and consolidated.

The Group incurs exposure to foreign currency exchange risk in two ways:

- Operational foreign currency exchange risk – by underwriting liabilities in currencies other than the currency of the primary environment in which the business units operate (non functional currencies),
- Structural foreign currency exchange risk – by investing in overseas subsidiaries and operating an international insurance group.

Operational foreign currency exchange risk is managed within the Group's individual operations by broadly matching assets and liabilities by currency.

Structural foreign currency exchange risk is managed at a Group level. In managing structural foreign currency exchange risk net assets maintained by the Group's subsidiaries in local currencies are taken into account to satisfy local regulatory solvency and internal risk based capital assessment requirements. These assets should prove adequate to support local insurance activities irrespective of foreign currency exchange rate movements. Consequently, this may affect the value of the consolidated shareholders' equity expressed in British pounds.

Derivatives

The Group may use derivative financial instruments for the purpose of reducing its exposure to adverse fluctuations in interest rates, foreign exchange rates and equity price risk. The Group does not use derivatives to leverage its exposure to markets and does not hold or issue financial instruments for speculative purposes. In addition forward contracts may be used to reduce exposure to adverse currency movements on loan capital in the Parent Company. Forward contracts are used to reduce the risk of adverse currency movements on certain forecast future cash transactions. The policy on use of derivatives is approved by BRC.

While these derivative instruments are subject to fluctuations in value, such fluctuations are generally offset by the changes in value of the underlying exposures. Derivatives are generally held until their maturity date.

	Remaining life			Notional principal amounts		Fair value	
	Less than one year £m	One to five years £m	More than five years £m	2005 £m	2004 £m	2005 £m	2004 £m
Cross currency							
Asset	–	–	–	5	141	–	–
Liability	1	–	–	30	1	1	1
Interest rate							
Asset	–	–	–	–	13	–	5
Liability	–	–	–	–	13	–	2
Credit							
Asset	–	–	23	38	38	23	25
Liability	2	11	99	226	289	112	121
Equity/index							
Asset	8	–	–	see below	see below	8	–
Liability	17	–	–	see below	see below	17	1

At 31 December 2005 there were derivative contracts in place to protect the value of the UK equity portfolios of the Group. These provided limited protection against declines in market levels whilst also capping participation in any appreciation of the market. In total, this strategy covered an underlying equity value of approximately £500m. The impact of these derivatives as of 31 December 2005 if world equity markets decreased by 15% would be to decrease the impact of the decline by **£18m** (2004: £25m).

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28. Management of risks continued

Sensitivity analysis

Change in fair value of investments and borrowings (note 1 and note 5)

	(Decrease)/increase	
	2005 £m	2004 £m
Interest rate markets (note 2):		
Impact on fixed interest securities of increase in interest rates of 100bps	(295)	(299)
Impact on loan capital of increase in interest rates of 100bps	132	112
Equity markets (note 3):		
Decrease of equity markets of 15%	(252)	(249)
Impact arising from derivatives	18	25
Property markets (note 3):		
Decrease of property markets of 15%	(65)	(63)
Currency markets (note 4):		
Decrease of major currencies versus British pound of 15%	(1,154)	(1,028)
Impact arising from derivatives	—	(18)

Notes

1. This analysis assumes that there is no correlation between equity price, interest rate, property market and foreign currency exchange rate risks. It also assumes that all other assets and liabilities remain unchanged and that no management action is taken. This analysis does not represent management's view of future market change.
2. The sensitivity of the bond assets of the Group has been modelled by reference to a reasonable approximation of the average interest rate sensitivity of the investments held within each of the portfolios.
3. The effect of movements in equity and property markets is reflected as a one time decrease of worldwide equity and property markets on 1 January 2006 and 1 January 2005 which results in a 15% decline in the value of the Group's assets in these investment categories.
4. The effect of currency movements on investments is reflected as a one time decrease in the value of major currencies against the British pound on 1 January 2006 and 1 January 2005.
5. This analysis has not considered the impact of the above market changes on the valuation of the Group's insurance liabilities.

Liquidity risk

Liquidity risk is the risk that cash may not be available to pay obligations when due at a reasonable cost. The Group has no appetite for incurring liquidity risk and is committed to meeting all liabilities as they fall due. The investment limits ensure the Group's portfolio is kept in highly liquid marketable securities sufficient to meet its liabilities as they come due based on actuarial assessment.

The limits are monitored at a Group level as part of the Group Risk exposure monitoring and BRC reporting process.

In addition the Group has committed credit facilities available as set out in note 22.

Insurance risk

The Group's insurance activities are primarily concerned with the pricing, acceptance and management of risks from its customers. In accepting risk the Group is committing to the payment of claims and therefore these risks must be understood and controlled.

The Group manages its exposure to insurance risk through the BRC which considers aggregation of risk and establishes how much risk the Group is willing to assume. The BRC also oversees an emerging risk identification process, including the identification of emerging issues and the setting of these into risk scenarios as part of an overall process of self appraisal.

For a portfolio of insurance contracts where the theory of probability is applied to pricing and provisioning, the principal risk that the Group faces under its insurance contracts is that the actual claims and benefit payments exceed the expected amount of the insurance liabilities. This could occur because the frequency or severity of claims and benefits payable are greater than estimated. Insurance events are random and the actual number and amount of claims and benefits will vary from year to year from the estimate established using statistical techniques.

Experience shows that the larger the portfolio of similar insurance contracts, the smaller will be the relative variability about the expected outcome. In addition, a more diversified portfolio is less likely to be affected across the board by a change in any subset of the portfolio. The Group has developed its insurance underwriting strategy to diversify the type of insurance risks accepted and within each of these categories to achieve a sufficiently large population of risks to reduce the variability of the expected outcome.

Further discussion on underwriting risk, estimation of claims provisions, emerging and legal risks and aggregation of risks is set out below.

28. Management of risks continued

Underwriting risk

Disciplined underwriting, encompassing risk assessment, risk management, pricing and exposure control is critical to the Group's success.

The Group has an Underwriting and Claims Policy statement that clearly identifies the approach to be adopted in respect of risk selection and management, pricing adequacy, identification and management of aggregation to exposure and claims handling and servicing. These principles are adapted to local market, legal and regulatory environments and further embodied in detailed underwriting procedures. The goal is for its underwriters to be in a position to:

- Understand and assess each risk,
- Make appropriate decisions within their area of competence and authority limits,
- Differentiate between risks,
- Apply suitable terms and conditions in order to manage the portfolio,
- Control exposure,
- Improve the predictability of the loss experience and make appropriate use of the Group's technical capacity.

In establishing prices, each of the Group's businesses has access to extensive customer data from its own records and access to appropriate market data.

Each of the Group's underwriters has a specific license that sets clear parameters for the business they can underwrite, based on the competence of the individual underwriter. Additionally, the Group has a centrally managed forum looking at Group underwriting issues, reviewing and agreeing underwriting direction and setting policy and directives where appropriate. The management of the underwriting and claims risks uses a number of key tools, including the licensing of business units to write certain higher risk classes of business, reviewing the performance and management of all the individual insurance portfolios throughout the Group and the investigation of potential emerging insurance risks.

Pricing for property and casualty products is generally based upon historical claims frequencies and claims severity averages, adjusted for inflation and trended forward to recognise anticipated changes in claims patterns. While claims remain the Group's principal cost, allowance is also made in the pricing procedures for acquisition expenses, administration expenses, investment income, the cost of reinsurance and for a profit loading that adequately covers the cost of the capital exposed to risk.

Specific considerations in relation to casualty insurance risks and property insurance risks are set out below:

Casualty insurance risks

The Group manages these risks through its underwriting strategy, adequate reinsurance arrangements and proactive claims handling. The underwriting strategy attempts to ensure that the underwritten risks are well diversified in terms of type and amount of risk, industry and geography.

Underwriting limits are in place to enforce appropriate risk selection criteria. For example, the Group has the right not to renew individual policies, it can impose deductibles and it has the right to reject the payment of a fraudulent claim. In certain territories, legislation requires that the maximum loss under each employers' liability contract is never lower than a prescribed amount. All the Group employers' liability contracts offer maximum cover in compliance with such minimums.

Reinsurance arrangements in place include excess, stop loss and catastrophe coverage. The effect of such reinsurance arrangements is that the Group should not suffer total net insurance losses of more than a specified amount in any one year. In addition to the overall Group reinsurance programme, individual business units are permitted to purchase additional reinsurance protection.

The Group has specialised claims units dealing with the mitigation of risks surrounding known asbestos claims. These units investigate and adjust all asbestos claims. The asbestos claims are reviewed individually at least semi annually and adjusted to reflect the latest information on the underlying facts, current law, jurisdiction, contractual terms and conditions, and other factors. The Group actively manages and pursues early settlements of asbestos claims to reduce its exposure to unpredictable developments.

Property insurance

Property insurance covers a diverse collection of risks and therefore property insurance contracts are subdivided into four risk groups: fire, business interruption, weather damage and theft. The insurance risk arising from these contracts is not concentrated in any of the territories in which the Group operates, and there is a balance between commercial and personal properties in the overall portfolio of insured buildings. Large risks are reinsured via treaty reinsurance arrangements.

The Group has the right to re price the risk on renewal. It also has the ability to impose deductibles and reject fraudulent claims. These contracts are underwritten by reference to the commercial replacement value of the properties and contents insured, and claims payment limits are always included to limit the amount payable on occurrence of the insured event. Cost of rebuilding properties, of replacement or indemnity for contents and time taken to restart operations for business interruption are the key factors that influence the level of claims under these policies. The greatest likelihood of significant losses on these contracts arises from storm, flood damage or other weather related incidents. The Group has reinsurance cover for such damage to limit losses.

Notes to the financial statements

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28. Management of risks continued

Estimation of claims provisions – non asbestos reserves

Reserves are analysed by line of business within the various regions. A single line of business may be written in one or more of the regions. Case reserves are established on each individual claim and are adjusted as new information becomes known during the course of handling the claim. Lines of business for which claims data (eg paid claims and case reserves) emerge over a long period of time are referred to as long tail lines of business. Lines of business for which claims data emerge more quickly are referred to as short tail lines of business. Within the Group's operations a typical short tail line of business is property. The longest tail lines of business include personal accident in Scandinavia, workers' compensation in the US, commercial liability and professional liability.

Our reserving managers regularly review reserves for both current and prior accident years using the most current claims data. These reserve reviews incorporate a variety of actuarial methods and judgements and involve extensive analysis. For most lines of business a variety of actuarial methods are reviewed and the reserving managers select methods and specific assumptions appropriate for each line of business based on the current circumstances affecting that line of business. These selections incorporate input from claims personnel, underwriters and operating management on reported claims trends and other factors that could affect the reserve estimates.

For short tail lines of business, development of paid claims and case reserves is reliable and indicative of ultimate losses. The method used is based on the amount of paid and case estimates for reported claims.

For long tail lines of business, initial development of paid claims and case reserves is less reliable and, accordingly, may not be fully indicative of ultimate losses. For this reason, within these lines, methods which incorporate a development pattern assumption are given less weight in calculating the reserves for the early stages of loss development. The estimation of reserves for these lines of business in the early stages of claims development is therefore largely influenced by prior accident years' loss ratios and changes to pricing, claims costs, mix of business, ceded reinsurance and other factors that are expected to affect the loss ratio. For later periods of loss emergence, methods which incorporate a development pattern assumption are given more weight in estimating ultimate losses.

Based on the results of the reserve reviews and after consideration of other factors such as the maturity of the accident year, trends observed over the recent past and the level of volatility within a particular line of business, we determine the appropriate level of reserves to book.

The Group is a multi line multi national property and casualty insurer. It is therefore subject to reserve uncertainty stemming from a number of conditions, including but not limited to those noted above, any of which could be material at any point in time for any line of business. Certain issues may become more or less important over time as conditions change. As various market conditions develop, we must assess whether those conditions constitute a long term trend that should result in a reserving action (ie increasing or decreasing the reserve).

Estimation of claims provisions – asbestos reserves

The Group has exposure to liabilities for asbestos related losses arising from the sale of commercial liability and multi peril policies prior to 1987. After 1987, policy wordings contained more prescriptive, and in many cases absolute, exclusions for these types of exposure thereby considerably reducing the potential for loss.

In the US, coverages provided under which these liabilities have emerged were in most cases with smaller commercial customers and involved small policy aggregate limits and limits to coverage. The Group wrote a limited amount of excess coverage in the US, most of which were excess policies on top of our own primary covers as opposed to primary policies written by other insurers. As a result, to a large extent, the Group was able to maintain underwriting and policy wording discipline. Excess policies are insurance policies which provide coverage in excess of the policy limits of another insurance policy, sometimes referred to as the primary policy. In other words, primary policies provide insurance coverage only to a defined limit of liability. Excess policies provide additional coverage beyond this liability limit.

In the UK, asbestos liabilities have emerged most frequently in the employers' liability line. This coverage indemnifies individuals injured in the workplace. The effect of reinsurance purchased against large individual losses is dampened by the often multi year nature of the liabilities which means a deductible for each year of exposure applies.

Reserving for asbestos claims is subject to a range of uncertainties that are generally greater than those presented by other types of claims. These include long reporting delays, unresolved legal issues on policy coverage and the identity of the insureds. As a consequence, traditional loss reserving techniques cannot wholly be relied on and we have employed specialised techniques to determine reserves in a prudent manner using the extensive knowledge of both internal asbestos experts and external legal and professional advisors.

UK risks written in the UK

The majority of business in this area is employers' liability (EL) written through our UK Commercial business with a small amount of public and products liability. The underlying method for the estimation of asbestos requirements for UK EL depends critically on establishing a distribution of expected deaths from asbestos related disease, which is then adjusted to allow for the delay between claim and death of claimant. Calibration of the resultant distribution to Group experience of reported claims allows an estimate of future numbers of claims against the Group to be produced.

Average claim cost is monitored from claim notifications over time and, from this data, after adjustment for inflation, a view is taken of current average claims cost taking into account evidence of trends etc. The average costs observed will reflect the proportion of claims cost being borne by the Group as a result of current sharing agreements amongst insurers, which in turn reflects the Group's proportion of claimant exposure periods.

28. Management of risks continued

UK Government Health & Safety Executive projections of probable numbers of future deaths from mesothelioma, published in December 2003, have been used as the basis to determine our UK reserves for future expected asbestos cases and we have applied this to our average cost, which is adjusted to allow for future inflation. The effect of using this data on our reserves is to increase the anticipated number of asbestos claims which are spread over an extended reporting period.

US risks written in the UK

US asbestos exposure arises from a variety of sources including: London market 'direct' business written through Marine operations many years ago, inward reinsurance exposures also written through the London market and from participation in UK aviation pools.

In establishing reserves for US asbestos claims we evaluate each insured's estimated liability for such claims using a ground up approach. We consider a variety of factors, including the state where underlying claims have been brought, past, current and anticipated future claim activity, disease mix, past settlement amounts for similar claims, dismissal rates, allocated claim adjustment expenses, and potential bankruptcy impact.

Having evaluated the insured's probability for asbestos claims we then evaluate each insured's insurance program for such claims. We consider each insured's total available coverage, including policies issued by us. We also consider relevant judicial interpretations of policy language and applicable defences or determinations.

Once the gross ultimate exposure for indemnity and allocated claim adjustment expenses is determined for each insured by each policy year, we calculate our ceded reinsurance projection based on any applicable facultative or treaty reinsurances.

US risks written in the US

Claimants include both primary defendants and peripheral defendants. Primary asbestos defendants manufactured and distributed asbestos products and most are expected to exhaust the majority of available insurance coverage.

The peripheral category is a newer group of defendants brought into litigation due to bankruptcies in the primary defendant group. Some may have manufactured, distributed or installed asbestos containing products, but exposure is more limited. Others owned or operated premises where asbestos products were used, giving rise to premises rather than products claims.

A similar approach, to the one outlined above in US risks written in the UK, is used to establish reserves.

Asbestos reserves contain a high degree of uncertainty. Factors contributing to this higher degree of uncertainty include:

- Plaintiffs' expanding theories of liability, compounded by inconsistent court decisions and judicial interpretations,
- A few large claims, accompanied by a very large number of small claims or claims made with no subsequent payment, often driven by intensive advertising by lawyers seeking claimants,
- The tendency for speculative, inflated and/or unsupported claims to be made to insurers, with the aim of securing a settlement on advantageous terms,
- The long delay in reporting claims and exposures, since the onset of illness and disability arising from exposure to harmful conditions may only become apparent many years later, for example, cases of mesothelioma can have a latent period of up to 40 years,
- Inadequate development patterns,
- Difficult issues of allocation of responsibility among potentially responsible parties and insurers,
- Complex technical issues that may give rise to delays in notification arising from unresolved legal issues on policy coverage and the identity of the insureds,
- The tendency for social trends and factors to influence jury verdicts,
- Developments pertaining to the Group's ability to recover reinsurance for claims of this nature.

The position in the US is particularly problematic, as plaintiffs have expanded their focus to defendants beyond the 'traditional' asbestos manufacturers and distributors. This has arisen as a consequence of the increase in the number of insureds seeking bankruptcy protection because of asbestos related litigation and the exhaustion of their policy limits. Plaintiffs, supported by lawyers remunerated on a contingent fee basis, are now seeking to draw in a wide cross section of defendants who previously only had peripheral or secondary involvement in asbestos litigation. This may include companies which have distributed or incorporated asbestos containing parts in their products or operated premises where asbestos was present. There are also increasing signs of attempts to reopen and reclassify into other insurance coverages previously settled claims, and the filing of claims under the non aggregate premises or operation section of general liability policies. There are also indications that plaintiffs may seek damages by asserting that insurers had a duty to protect the public from the dangers of asbestos.

Notes to the financial statements

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28. Management of risks continued

Emerging and legal risks

These are risks that have been identified as potentially affecting the Group but for which the extent of risk has not yet been identified. Existing or potential future risk exposures are investigated in a structured way, using internal and external resources, and appropriate proposals for actions to mitigate, contain or remove these risks are made to the BRC.

In addition, to the extent that legal decisions in any of the jurisdictions in which the Group operates worldwide may increase court awards, and that the impact may be applied prospectively or retrospectively, claims and benefits provisions may prove insufficient to cover actual losses, loss adjustment expenses or future policy benefits. In such an event, or where it has been previously estimated that no liability would apply, the Group would add to its loss provisions and incur a charge to earnings. Such insufficiencies could have a material adverse effect on the Group's future consolidated financial condition, results of operations and cashflows.

In the ordinary course of its insurance activities, the Group is routinely involved in legal or arbitration proceedings with respect to liabilities, which are the subject of policy claims.

As insurance industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues can have a negative effect on the Group's business by either extending coverage beyond its underwriting intent or by increasing the number and size of claims.

Aggregation of risks

The Group is exposed to multiple insured losses arising out of a single occurrence, whether a natural peril event such as a hurricane, flood or an earthquake, or man made catastrophes such as an explosion or fire at a major industrial facility. Any such catastrophic event could generate insured losses under one or more of its policies.

The ability of the businesses in each territory to assess the aggregation risk of a single event impacting on thousands of policyholders is vital. The Group employs proprietary exposure measurement systems to assess these risks. In some markets, particularly in the UK, the Group has in addition developed its own expertise in catastrophe modelling that is used in conjunction with outside consultants. The accurate estimation of the potential expected maximum loss for a catastrophe is critical and is the primary factor considered in designing the Group's catastrophe reinsurance programme.

The expertise within the Group on catastrophe modelling is shared through the Worldwide Reinsurance Practice Group, which also provides an overview of the company wide catastrophe exposures and reinsurance adequacy. A reinsurance program is considered to be 'adequate' only if it covers at least 199 out of 200 possible events by loss size. This is referred to as the '1 in 200 year expected maximum loss'. Since 1999, the Group has set its total retention for a single catastrophic event based on geographic location.

The subsidiaries of the Group are responsible for buying reinsurance to protect their results against catastrophes and for determining their own retentions. The Group Corporate Centre reviews the operations' proposed catastrophe purchases to check that they at least meet the Group's '1 in 200 year' standard. Group Corporate Centre also checks to see that total Group exposures are within the limits set out above and also are consistent with the required risk based capital. As a result the Group may decide to purchase further catastrophe coverage at the Group level.

Reinsurance risk

The Group reinsures a portion of the risks underwritten to control exposure to losses to reduce volatility and protect capital. The Group's reinsurance strategy is to purchase reinsurance in the most effective manner from reinsurers who meet its security standards.

The Group uses financial analysis models to assess the risk and reward effects of different reinsurance structures and prices.

The Group remains primarily liable as the direct insurer on all risks reinsured, although the reinsurer is liable to the Group to the extent of the reinsurance ceded. To limit the risk that the reinsurer is unable to pay in full, under certain reinsurance agreements the Group holds collateral, including escrow funds and letters of credit. The Group monitors the financial condition of reinsurers on an ongoing basis, and reviews its reinsurance arrangements regularly to ensure that its total counterparty exposure to individual reinsurance groups is within the limits set by the BRC and the Financial Services Authority for insurers domiciled in the UK.

In selecting the reinsurers with whom the Group does business:

- Its strategy is to seek reinsurers with the best combination of credit rating, price and capacity. The Group publishes internally a list of authorised reinsurers who pass its security review process and which its operations may use for new transactions.
- The Group reviews the financial security of each of its reinsurers having regard to the work of rating agencies and specialist advice from other sources, such as the counterparty risk assessment units of its reinsurance brokers.
- As part of this review work, the Group assesses public ratings of its reinsurers. Reinsurers that have a Financial Strength Rating of less than 'A-' with Standard & Poor's, or a comparable rating with AM Best, are removed from the Group's authorised list unless the Group's own review discovers exceptional circumstances in favour of the reinsurer. Further, if a rating agency reduces a reinsurer's rating, the Group carries out its own review of that reinsurer to see whether it should remain on the list of authorised reinsurers.
- The BRC sets targets for the credit profile of reinsurers on the Group's treaty purchases.

28. Management of risks continued

The Group limits the credit risk exposure to individual captive reinsurers, with whom it deals as part of the commercial lines business, by analysis of their finances and controlling the maximum exposure to each captive each time the reinsurance contract is renewed.

The Group monitors changes in the financial security of all of its reinsurers to see whether their ability to pay recoverables in full is doubtful. Where a reinsurer's ability to pay in full is believed to be doubtful, the Group Corporate Centre sets guidelines for provisioning for uncollectable reinsurance. These guidelines apply to all operations. Group Corporate Centre analyses local provisions against the Group's guidelines.

Credit profile of Group reinsurance counterparties

The table below sets forth the rating assigned by Standard & Poor's to the Group's primary property and casualty treaty reinsurers and the amounts ceded to them under outward reinsurance contracts during 2005 and 2004. This type of reinsurance requires the reinsurer to assume insurance risk, on a predetermined basis, for all of the contracts underwritten by the Group and that are covered by the treaty. For each reinsurance group, the table shows the rating category of each reinsurance group as of 31 December 2005 together with the rating category of that reinsurance group as of 1 January 2005.

Reinsurance group	2005		2004	
	Ceded treaty premiums £m	S&P rating at 31 December 2005	Ceded treaty premiums £m	S&P rating at 1 January 2005
Munich Re Group	280	A+	584	A+
HDI Group	56	AA-	50	AA-
Lloyd's of London	44	A	59	A
Renaissance Re Holdings	37	A+	55	AA-
Swiss Re Group	37	AA	40	AA

During 2005, over 99% of the Group's property and casualty treaty cessions by premium were to reinsurers that had a Standard & Poor's financial strength rating of at least 'A-' or better, or equivalent from AM Best, as at the start date of the contract.

The Group's property and casualty facultative placements, other than those with captive reinsurers of its major retail clients, are mainly with the same reinsurers used on treaty placements. Facultative placements, or risks under facultative treaties, reinsure all or part of a single policy determined on a contract by contract basis.

As of 31 December 2005 total provisions for uncollectable reinsurance were **£141m** (2004: £129m).

Certain of the Group's subsidiaries are members of government mandated pools in various parts of the world. As of 31 December 2005 the largest pool (by premium volume) was Pool Re operated by the UK government to provide terrorism cover.

29. Hedge accounting

At 1 January 2005, the Group designated the loan capital as denominated in foreign currencies as hedging instruments against the net investment in designated subsidiaries to reduce the foreign currency exchange risk exposure. The book value of the hedging instruments at 31 December 2005 was **£626m**. The fair value of the hedging instruments at 31 December 2005 was **£735m**.

30. Segment reporting

The Group's internal reporting is organised into distinguishable components based on the major geographical regions in which it operates. These components represent the primary format for reporting segment information. The secondary segment reporting format is the Group's business segments: Personal and Commercial.

Items of segment revenue, segment expense, segment assets and segment liabilities include amounts of such items that are directly attributable to a segment and amounts of such items that can be allocated to a segment on a reasonable basis. Items are allocated consistently, such that an item of segment revenue is allocated to the segment that holds the income generating asset.

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30. Segment reporting continued

Primary segment – geographical

Year ended 31 December 2005

	UK £m	Scandinavia £m	International £m	Central functions and eliminations £m	Core Group £m	US £m	Group £m
Gross written premiums	3,359	1,368	1,680	(170)	6,237	183	6,420
Less: reinsurance premiums	(727)	(44)	(343)	177	(937)	(83)	(1,020)
Net written premiums	2,632	1,324	1,337	7	5,300	100	5,400
Underwriting result	154	65	63	(19)	263	(145)	118
Investment income	274	108	116	—	498	118	616
Realised gains	61	23	25	—	109	20	129
Unrealised gains/(losses), impairments and foreign exchange	7	2	3	—	12	—	12
Unwind of discount	(21)	(18)	—	—	(39)	(22)	(61)
Investment result	321	115	144	—	580	116	696
Insurance result	475	180	207	(19)	843	(29)	814
Other activities	(1)	(8)	2	(93)	(100)	(16)	(116)
Operating result (management basis)	474	172	209	(112)	743	(45)	698
Amortisation	—	(6)	(5)	—	(11)	(6)	(17)
Reorganisation costs	(37)	—	—	—	(37)	(49)	(86)
Benefit from change of pension scheme design	180	—	—	—	180	—	180
Profit on disposal of significant shareholding in Rothschilds	—	—	—	61	61	—	61
Share of associates	—	—	(3)	—	(3)	—	(3)
Results of operating activities (per Income Statement)	617	166	201	(51)	933	(100)	833
Interest costs	(2)	(5)	—	(100)	(107)	—	(107)
Profit/(loss) on disposals of subsidiaries	—	—	—	65	65	71	136
Share of associates net of tax	—	—	3	—	3	—	3
Profit/(loss) before tax	615	161	204	(86)	894	(29)	865
Income tax expense	—	—	—	—	(259)	(1)	(260)
Profit/(loss) for the year					635	(30)	605

Other segment items included in the Income Statement:

Depreciation and amortisation expenses	38	18	23	4	83	10	93
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Other significant non cash expenses include unwind of discount and the benefit from change of pension scheme design.

The segment assets and liabilities at 31 December 2005 and capital expenditure for the year then ended are as follows:

	UK £m	Scandinavia £m	International £m	Central functions and eliminations £m	Core Group £m	US £m	Group £m
Segment assets	9,098	4,182	4,991	1,332	19,603	4,893	24,496
Associates	—	3	—	26	29	—	29
Income tax assets	3	6	60	3	72	—	72
Total assets	9,101	4,191	5,051	1,361	19,704	4,893	24,597
Segment liabilities	7,939	3,054	3,901	1,754	16,648	4,524	21,172
Income tax liabilities	26	116	71	75	288	3	291
Total liabilities	7,965	3,170	3,972	1,829	16,936	4,527	21,463

Capital expenditure:							
Property and equipment	34	13	13	—	60	1	61
Goodwill and other intangible assets	102	8	72	—	182	—	182

30. Segment reporting continued

Year ended 31 December 2004

	UK £m	Scandinavia £m	International £m	Central functions and eliminations £m	Core Group £m	US £m	Group £m
Gross written premiums	3,585	1,326	1,596	(156)	6,351	304	6,655
Less: reinsurance premiums	(1,030)	(98)	(410)	159	(1,379)	(194)	(1,573)
Net written premiums	2,555	1,228	1,186	3	4,972	110	5,082
Underwriting result	95	54	45	(9)	185	(462)	(277)
Investment income	244	96	103	—	443	108	551
Realised gains	61	25	26	—	112	1	113
Unrealised gains/(losses), impairments and foreign exchange	(2)	(1)	(1)	—	(4)	2	(2)
Unwind of discount	(21)	(29)	—	—	(50)	(21)	(71)
Investment result	282	91	128	—	501	90	591
Insurance result	377	145	173	(9)	686	(372)	314
Other activities	32	(13)	4	(86)	(63)	7	(56)
Operating result (management basis)	409	132	177	(95)	623	(365)	258
Amortisation	—	(7)	(7)	—	(14)	(8)	(22)
Reorganisation costs	(62)	—	(7)	—	(69)	(49)	(118)
Share of associates	(3)	—	(9)	(2)	(14)	—	(14)
Results of operating activities (per Income Statement)	344	125	154	(97)	526	(422)	104
Total interest costs	—	—	—	(75)	(75)	—	(75)
Profit/(loss) on disposals of subsidiaries	—	(1)	(5)	(3)	(9)	7	(2)
Share of associates net of tax	2	—	6	—	8	—	8
Profit/(loss) before tax on continuing operations	346	124	155	(175)	450	(415)	35
Income tax expense	—	—	—	—	(111)	23	(88)
Profit/(loss) for the year from continuing operations	—	—	—	—	339	(392)	(53)
Discontinued life	—	—	—	—	(27)	—	(27)
Profit/(loss) for the year	—	—	—	—	312	(392)	(80)

Other segment items included in the Income Statement:

Depreciation and amortisation expenses	23	18	18	5	64	15	79
--	----	----	----	---	----	----	----

Other significant non cash expenses include unwind of discount.

The segment assets and liabilities at 31 December 2004 and capital expenditure for the year then ended are as follows:

	UK £m	Scandinavia £m	International £m	Central functions and eliminations £m	Core Group £m	US £m	Group £m
Segment assets	9,162	4,016	4,149	154	17,481	6,964	24,445
Associates	—	3	1	25	29	—	29
Income tax assets	3	4	37	136	180	—	180
Total assets	9,165	4,023	4,187	315	17,690	6,964	24,654
Segment liabilities	8,068	2,956	3,308	450	14,782	6,560	21,342
Income tax liabilities	34	91	45	7	177	2	179
Total liabilities	8,102	3,047	3,353	457	14,959	6,562	21,521
Capital expenditure:							
Property and equipment	17	32	8	—	57	—	57
Goodwill and other intangible assets	101	4	20	—	125	—	125

Notes to the financial statements

continued

30. Segment reporting continued

Secondary segment – business

Year ended 31 December 2005

	Core Group				US		Total £m
	Personal £m	Commercial £m	Central functions and eliminations £m	Core Group £m	Personal £m	Commercial £m	
Gross written premiums from external customers	2,805	3,602	(170)	6,237	183	—	6,420
Total assets	5,717	12,626	1,361	19,704	949	3,944	24,597
Capital expenditure:							
Property and equipment	18	42	—	60	—	1	61
Goodwill and other intangible assets	47	135	—	182	—	—	182

Year ended 31 December 2004

	Core Group				US		Total £m
	Personal £m	Commercial £m	Central functions and eliminations £m	Core Group £m	Personal £m	Commercial £m	
Gross written premiums from external customers	2,770	3,737	(156)	6,531	304	—	6,855
Total assets	5,306	12,069	315	17,690	1,350	5,614	24,654
Capital expenditure:							
Property and equipment	23	34	—	57	—	—	57
Goodwill and other intangible assets	26	99	—	125	—	—	125

31. Subsidiaries

Country of incorporation		Principal activity
United Kingdom (note 1)	Royal Insurance Holdings plc (note 2)	Holding company
	Royal & Sun Alliance Insurance plc	General insurance
	British Aviation Insurance Company Limited (57.1%)	General insurance
	The Globe Insurance Company Limited	General insurance
	The Marine Insurance Company Limited	General insurance
	Royal International Insurance Holdings Limited	General insurance
	Royal & Sun Alliance Reinsurance Limited	General insurance
	Sun Alliance and London Insurance plc	General insurance
	Sun Insurance Office Limited	General insurance
Argentina	Royal & Sun Alliance Seguros (Argentina) SA	General insurance
	La Republica Compania Argentina de Seguros Generales SA	General insurance
Bahrain	Royal & Sun Alliance Insurance (Middle East) Limited E.C. (50.01%)	General insurance
Brazil	Royal & Sun Alliance Seguros (Brasil) SA	General insurance
Canada	Roins Financial Services Limited	Holding company
	Compagnie d'Assurance du Quebec	General insurance
	The Johnson Corporation	General insurance
	Royal & Sun Alliance Insurance Company of Canada	General insurance
	Western Assurance Company	General insurance
Chile	Royal & Sun Alliance Seguros (Chile) SA (97.5%)	General insurance
	Compania de Seguros Generales Cruz del Sur SA	General insurance
Colombia	Royal & Sun Alliance Seguros (Colombia) SA (86.5%)	General insurance
Denmark	Codan A/S (71.7%)	Holding company
	Codan Forsikring A/S (71.7%)	General insurance
Guernsey	Insurance Corporation of the Channel Islands Limited	General insurance
Hong Kong	Royal & Sun Alliance Insurance (Hong Kong) Limited	General insurance
Isle of Man	Tower Insurance Company Limited	General insurance
Mexico	Royal & Sun Alliance Seguros (Mexico) SA	General insurance
Netherlands Antilles	Royal & Sun Alliance Insurance (Antilles) NV (51.0%)	General insurance
Singapore	Royal & Sun Alliance Insurance (Singapore) Limited	General insurance
Sweden	Trygg-Hansa Försäkrings AB, Publikt (71.7%)	General insurance
United States of America	Royal & Sun Alliance USA, Inc	Holding company
	Guaranty National Insurance Company	General insurance
	Royal Indemnity Company	General insurance
	Royal Surplus Lines Insurance Company	General insurance
	Security Insurance Company of Hartford	General insurance
Uruguay	Royal & Sun Alliance Seguros (Uruguay) SA	General insurance
Venezuela	Royal & Sun Alliance Seguros (Venezuela) SA (99.9%)	General insurance

Notes:

1. All UK companies are incorporated in Great Britain and are registered in England.
2. 100% direct subsidiary of Royal & Sun Alliance Insurance Group plc.
3. Except where indicated all holdings are of equity shares and represent 100% of the nominal issued capital. In all cases the proportion of voting power held equals the proportion of ownership interest.
4. Some subsidiaries have been omitted from this statement to avoid providing particulars of excessive length but none materially affects the results or assets of the Group.

Notes to the financial statements

continued

32. Business combinations

Acquisition of subsidiaries

On 15 November 2005 the Group acquired 100% of the share capital of Compania de Seguros Generales Cruz del Sur SA located in Chile and on 1 December 2005 the Group acquired 100% of the share capital of La Republic Compania Argentina de Seguros Generales SA located in Argentina. The total consideration was **£69m** and goodwill of **£42m** arose on the acquisitions.

	£m
Investments	37
Cash and cash equivalents	6
Other assets	79
Insurance contract liabilities	(82)
Other liabilities	(13)
Net assets	27
Cash consideration including acquisition costs	69
Goodwill on acquisition	42
Fair value adjustment	(4)
Goodwill	38

The total income and profit after tax of the acquired entities for the 11 months to 30 November 2005 was **£49m** and **£nil** respectively. The total income and profit after tax of the acquired entities for the one month to 31 December 2005 was **£5m** and **£nil** respectively.

During 2004, the Group acquired for £5m further minority interests in existing subsidiaries.

Disposal of subsidiaries

During the year, disposals of subsidiary undertakings and books of business were made for a total consideration of **£181m**, giving rise to a pre tax profit of **£136m**. Group disposals during the year comprise:

1. The disposal of its Japanese business on 28 February 2005. The transaction generated proceeds, net of costs, of **£59m** and generated a pre tax profit of **£59m**.
2. The disposal of its specialty US Nonstandard Auto business, Viking Insurance Company of Wisconsin, on 2 November 2005. The transaction generated proceeds, net of costs, of **£112m** and generated a pre tax profit of **£71m**.
3. The disposal of its Latvian life interests and adjustments relating to prior year disposals generated proceeds of **£10m** and a pre tax profit of **£6m**.

The fair value of assets and liabilities disposed of were as follows:

	£m
Investments	78
Cash	68
Other assets	37
Technical provisions	(123)
Other liabilities	(15)
Profit on disposal	136
Total cash consideration	181

33. Cash generated from continuing operations

	2005 £m	2004 £m
Net profit for the year before tax on continuing operations	865	35
Adjustments for:		
Depreciation	37	39
Amortisation	56	40
Fair value (gains)/losses (including (gain)/loss on disposal) on property and equipment	3	10
Fair value (gains)/losses (including (gain)/loss on disposal) on investments	(186)	(120)
Fair value (gains)/losses (including (gain)/loss on disposal) on investment property	(51)	(27)
Impairment charge on available for sale financial assets	5	16
Share of (loss)/profit from associates	(3)	(8)
(Profit)/loss on disposal of subsidiaries	(136)	2
Foreign exchange loss/(gain)	25	(32)
Amortisation of available for sale investments	70	82
Other non cash movements	24	24
Changes in operating assets/liabilities:		
Movement in technical provisions		
Unearned premiums	18	(664)
Outstanding claims	(318)	(135)
Movement in working capital	(345)	802
Movement in deferred acquisition costs	32	201
Reclassification of interest (received)/paid	(558)	(509)
Cash generated from continuing operations	(462)	(244)

34. Related party transactions

The ultimate Parent Company of the Group is Royal & Sun Alliance Insurance Group plc which is incorporated in England.

The following transactions were carried out with related parties:

Key management compensation

	2005 £m	2004 £m
Salaries and other short term employee benefits	5	4
Bonus awards	3	3
Pension benefits	1	1
Share based awards	1	1
Total	10	9

A number of the directors, other key managers, their close families and entities under their control have general insurance policies with subsidiary companies of the Group. Such policies are on normal commercial terms except that executive directors and key managers are entitled to special rates which are also available to other members of staff.

Year end balances arising from insurance transactions

	2005 £m	2004 £m
Receivables from associates	1	4

Notes to the financial statements

continued

35. Commitments

Capital commitments

The Group's significant capital commitments in respect of investment property, property and equipment, intangible assets and associates are detailed in the table below:

	2005 £m	2004 £m
Property and equipment	4	4

Financial instrument commitments

The Group has a number of guarantees and commitments.

Bank loan guarantees

In Canada, the Group guarantees outstanding loan repayments in the event of bank loan default by broker subsidiaries and special relationship brokers. The bank loan guarantees amount in total to **£9m** (2004: £11m) and have a term of up to 10 years. It is not anticipated that any of the brokers will default, and full recourse is available on any default. Scandinavia has financial and performance guarantees totalling **£2m** (2004: £2m). The fair value of the guarantees did not materially impact the consolidated financial position of the Group.

Financial enhancement products

Within the financial enhancement product portfolio of the UK operations, are a number of credit default swaps, residual value insurance contracts, bonds, residential property loan and lease guarantees. The guarantees are accounted for as derivative instruments at fair value. The carrying amount of the guarantees in total is a liability of **£21m** (2004: £29m) and the maximum term is 16 years 4 months. The total maximum potential amount of future payments in respect of these guarantees is **£112m** (2004: £104m). There is recourse available on one of the above guarantees of **£39m** (2004: £38m). The majority of the guarantee contracts are 100% reinsured with the relating recoverable held as a derivative asset.

Operating lease commitments

The Group leases various outlets and offices under non cancellable operating lease agreements. The leases have varying terms, escalation clauses and renewal rights.

Operating lease commitments where the Group is the lessee

The future aggregate minimum lease payments under non cancellable operating leases are as follows:

	Land and buildings		Other	
	2005 £m	2004 £m	2005 £m	2004 £m
One year or less	58	62	5	4
Between one and five years	179	186	2	5
After five years	162	182	—	—
	399	430	7	9
Recoveries under sub tenancies	(104)	(131)	—	—
Total	295	299	7	9

Operating lease commitments where the Group is the lessor

The future aggregate minimum lease payments under non cancellable operating leases are as follows:

	Land and buildings	
	2005 £m	2004 £m
One year or less	4	9
Between one and five years	4	9
After five years	2	1
Total	10	19

36. Discontinued operations, non current assets and assets and liabilities of operations held for sale

Discontinued operations

The UK Life, Codan Life, Poland Life and Peru Life operations (part of the Life business segment) have been presented as discontinued operations following their sale. The completion dates for the transactions were 30 September 2004 (UK Life), 1 October 2004 (Codan Life), 16 April 2004 (Poland Life) and 1 January 2004 (Peru Life).

An analysis of the result of discontinued operations, and the result recognised on the remeasurement of assets of the disposal group is as follows:

	2005 £m	2004 £m
Net earned premiums	—	890
Net investment return	—	1,276
Claims incurred	—	(1,885)
Policy acquisition costs	—	(46)
Movements in funds for future appropriations	—	48
Other expenses	—	(93)
Profit before tax of discontinued operations	—	190
Tax	—	(110)
Profit after tax of discontinued operations	—	80
Loss after tax on disposal (tax: £nil)	—	(107)
Loss for the year from discontinued operations	—	(27)

Non current assets and assets and liabilities of operations held for sale

At 31 December 2005 a Group occupied property within the UK segment was presented as held for sale following the decision to dispose of it and the sale being considered highly probable. At 31 December 2004 the assets and liabilities relating to the Group's operations in Japan (part of International segment) were presented as held for sale following the approval by the Group's management to sell and initiation of an active programme to locate a buyer. The disposal transaction was completed in February 2005.

	2005 £m	2004 £m
Assets		
Total investments	36	46
Insurance and reinsurance debtors	—	11
Deferred acquisition costs	—	2
Other debtors and other assets	—	7
Cash and cash equivalents	—	15
Total assets	36	81
Liabilities		
Insurance contract liabilities	—	39
Insurance and reinsurance liabilities	—	4
Other liabilities	—	34
Total liabilities	—	77

Independent auditors' report to the members of Royal & Sun Alliance Insurance Group plc

We have audited the Parent Company financial statements of Royal & Sun Alliance Insurance Group plc for the year ended 31 December 2005 which comprise the Parent Company Balance Sheet, Statement of Changes in Equity of the Parent Company, the Parent Company Cashflow Statement and the related notes on pages 118 to 125. These Parent Company financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Emoluments and the Directors' Interests that is described as having been audited.

We have reported separately on the consolidated financial statements of Royal & Sun Alliance Insurance Group plc for the year ended 31 December 2005.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report, the Directors' Emoluments and the Directors' Interests and the Parent Company financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union are set out in the Directors' Report.

Our responsibility is to audit the Parent Company financial statements and the sections on Directors' Emoluments and the Directors' Interests that are described as having been audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the Parent Company financial statements give a true and fair view and whether the Parent Company financial statements and the sections on Directors' Emoluments and the Directors' Interests that are described as having been audited have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Directors' Report is not consistent with the Parent Company financial statements, if 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 read other information contained in the Annual Report and consider whether it is consistent with the audited Parent Company financial statements. The other information comprises only the Highlights, the Key business information, the Chairman's statement, the Group CEO's review, the Royal & SunAlliance today section, the Operating

and Financial review, the Corporate Responsibility section, the Share and shareholder analysis, the Directors' Report, the Corporate Governance statement, the Remuneration Report and the unaudited part of Directors' Interests. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Parent Company 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 Parent Company financial statements and the sections on Directors' Emoluments and the Directors' Interests that are described as having been audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Parent Company financial statements, and of whether the accounting policies are appropriate to the 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 Parent Company financial statements and the part of the Directors' Emoluments and Directors' Interests 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 Parent Company financial statements and the sections on Directors' Emoluments and the Directors' Interests that are described as having been audited.

Opinion

In our opinion:

- The Parent Company financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the Company's affairs as at 31 December 2005 and cashflows for the year then ended,
- The Parent Company financial statements and the sections on Directors' Emoluments and the Directors' Interests that is described as having been audited have been properly prepared in accordance with the Companies Act 1985.


PricewaterhouseCoopers LLP

Chartered Accountants and Registered Auditors
London
8 March 2006

Parent Company Balance Sheet

as at 31 December 2005

	Notes	2005 £m	2004 £m
Assets			
Investments	3	4,870	3,981
Amounts owed by subsidiaries	10	1,149	913
Current income tax assets	7	27	63
Deferred tax assets	7	2	—
Other debtors and other assets	4	7	73
		1,185	1,049
Cash and cash equivalents		—	1
Total assets		6,055	5,031
Equity, reserves and liabilities			
Equity and reserves			
Share capital	5	932	926
Subordinated guaranteed perpetual notes	6	—	444
Reserves		3,174	2,186
Retained earnings		338	(3)
Total equity and reserves		4,444	3,553
Liabilities			
Amounts owed to subsidiaries	10	474	808
Loan capital	6	1,071	607
Deferred tax liabilities	7	—	14
Accruals and other liabilities		66	49
Total liabilities		1,611	1,478
Total equity, reserves and liabilities		6,055	5,031

The attached notes form an integral part of these separate financial statements.

The separate financial statements were approved on 8 March 2006 by the Board of Directors and are signed on its behalf by:

George Culmer
Chief Financial Officer



Statement of Changes in Equity of the Parent Company

for the year ended 31 December 2005

Changes in equity for the year ended 31 December 2005

	Ordinary share capital £m	Ordinary share premium £m	Preference shares £m	Revaluation reserves £m	Capital redemption reserve £m	Subordinated guaranteed perpetual debt £m	Retained earnings £m	Total equity £m
Balance at 1 January	801	790	125	1,388	8	444	(3)	3,553
Profit for the year	—	—	—	—	—	—	476	476
Dividends – paid (note 8)	—	—	—	—	—	—	(144)	(144)
Issued by scrip	5	13	—	—	—	—	—	18
Issued for cash	1	1	—	—	—	—	—	2
Share options	—	—	—	—	—	—	9	9
Fair value gains/(losses) net of tax	—	—	—	974	—	—	—	974
Reclassification to debt (note 6)	—	—	—	—	—	(444)	—	(444)
Balance at 31 December	807	804	125	2,362	8	—	338	4,444

All items are stated net of tax.

Changes in equity for the year ended 31 December 2004

	Ordinary share capital £m	Ordinary share premium £m	Preference shares £m	Revaluation reserves £m	Capital redemption reserve £m	Subordinated guaranteed perpetual debt £m	Retained earnings £m	Total equity £m
Balance at 1 January	792	775	125	1,335	8	—	14	3,049
Profit for the year	—	—	—	—	—	—	128	128
Dividends – paid (note 8)	—	—	—	—	—	—	(139)	(139)
Issued by scrip	9	15	—	—	—	—	—	24
Share options	—	—	—	—	—	—	4	4
Fair value gains/(losses) net of tax	—	—	—	53	—	—	—	53
Issue of subordinated guaranteed perpetual notes (note 6)	—	—	—	—	—	444	—	444
Interest on subordinated guaranteed perpetual notes – net of tax (note 6)	—	—	—	—	—	—	(10)	(10)
Balance at 31 December	801	790	125	1,388	8	444	(3)	3,553

All items are stated net of tax.

The attached notes form an integral part of these separate financial statements.

Parent Company Cashflow Statement

for the year ended 31 December 2005

	Note	2005 £m	2004 £m
Cash generated from operations	9	(112)	(176)
Income tax refunded/(paid)		—	—
Net cashflows from operating activities		(112)	(176)
Net movement in amounts owed to/by subsidiaries		235	1
Investments in subsidiaries		—	(5)
Net cashflows from investing activities		235	(4)
Proceeds from issue of share capital		2	—
Dividends paid		(126)	(126)
Repayment of long term borrowings		—	(150)
Net movement in other borrowings		—	449
Net cashflows from financing activities		(124)	173
Net decrease in cash and cash equivalents		(1)	(7)
Cash and cash equivalents at beginning of the year		1	8
Cash and cash equivalents at end of the year		—	1

The attached notes form an integral part of these separate financial statements.

Notes to the separate financial statements

1. Significant accounting policies

Royal & Sun Alliance Insurance Group plc, domiciled in the United Kingdom is the ultimate Parent Company (the Company) for the Royal & Sun Alliance Insurance Group. The principal activity of the Company is to hold investments in its subsidiaries and the receipt and payment of dividends.

These separate financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union.

Except where otherwise stated, all figures included in the separate financial statements are presented in millions of British pounds sterling (£m), rounded to the nearest million.

In accordance with Section 230 of Companies Act 1985, the Company's Income Statement and related notes have not been presented in these separate financial statements.

The accounting policies that are used in preparation of these separate financial statements are consistent with the accounting policies used in preparation of the consolidated financial statements of Royal & Sun Alliance Insurance Group as set out in those financial statements.

The additional accounting policies that are specific to the separate financial statements of the Company are set out below.

Investment in subsidiaries

The Company accounts for its investments in directly owned subsidiaries as available for sale financial assets, which are included in the accounts at fair value.

Changes in the fair value of the investments in subsidiaries are recognised directly in equity in the Statement of Changes in Equity. Where there is a decline in the fair value of a directly owned subsidiary below cost, and there is objective evidence that the investment is impaired, the cumulative loss that has been recognised in equity is removed from equity and recognised in the Income Statement.

Dividend income

Dividend income from investments in subsidiaries is recognised when the right to receive payment is established.

2. First time adoption of International Financial Reporting Standards

The Company's separate financial statements for the year ended 31 December 2005 are the first separate financial statements that comply with IFRS.

The Company has applied IFRS 1 'First Time Adoption of International Financial Reporting Standards', in preparing these separate financial statements. The Company's transition date is 1 January 2004 and an opening IFRS Balance Sheet has been prepared at that date.

IFRS 1 allows some exemptions from full retrospective application of certain standards. In preparing these separate financial statements in accordance with IFRS 1, the Company has applied the applicable mandatory exceptions and the following optional exemption from full retrospective application of IFRS.

Estimates exception

Estimates under IFRS at 1 January 2004 are consistent with estimates made for the same date under UK Generally Accepted Accounting Principles (UK GAAP).

Reconciliations between IFRS and UK GAAP

The following reconciliations provide a quantification of the effect of the transition to IFRS on both the Income Statement for the year ended 31 December 2004 and Balance Sheets as at 31 December 2004 and 1 January 2004.

Explanations of the adjustments are also set out below.

Profit for the year ended 31 December 2004

	Note	£m
Profit for the year ended 31 December 2004 as reported under UK GAAP		379
Adjusted for:		
Dividend income from subsidiaries	a	(260)
Loan capital – finance costs	b	3
Subordinated guaranteed perpetual notes	c	10
Other	d	(4)
Profit for the year ended 31 December 2004 as reported under IFRS		128

2. First time adoption of International Financial Reporting Standards continued

Equity at 31 December 2004 and 1 January 2004

	Notes	31 December 2004 £m	1 January 2004 £m
Total equity and reserves as reported under UK GAAP		2,672	2,986
Adjusted for:			
Dividend income from subsidiaries	a	(390)	(130)
Loan capital – derivatives	b	2	(1)
Subordinated guaranteed perpetual notes	c	444	–
Dividends	e	86	83
Investment in subsidiaries carried at fair value	f	739	111
Total equity and reserves as reported under IFRS		3,553	3,049

Explanations

a) Dividend income from subsidiaries

Under UK GAAP, dividend income from a subsidiary proposed up to the date of the approval of the subsidiary's financial statements was recognised in that accounting period. Under IFRS, only dividends approved by subsidiaries during the year are recognised as income. The adjustment reflects the impact of reversing dividends receivable, proposed but not approved at 31 December 2004. The effect of this was a reduction of equity and reserves of £390m at 31 December 2004 and a reduction in profit for the year of £260m.

b) Loan capital

Under UK GAAP, the separate financial statements reflect an accrual or prepayment for the interest accrued on derivatives on dated loan capital. Under IFRS, this accrual or prepayment is reversed and the fair value of the derivative contracts is reflected in the separate financial statements. At 31 December 2004 the impact was an increase in equity and reserves for the year of £2m. A further increase of £1m arose regarding the calculation of a loss of the cancellation of interest rate swaps during the year.

c) Subordinated guaranteed perpetual notes

Under UK GAAP, the subordinated guaranteed perpetual notes issued during 2004 are classified as a liability. As described in note 6, IFRS requires the perpetual notes to be classified as equity and the interest payments to be recognised directly in equity. The impact of this adjustment is to increase the profit for the year by £10m and to increase equity and reserves by £444m.

d) Other

Other includes other miscellaneous adjustments.

e) Dividends proposed

Under UK GAAP, all dividends relating to an accounting period that are proposed up to the date of the approval of the financial statements by the Board of Directors were accrued in that accounting period. Under IFRS, only dividends approved during the year are accrued. The adjustment reflects the impact of reversing the proposed dividend, which at 31 December 2004 was £86m.

f) Investment in subsidiaries

Under UK GAAP, investments in subsidiaries are carried at current value and unrealised gains and losses are recognised in the revaluation reserve. Under IFRS, investments in subsidiaries are recognised in the Balance Sheet at fair value. The adjustment reflects the reversal of the current asset value adjustment under UK GAAP and the impact of the recognition of the fair value of investment in subsidiaries.

Cashflow reconciliation for year ended 31 December 2004

The Company's Cashflow Statement is presented under IFRS in accordance with IAS 7 'Cashflow Statements'. No Cashflow Statement was presented under UK GAAP.

Notes to the separate financial statements

continued

3. Investments

	2005 £m	2004 £m
Investments at 1 January – at valuation	3,981	3,549
(Disposals)/additions during the year	(85)	394
Fair value adjustments	974	53
Impairments	–	(15)
Investments at 31 December – at valuation	4,870	3,981

The balances at 31 December comprise:

	2005 £m	2004 £m
Investment in subsidiaries	4,547	3,573
Loans to subsidiaries	323	323
Other equity investments	–	85
	4,870	3,981

The investments in subsidiaries are recognised in the Balance Sheet at fair value measured in accordance with the Company's accounting policies. Fair value of the Company's significant subsidiary is determined by reference to the market value (derived from relevant indices) of the Company's ordinary shares and loan capital instruments at the Balance Sheet date, being the most transparent independent available indicator. The market value is adjusted for the fair value of the Company's preference shares, assets and liabilities, excluding directly owned subsidiaries. The adjusting items have been fair valued by determining the present value of future cashflow projections, using an appropriate arms length discount rate. The remaining subsidiaries are held at fair value which has been determined to be net asset value.

The directors believe that the methodology used supports the inclusion of the investments in subsidiaries on the Balance Sheet, at the fair values ascribed to them. The market value of the Company's ordinary shares at 31 December 2005 was **125.75p**. A movement of 1% in the share price would have an impact of £37m on the fair value.

The principal subsidiaries of the Company are set below.

Country of incorporation		Principal activity
United Kingdom (note 1)	Royal Insurance Holdings plc (note 2)	Holding company
	Royal & Sun Alliance Insurance plc	General insurance
	British Aviation Insurance Company Limited (57.1%)	General insurance
	The Globe Insurance Company Limited	General insurance
	The Marine Insurance Company Limited	General insurance
	Royal International Insurance Holdings Limited	General insurance
	Royal & Sun Alliance Reinsurance Limited	General insurance
	Sun Alliance and London Insurance plc	General insurance
	Sun Insurance Office Limited	General insurance
Argentina	Royal & Sun Alliance Seguros (Argentina) SA	General insurance
	La Republica Compania Argentina de Seguros Generales SA	General insurance
Bahrain	Royal & Sun Alliance Insurance (Middle East) Limited E.C. (50.01%)	General insurance
Brazil	Royal & Sun Alliance Seguros (Brasil) SA	General insurance
Canada	Roins Financial Services Limited	Holding company
	Compagnie d'Assurance du Quebec	General insurance
	The Johnson Corporation	General insurance
	Royal & Sun Alliance Insurance Company of Canada	General insurance
	Western Assurance Company	General insurance
Chile	Royal & Sun Alliance Seguros (Chile) SA (97.5%)	General insurance
	Compania de Seguros Generales Cruz del Sur SA	General insurance
Colombia	Royal & Sun Alliance Seguros (Colombia) SA (86.5%)	General insurance
Denmark	Codan A/S (71.7%)	Holding company
	Codan Forsikring A/S (71.7%)	General insurance
Guernsey	Insurance Corporation of the Channel Islands Limited	General insurance
Hong Kong	Royal & Sun Alliance Insurance (Hong Kong) Limited	General insurance

3. Investments continued

Country of incorporation		Principal activity
Isle of Man	Tower Insurance Company Limited	General insurance
Mexico	Royal & SunAlliance Seguros (Mexico) SA	General insurance
Netherlands Antilles	Royal & Sun Alliance Insurance (Antilles) NV (51.0%)	General insurance
Saudi Arabia	Royal & Sun Alliance Insurance (Middle East) Limited E.C. (50.01%)	General insurance
Singapore	Royal & Sun Alliance Insurance (Singapore) Limited	General insurance
Sweden	Trygg-Hansa Försäkrings AB, Publikt (71.7%)	General insurance
United States of America	Royal & Sun Alliance USA, Inc Guaranty National Insurance Company Royal Indemnity Company Royal Surplus Lines Insurance Company Security Insurance Company of Hartford	Holding company General insurance General insurance General insurance General insurance
Uruguay	Royal & Sun Alliance Seguros (Uruguay) SA	General insurance
Venezuela	Royal & Sun Alliance Seguros (Venezuela) SA (99.9%)	General insurance

Notes:

1. All UK companies are incorporated in Great Britain and are registered in England.
2. 100% direct subsidiary of the Company.
3. Except where indicated all holdings are of equity shares and represent 100% of the nominal issued capital. In all cases the proportion of voting power held equals the proportion of ownership interest.
4. Some subsidiaries have been omitted from this statement to avoid providing particulars of excessive length.

4. Other debtors and other assets – to be settled within 12 months

	2005 £m	2004 £m
Accrued interest and rent	–	1
Other prepayments and accrued income	3	66
Other debtors	4	6
Total other debtors and other assets	7	73

5. Share capital

Ordinary and preference shares

During the year **2,137,513** (2004: 449,832) ordinary shares were issued on the exercise of employee share options for a cash consideration of **£2m** (2004: £0.3m). The Parent Company also issued **20,661,210** (2004: 31,669,408) ordinary shares during the year under the scrip scheme approved by the shareholders at the 2005 Annual General Meeting (AGM). The total nominal value of ordinary shares issued during the year was **£6m** (2004: £9m).

	2005 £m	2004 £m
Authorised		
3,923,636,364 ordinary shares of 27.5p each (2004: 3,923,636,364 ordinary shares of 27.5p each)	1,079	1,079
300,000,000 preference shares of £1 each (2004: 300,000,000 preference shares of £1 each)	300	300
Issued and fully paid		
2,935,117,294 ordinary shares of 27.5p each (2004: 2,912,318,571 ordinary shares of 27.5p each)	807	801
125,000,000 preference shares of £1 each (2004: 125,000,000 preference shares of £1 each)	125	125
	932	926

The preference shares carry a right to a fixed cumulative preferential dividend of 7.375% per annum, payable in half yearly instalments, and are not redeemable. On a return of capital on a winding up (liquidation), the holders are entitled, in priority to holders of all shares of the Parent Company, to receive out of the surplus assets of the Parent Company any arrears and accruals of the dividend together with the greater of the price at which the gross yield on 3.5% War Loan or such Government Stock as may be agreed (but not exceeding twice the nominal amount of the preference share) and the nominal amount of the share together with any premium paid on issue. The holders of preference shares have the right to vote at a general meeting of the Group only if at the date of the notice of the meeting the dividend payable on the share is in arrears or otherwise on a resolution to vary the rights attaching to the preference shares.

Notes to the separate financial statements

continued

6. Loan capital

	2005 £m	2004 £m
Subordinated guaranteed US\$ bonds	285	255
Subordinated guaranteed Euro bonds	341	352
Total dated loan capital	626	607
Subordinated guaranteed perpetual notes	445	--
Total loan capital	1,071	607
Subordinated guaranteed perpetual notes	—	444

The subordinated guaranteed US\$ bonds have a redemption date of 15 October 2029.

The subordinated guaranteed Euro bonds (€500m) have a redemption date of 15 October 2019. €200m of the Euro bonds bear interest at a fixed rate of 6.875% until 15 October 2009 and a floating rate thereafter. €300m of the Euro bonds bear interest at a floating rate from the date of issue. The Company has the option to repay the Euro bonds on specific dates from 15 October 2009.

Subordinated guaranteed perpetual notes of £450m (£444m net of discount and fees) were issued on 23 July 2004. The notes pay an annual coupon of 8.50% with an option to call the notes, or if not called for the coupon rate to be reset, on 8 December 2014 and every five years thereafter.

IFRS require perpetual debt to be classified as equity where the issuer has no contractual obligation to deliver cash (or another financial asset) to another party. Once classified as equity the subsequent interest payments (and related income tax benefits) are recognised directly in equity. Under the original terms of the loan agreement the Company had an option to defer interest payments indefinitely, provided no dividend was declared or distribution paid in respect to any class of share capital since the most recent AGM. Accordingly, the interest payments for the year ended 31 December 2004 of £14m (net £10m) were recognised directly in equity.

During the year ended 31 December 2005, the loan agreement was amended such that the subordinated guaranteed perpetual notes became a financial liability.

The bonds and the notes are contractually subordinated to all other creditors of the Company such that in the event of a winding up or of bankruptcy, they are to be repaid only after the claims of all other creditors have been met.

The fair value of the loan capital and subordinated guaranteed perpetual notes at 31 December was **£1,271m** (2004: £1,206m).

7. Current and deferred tax

Current income tax

	2005 £m	2004 £m
To be settled within 12 months	27	63
To be settled after 12 months	—	—
	27	63

Deferred tax

	2005 £m	2004 £m
Deferred tax assets	2	—
Deferred tax liabilities	—	(14)
Net deferred tax position at 31 December	2	(14)

The movement for the year in the Company's net deferred tax position was as follows:

	2005 £m	2004 £m
Net deferred tax position at 1 January	(14)	(1)
Charge to the Income Statement for the year	—	(13)
Net liability transferred to a subsidiary company	16	—
Net deferred tax position at 31 December	2	(14)

The following are the major deferred tax liabilities and assets recognised by the Company and their movements during the year:

Deferred tax liabilities

	Other temporary differences £m
Deferred tax liabilities at 1 January 2004	(1)
Charge to the Income Statement for the year	(13)
Deferred tax liabilities at 31 December 2004	(14)
Transferred to a subsidiary company	14
Deferred tax liabilities at 31 December 2005	—

Deferred tax assets

	Accelerated capital allowances £m
Deferred tax assets at 1 January 2004	—
Charge to the Income Statement for the year	—
Exchange adjustment	—
Deferred tax assets at 31 December 2004	—
Charge to the Income Statement for the year	—
Transfers	2
Deferred tax assets at 31 December 2005	2

At the Balance Sheet date, the Company had unused tax losses of **£4m** (2004: £4m) available for offset against future profits. No deferred tax asset has been recognised in respect of the tax losses of **£4m** (2004: £4m) due to the unpredictability of future profit streams. The losses may be carried forward indefinitely.

The aggregate current tax relating to items that were charged or credited to equity is **£2m** (2004: £6m).

Notes to the separate financial statements

continued

8. Dividends

	2005 p	2004 p	2005 £m	2004 £m
Ordinary dividend:				
Final paid in respect of prior year	2.96	2.90	86	83
Interim paid in respect of current year	1.69	1.65	49	47
			135	130
Preference dividend			9	9
			144	139

At the AGM on 22 May 2006, a dividend in respect of 2005 of **3.05p** per share amounting to a total dividend of **£89m** is to be proposed. The dividend will be paid and accounted for in shareholders' equity as an appropriation of retained earnings in the year ending 31 December 2006.

The trustees of the Royal & SunAlliance ESOP Trust and the Royal & SunAlliance ESOP Trust No 2 waived their entitlement to dividends which reduced the total dividend paid by **£1m** (2004: £1m).

9. Cash generated from operations

	2005 £m	2004 £m
Net profit for the year before tax	450	78
Realised losses	2	—
Loss on disposal of subsidiaries	—	3
Foreign exchange loss/(gain)	7	(21)
Dividends received	(590)	(230)
Changes in operating assets/liabilities	19	(6)
Cash generated from operations	(112)	(176)

10. Related party transactions

Royal & Sun Alliance Insurance Group plc (incorporated in England) is the ultimate Parent Company of the Royal & Sun Alliance Insurance Group.

The following transactions were carried out with related parties:

Provision of services and benefits

Royal & Sun Alliance Insurance Group plc provides services and benefits to its subsidiary companies operating within the UK and Overseas as follows:

- Provision of technical support in relation to risk management, information technology and reinsurance services. Services are charged for annually on a cost plus basis, allowing for a margin of **5%** (2004: 4.1%).
- Issue of share options and share awards to employees of subsidiaries. Costs are charged for annually based on the underlying value of the awards granted calculated in accordance with the guidance set out within IFRS 2 'Share Based Payment'.

Key management compensation

	2005 £m	2004 £m
Salaries and other short term employee benefits	5	4
Bonus awards	3	3
Pension benefits	1	1
Share based awards	1	1
Total	10	9

A number of the directors, other key managers, their close families and entities under their control have general insurance policies with subsidiary companies of the Group. Such policies are on normal commercial terms except that executive directors and key managers are entitled to special rates which are also available to other members of staff.

Year end balances with related parties are set out below

	2005 £m	2004 £m
Receivable from related parties:		
Receivable from subsidiaries, interest bearing loans	955	525
Receivable from subsidiaries, non interest bearing	194	388
Total receivable from related parties	1,149	913
Payable to related parties:		
Payable to subsidiaries, interest bearing loans	369	673
Payable to subsidiaries, non interest bearing	105	135
Total payable to related parties	474	808

Interest is charged on interest bearing loans, which are repayable on 24 hours written notice, at three month LIBOR + 1.2%.

Additional loans to subsidiaries of **£323m** (2004: £323m) as disclosed within note 3 have been made. Of this, **£294m** (2004: £294m) is a subordinated loan on which interest is charged at 8.5% with the remaining loan balance interest free with no specified repayment date.

11. Share based payments

Full details of share based payment plans are provided in note 27 to the consolidated financial statements.

Shareholder information

Registered Office and Group Corporate Centre

9th Floor, One Plantation Place, 30 Fenchurch Street, London EC3M 3BD.
Telephone: +44 (0)20 7111 7000. Registered in England No. 2339826.

Company website

The Annual Report & Accounts, interim results and other useful information about the Company is available on the website www.royalsunalliance.com.

Investor Relations

For further information about Royal & SunAlliance, please contact the Investor Relations department at: Royal & Sun Alliance Insurance Group plc, 9th Floor, One Plantation Place, 30 Fenchurch Street, London EC3M 3BD. Telephone: +44 (0)20 7111 7136.

Annual General Meeting

Ordinary shareholders are invited to attend the Company's Annual General Meeting (AGM), which will be held in The Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE at 11.00am on 22 May 2006. Ordinary shareholders who are unable to attend the AGM to ask a question in person may write to the Company Secretary's department at the address above.

Disabled shareholders

Royal & SunAlliance is committed to providing a quality service to all of its shareholders. An induction loop is installed at the AGM venue. Please contact the Company Secretary's department at the address above.

Share price

The Company's share price is shown on Ceefax BBC1 page 230, BBC2 page 223 and on Teletext Ch4 page 519. It is also available on the Company website.

Share dealing

Shares can be bought or sold through a stockbroker, bank or building society. The rates of commission charged for share dealing services will vary depending on the kind of service required. The cheapest way to deal in shares is usually on an 'execution only' basis which means that a broker will act on their client's instructions to buy or sell, but will not give advice on the merits of the transaction.

The Company has established an execution only sharedealing service with Lloyds TSB Registrars for existing shareholders with a UK registered address. Shares can be bought or sold within minutes, between the hours of 8.30am and 4.30pm (UK time), Monday to Friday. To deal, log on to www.shareview.co.uk/dealing or telephone +44 (0)870 850 0852. Shareholders will need to have their share certificate(s) to hand when dealing.

Capital gains tax

The market value at 31 March 1982 of each post consolidation ordinary share of 27.5p in the Company, for capital gains tax purposes after relevant adjustments, was 146.41p (25p shares 133.1p) for former Royal Insurance shareholders and 57.97p (25p shares 52.7p) for former Sun Alliance shareholders. An adjustment to tax cost is required to take account of the 2003 rights issue, according to whether the rights were taken up or sold. Similarly, for former Royal Insurance shareholders an adjustment to tax cost is required to take account of the 1993 rights issue, according to whether the rights were taken up or sold.

ShareGift

The purpose of ShareGift is to make it easy for shareholders to donate any number of shares to charity. The service can be particularly useful for shareholders with a small number of shares, which would be

uneconomic to sell. Shares donated through ShareGift are transferred into the name of The Orr Mackintosh Foundation, registered charity number 3150478. ShareGift's purpose is to realise as much value as possible by collecting shares, selling them and using the proceeds to make donations to a wide range of UK charities. Further details can be obtained from: The Orr Mackintosh Foundation, 46 Grosvenor Street, London W1K 3HN. Telephone: +44 (0)20 7828 1151. The website address is www.sharegift.org.

The Unclaimed Assets Register

Royal & SunAlliance supplies unclaimed dividend data to The Unclaimed Assets Register (UAR), which provides investors who have lost track of shareholdings with the opportunity to search the UAR's database of unclaimed financial assets on payment of a small, fixed fee. The UAR donates part of the search fee to charity. Further details can be obtained from: The Unclaimed Assets Register, Bain House, 16 Connaught Place, London W2 2ES. Telephone: +44 (0)870 241 1713. The website address is www.uar.co.uk.

Registrar

Lloyds TSB Registrars, The Causeway, Worthing, West Sussex BN99 6DA. The shareholder helpline telephone number is +44 (0)870 600 3988. Overseas callers should use +44 (0)121 415 7064. Shareholders with a text phone facility should use +44 (0)870 600 3950.

Please quote the company reference number '0059' and your shareholder account number (on your share certificate and dividend tax vouchers) when contacting or corresponding with Lloyds TSB Registrars.

The Company has appointed Lloyds TSB Registrars as its registrar to manage the shareholder register, to ensure that all information held about the Company's shareholders is kept up to date and to pay dividends. Further details about the services provided by Lloyds TSB Registrars can be found on page 127.

American Depositary Receipts

The Company's ordinary shares are quoted on the New York Stock Exchange, in the form of American Depositary Shares (ADSs). One ADS is equivalent to five ordinary shares. ADSs are represented by American Depositary Receipts (ADRs).

Any enquiry relating to registered ADR holdings should be addressed to: Citibank Shareholder Services, PO Box 43077, Providence RI 02940-3077. Telephone: +1 877 248 4237. The website address is www.citibank.com/adr.

The Annual Review & Summary Financial Statements are distributed to registered and beneficial ADR holders, followed by financial statements in a US format. The Group files its annual report on Form 20-F and other information with the US Securities and Exchange Commission.

ADR dividends

ADR holders are eligible for stock dividends and other entitlements accruing on the underlying Royal & Sun Alliance Insurance Group plc ordinary shares and receive all cash dividends in US dollars. Dividends are usually paid twice a year. Dividend cheques are mailed directly to registered ADR holders on the ADR dividend payment date. Dividends on ADRs held via the Depositary Trust Company are subsequently paid to beneficial ADR holders in the Book Entry Only system.

Frequently asked questions

A range of shareholder information is available on line at www.shareview.co.uk, including practical help on transferring shares or updating details. Shareholders can also register for secure access to their 'portfolio', enabling them to check holdings and register their email address to receive shareholder information and the Annual Report & Accounts electronically. At present, the portfolio service is free.

Q I have recently moved house – who should I tell?

A Please notify Lloyds TSB Registrars in writing at the above address. Remember to state clearly your old address. If you hold shares in joint names, the letter must be signed by the first named person on the share certificate. If you have previously registered for the Shareview portfolio service, you can log onto www.shareview.co.uk and change your address electronically.

Q What should I do if I change my name?

A To ensure that your shareholding is registered in your new name, please write to Lloyds TSB Registrars. You will need to enclose evidence of the change, for example, a copy of your marriage certificate or change of name deed (please do not send originals), together with your share certificate(s) and any uncashed dividend cheques. New documents will then be issued in the right name.

Q My share certificate has been lost/stolen. How do I get a replacement?

A You should inform Lloyds TSB Registrars immediately. They will send you a form of indemnity to complete and request payment of an administration fee. The form of indemnity is required to protect the Company from the potential misuse of the missing share certificate, so must be returned before a new share certificate can be issued.

Q I have lost my dividend tax voucher – how can I get another one?

A To get a replacement, you will need to contact Lloyds TSB Registrars. A small fee will be payable for this service.

Q I have found an out of date dividend cheque – how can I cash it?

A Please send the out of date cheque to Lloyds TSB Registrars, with a request that they issue a replacement cheque. There will be a small administration charge for issuing replacement dividend cheques for larger payments.

Q I would like to receive future communications electronically – how can I arrange this?

A Please register at www.shareview.co.uk and create your own portfolio. You will need your shareholder account number (on your share certificate(s) and dividend tax vouchers) to access this service.

Q Why do I receive multiple sets of information whenever you send anything to me?

A If you have acquired shares on more than one occasion, your holdings may have been recorded on the register of shareholders with slightly different details. As a result, two or more accounts may have been set up for you. Sometimes multiple accounts are necessary, eg if you hold shares in your own name and also in joint names with a partner. However, sometimes multiple accounts can be amalgamated. Please contact Lloyds TSB Registrars to discuss whether your accounts can be amalgamated.

Q How can I get my dividends paid directly into my bank or building society account?

A You will need to supply your bank or building society account details to Lloyds TSB Registrars. You can obtain a dividend payment mandate form from Lloyds TSB Registrars. A copy of the form is also attached when dividend cheques are mailed out.

Q Can I receive shares in lieu of cash dividends?

A The Company offers a scrip dividend scheme, which allows ordinary shareholders to receive new ordinary shares of 27.5p each instead of cash dividends. The scrip dividend scheme applies to both interim and final dividends, and enables shareholders to increase their holdings in the Company without incurring dealing costs or stamp duty. At the same time, the Company retains cash for reinvestment in the business, which would otherwise be paid out as a dividend. Please telephone Lloyds TSB Registrars on 0870 600 3988 for further information.

Q I would like to transfer shares to somebody I know. How do I arrange this?

A Such transactions need not involve a stockbroker; you can use a stock transfer form. The form can be obtained from Lloyds TSB Registrars or printed from their website www.shareview.co.uk.

Q How do I register the death of a shareholder?

A The first step is to write to Lloyds TSB Registrars, to let them know what you are going to do. They will then place a temporary marker on the register to ensure that further dividend payments are not issued in the late shareholder's name. They will also send you the forms that you will need to complete.

Financial calendar

9 March 2006

Announcement of the full year results for 2005, the ordinary final dividend for 2005 and the first preference dividend for 2006

15 March 2006

Ex dividend date for the ordinary final dividend for 2005 and the first preference dividend for 2006

17 March 2006

Record date for the ordinary final dividend for 2005 and the first preference dividend for 2006

23 March 2006

Announcement of the scrip dividend price for the ordinary final dividend for 2005

3 April 2006

Payment date for the first preference dividend for 2006

10 May 2006

Deadline for sending scrip dividend mandates to Lloyds TSB Registrars (in relation to ordinary final dividend for 2005)

11 May 2006

Announcement of the results for the three months ended 31 March 2006

22 May 2006

Annual General Meeting

2 June 2006

Payment date for the ordinary final dividend for 2005 (subject to shareholder approval at the AGM)

9 June 2006

ADR payment date for the ordinary final dividend for 2005 (subject to shareholder approval at the AGM)

10 August 2006

Announcement of the interim results for the six months ended 30 June 2006, the ordinary interim dividend for 2006 and the second preference dividend for 2006

16 August 2006*

Ex dividend date for the ordinary interim dividend for 2006

18 August 2006*

Record date for the ordinary interim dividend for 2006

24 August 2006*

Announcement of the scrip dividend price for the ordinary interim dividend for 2006

30 August 2006*

Ex dividend date for the second preference dividend for 2006

1 September 2006*

Record date for the second preference dividend for 2006

2 October 2006*

Payment date for the second preference dividend for 2006

1 November 2006*

Deadline for sending scrip dividend mandates to Lloyds TSB Registrars (in relation to ordinary interim dividend 2006)

9 November 2006

Announcement of the results for the nine months ended 30 September 2006

30 November 2006*

Payment date for the ordinary interim dividend for 2006

7 December 2006*

ADR payment date for the ordinary interim dividend for 2006

*provisional date

Important disclaimer

This document contains forward-looking statements as defined in the US Private Securities Litigation Reform Act of 1995. It contains forward-looking statements and information relating to the Company's financial condition, results of operations, business, strategy and plans, and general industry outlook (including trends in results, prices, volumes, operations, margins, overall market conditions, risk management and exchange rates) based on currently available information. These statements are often, but not always, made through the use of words or phrases such as 'aim', 'anticipate', 'believe', 'continue', 'could', 'estimate', 'expect', 'intend', 'may', 'plan', 'seek', 'should' or 'will' or the negative of these terms or similar expressions. The specific forward-looking statements cover, among other matters, our strategy and operational objectives; financial results; restructuring plans, our expense savings, completion of disposals, losses related to the US financial enhancement products, capital and solvency requirements in the UK, regulatory position in the US, effect of litigation on the Company's financial position, delays in claims notifications for asbestos and environmental claims and adverse claims development on long tail business and court judgments. Actual future results and trends could differ materially from those set forth

in such statements due to various factors. Such factors include general economic conditions, including in particular economic conditions in the United Kingdom; political and social conditions; the frequency, severity and development of insured loss events, including catastrophes and man made disasters; the availability and pricing of, and ability to collect on, reinsurance; the ability to exclude and to reinsure the risk of loss from terrorism; mortality and morbidity experience and trends; policy renewal and lapse rates; fluctuations in interest and inflation rates; returns on and fluctuations in the value of the Company's investment portfolios; corporate bankruptcies; fluctuations in foreign currency exchange rates; the ability of our subsidiaries to pay dividends; a downgrade in the Company's financial strength or claims paying or other credit ratings; adverse changes in laws and regulations; adverse outcomes in judicial decisions and rulings and general competitive factors, and other risks and uncertainties, including those detailed in the Company's filings with the US Securities and Exchange Commission and the UK Listing Authority. The Company undertakes no obligation to update or revise any of the forward-looking statements publicly, whether as a result of new information, future events or otherwise, save in respect of any requirement under applicable law or regulation.

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