

THIS DOCUMENT IS IMPORTANT AND REQUIRES YOUR IMMEDIATE ATTENTION. If you are in any doubt as to the action you should take, you are recommended to seek your own financial advice immediately from your stockbroker, bank manager, solicitor, accountant or other independent financial adviser authorised under the Financial Services and Markets Act 2000 if you are resident in the United Kingdom or, if not, from another appropriately authorised independent financial adviser.

If you have sold or otherwise transferred all your Ordinary Shares in Chesnara plc, please send this document, together with the accompanying Form of Proxy, as soon as possible, to the purchaser or transferee, or to the stockbroker, bank or other agent through whom the sale or transfer was effected for delivery to the purchaser or transferee. If you have sold or otherwise transferred only part of your holding, you should retain these documents.

Canaccord Genuity Limited (“**Canaccord**”), which is authorised and regulated in the United Kingdom by the Financial Conduct Authority, is acting exclusively as financial adviser and sponsor to Chesnara plc and no one else in connection with the Acquisition and, apart from the responsibilities and liabilities, if any, which may be imposed on Canaccord by FSMA and the regulatory regime established thereunder, Canaccord accepts no responsibility whatsoever for, and makes no representation or warranty, express or implied, in relation to the contents of this document (including, but not limited to, its accuracy, fairness, sufficiency completeness or verification) and will not be responsible to anyone other than Chesnara plc for providing the protections afforded to clients of Canaccord or for giving advice in connection with the Acquisition, or any other matter described in this document.

Chesnara plc

(Registered in England and Wales No. 4947166)

Proposed Acquisition of Direct Line Life Insurance Company Limited

Circular and Notice of General Meeting

Canaccord Genuity Limited

Financial adviser and sponsor

Your attention is drawn to the letter from the Chairman of Chesnara plc which is set out on pages 3 to 7 of this document and recommends you to vote in favour of the resolution to be proposed at the General Meeting referred to below. You should read the whole text of this document.

Notice of a General Meeting of Chesnara plc, to be held at 11.00 a.m. on 7 November 2013 at the offices of Canaccord Genuity Limited, 41 Lothbury, London, EC2R 7AE, is set out at the end of this document. The Form of Proxy for use at the meeting accompanies this document and, to be valid, should be completed and returned to the Company’s registrars, Capita Asset Services at PXS, 34 Beckenham Road, Beckenham, Kent BR3 4TU as soon as possible and, in any event, so as to arrive by no later than 11.00 a.m. on 5 November 2013. Completion and return of the Form of Proxy will not preclude Shareholders from attending and voting in person at the General Meeting, should they so wish.

This document includes forward-looking statements concerning the Enlarged Group. Forward-looking statements are based on current expectations and projections about future events. These forward-looking statements are subject to risks, uncertainties, and assumptions about the Enlarged Group. The forward-looking statements in this document are made based upon the Company’s expectations and beliefs concerning future events affecting the Enlarged Group and therefore involve a number of known and unknown risks and uncertainties. Such forward-looking statements are based on numerous assumptions regarding the Group’s present and future business strategies and the environment in which it will operate, which may not prove to be accurate. The Company cautions that these forward-looking statements are not guarantees, and that actual results could differ materially from those expressed or implied in these forward-looking statements. Subject to the Company’s continuing obligations under the Listing Rules, the DTRs and the Prospectus Rules, the Enlarged Group undertakes no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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EXPECTED TIMETABLE OF PRINCIPAL EVENTS

Latest time and date for receipt of Forms of Proxy	11.00 a.m. on 5 November 2013
General Meeting	11.00 a.m. on 7 November 2013
Expected date for Completion	on or before 31 December 2013

Notes:

1. References to times in this document are to London time.
2. Future dates are indicative only and are subject to change by the Company, in which event details of the new times and dates will be notified to the Financial Conduct Authority and, where appropriate, Shareholders.

PART I – LETTER FROM THE CHAIRMAN OF CHESNARA PLC

*Registered in England and Wales, Registration No. 04947166
Registered office: Harbour House, Portway, Preston, Lancashire PR2 2PR*

21 October 2013

Directors

Peter Mason	(Non-Executive Chairman)
Graham Kettleborough	(Chief Executive Officer)
Frank Hughes	(Business Services Director)
David Rimmington	(Finance Director)
David Brand	(Non-Executive Director)
Mike Evans	(Non-Executive Director)
Veronica France	(Non-Executive Director)
Peter Wright	(Non-Executive Director)

Dear Shareholder

Proposed Acquisition of Direct Line Life and Notice of General Meeting

Introduction

The Board announced on 8 October 2013 that Chesnara had entered into the Acquisition Agreement to acquire Direct Line Life Insurance Company Limited (“**Direct Line Life**”) for £39.3 million in cash. The acquisition will be financed from a mixture of cash resources and a new bank facility.

The document constitutes a “Class 1” circular for the purposes of Chapter 10 of the Listing Rules in connection with the Acquisition (as described below), for which the prior approval of shareholders is required. Its purpose is to provide you with details of the Acquisition, to explain why the Board believes that the Acquisition is in the best interests of the Company and its Shareholders, and why the Board unanimously recommends that you vote in favour of the resolution at the General Meeting to be held on 7 November 2013. The notice of the General Meeting is set out at the end of this document.

Background to and reasons for the Acquisition

The acquisition of Direct Line Life is consistent with Chesnara’s stated aim of acquiring life and pensions businesses in the UK and Western Europe. The Acquisition is a logical transaction for Chesnara given the Company’s proven track record in consolidating UK life assurance companies that are closed to new business. The Acquisition at a discount to embedded value (a term commonly used to refer to an economic valuation technique that is in widespread use in the insurance industry) is expected to enhance the future cash flows available for distribution to Shareholders, achieved through the generation of surplus as the Direct Line Life business runs down over time. Management plans to combine the UK life companies by means of a transfer pursuant to the provisions of Part VII of FSMA 2000 by the end of 2014, a process which involves obtaining Court approval and contacting policyholders to advise them of the proposed transfer. The transfer of the business of Direct Line Life into CA is expected to produce a non-recurring benefit, net of associated costs, within the Enlarged Group post the Acquisition as a result of the more efficient use of share capital and the regulatory requirements of CA. Similar benefits have been realised on previous acquisitions by the Group, and such benefits would not arise were the transaction not to take place.

Information on Direct Line Life

Direct Line Life is a UK based provider of mortgage life cover, fixed term life cover (both with and without critical illness cover) and over 50s life cover with approximately 150,000 policies in force as at 31 July 2013. Direct Line Life became substantially closed to new business on 5 July 2011 and has been focused since then on managing the existing portfolio in line with the run-off plan agreed at the time with the FSA. Direct Line Life distributed policies under its own name and also in recent years, but before the closure to new business, on a white label basis. Direct Line Life also underwrote the life cover element of creditor insurance policies which are administered by UK Insurance Limited who were also responsible for underwriting the general insurance element of the product. Following Completion, Chesnara intends to transfer the administration role to HCL (one of Chesnara’s current outsourcing partners). Management

also plans to combine the underlying UK life companies of the Enlarged Group by means of a transfer pursuant to the provisions of Part VII of FSMA 2000.

The Directors have estimated an unaudited embedded value of Direct Line Life as at 30 June 2013 of £75.6 million. At Completion the Seller will extract an additional £23.0 million of excess capital and Chesnara will retain the residual embedded value of £52.6 million (estimated as at 30 June 2013, post capital extraction adjustments). The capital extraction is based on the estimated level of surplus capital over and above 100 per cent. of the capital requirement as at 31 August 2013. The effect of this is that Chesnara will acquire the business under capitalised as compared to its long term target of 150 per cent. and will therefore immediately on Completion need to inject capital into Direct Line Life, estimated at £10.4 million. This will be funded by a short term loan facility that is repayable by 30 June 2015. This increased funding requirement is expected to be released by way of the combination of the UK life companies of the Enlarged Group by means of a transfer pursuant to the provisions of Part VII of FSMA 2000 during 2014, a process which is subject to Court approval and any reduction of capital requirements will be subject to the approval of the PRA. Embedded value is a term commonly used to refer to an economic valuation technique that has been in widespread use in the insurance industry for some time. An embedded value is an estimate of the economic value of a company, excluding the value of any future new business that the company may be expected to write. The embedded value of the business is the aggregate of the shareholder net worth and the present value of future shareholder cash flows from in-force covered business (value of in-force business) less deductions for the cost of required capital. It is stated after allowance has been made for aggregate risks in the business. Shareholder net worth comprises those amounts within the long-term business which are either regarded as required capital or which represent surplus assets within the business. The components of Direct Line Life's unaudited estimated embedded value, which has been prepared on a market consistent basis, are as follows:

	30 June 2013 Unaudited £ million
Directors' estimate of embedded value	
Adjusted shareholder net worth	48.3
Value of in-force business (including cost of capital)	27.3
Embedded value	75.6
Dividend to be paid to Seller post 30 June 2013	(23.0)
Estimated embedded value post dividends paid to Seller	52.6

Embedded Value Assumptions

The Directors have estimated the unaudited market-consistent embedded value of Direct Line Life as at 30 June 2013 on projections of surplus which were derived from the actuarial systems of Direct Line Life using a methodology which is consistent with that used by Chesnara and which are in accordance with assumptions established on the following bases:

(a) Discount rates

The discount rates applied to the cash flows at differing durations are a combination of the reference rate and a risk margin. The reference rate reflects the time value of money and is consistent with the investment return assumptions set out below, while the risk margin, which is established to cover any risks which are considered to be non-market and non-diversifiable, is set at 50 basis points and gives due recognition to the fact that:

- (i) the covered business is substantially closed to new business; and
- (ii) expense risk is limited as a result of the outsourcing of substantially all policy administration and related functions to third-party business process administrators.

(b) Economic assumptions

<u>Investment Return duration*</u>	<u>%</u>
5 year	1.57
10 year	2.66
15 year	3.17
20 year	3.41
25 year	3.52
30 year	3.56
Inflation (RPI)	2.60

* a full swap curve is used: the rates quoted are presented as indicative rates.

(c) Demographic assumptions

The demographic assumptions used to determine the value of the in-force business have been set at levels commensurate with the underlying operating experience identified in the periodic actuarial investigations.

(d) Expense assumptions

The expense levels are based on internal expense analysis investigations and are allocated to the policy maintenance functions.

These have been determined by reference to:

- (i) the outsourcing agreement planned with our third-party business process administrator, including appropriate inflation rates based on the observed RPI inflation rate; and
- (ii) additional corporate governance costs relating to the covered business.

No allowance has been made for future productivity improvements in the expense assumptions.

(e) Taxation

Projected tax has been determined assuming current tax legislation and rates, and allow for changes in corporation tax as announced by the Chancellor of the Exchequer in his budget speech of 20 March 2013, so reflect a reduction from the current 23 per cent. to 20 per cent.

Sensitivities to alternative assumptions

The following tables show the sensitivity of the embedded value as reported at 30 June 2013, to variations in the assumptions adopted in the calculation of the embedded value:

	<u>Increase/ (decrease) in embedded value</u> <u>£ million</u>
Economic sensitivities	
100 basis point increase in yield curve*	(1.9)
100 basis point reduction in yield curve*	1.2
10% decrease in equity and property values	nil
Operating sensitivities	
10% decrease in maintenance expenses	1.0
10% increase in lapse rates	(3.9)
5% increase in mortality rates	(1.2)

* The 100 basis point increase in yield curve reflects a parallel upward shift in yields and discount rates, but assumes no change in inflation. The reduction in yield curve assumes base rates are reduced to 0.25%, and that longer term yields are reduced across the curve in a way that flattens its shape, with 10-year risk free rates reducing by 1.22% and 20 year rates by 1.59%.

In the financial year ended 31 December 2012 Direct Line Life generated total income, net of investment return, of £23.3 million, operating profit before income taxes of £9.4 million and had total assets of £177.6 million on an IFRS basis. Further financial information relating to Direct Line Life is included in Part III of this document.

Terms and Financing of the Acquisition

As summarised in Part V of this document, the Acquisition will require payment by Chesnara of £39.3 million. The Acquisition will be financed by a mixture of cash resources of Chesnara and a new loan facility which has been arranged for the purposes of the Acquisition and to refinance the existing outstanding bank debt of £30.0 million. Further details on the loan facility are included below.

Completion of the transaction remains conditional upon approval of the Resolution and the approval of the PRA. The Company will issue an announcement on the satisfaction of these conditions. Completion is expected to take place five days following satisfaction of these conditions unless agreed otherwise between the parties. Further details of the Acquisition Agreement are set out in Part V of this document.

Loan Facility

On 7 October 2013, Chesnara agreed a new loan facility for £73.8 million with The Royal Bank of Scotland plc. It is expected that £12.8 million of this total facility will be repaid on the date which is the earlier of 18 months from completion of the Acquisition or 30 June 2015 which is expected to be post the combination of the underlying UK life companies of the Enlarged Group by means of a transfer pursuant to the provisions of Part VII of FSMA 2000. Further details of the Facility are set out in paragraph 5.1 of Part VI of this document.

Effect of the Acquisition

The Directors believe that the Acquisition will enable the Group to enhance embedded value per share following the Completion of the Acquisition. Embedded value per share is calculated by dividing the embedded value by the numbers of shares in issue. The Directors believe that the Acquisition also will be accretive on an IFRS earnings per share basis. However this does not mean that the future embedded value per share or IFRS earnings per share of Chesnara will necessarily be lower, match or exceed its historical embedded value per share or IFRS earnings per share.

Had the Acquisition taken place at the date of Chesnara's last balance sheet, being 30 June 2013, the effect of the transaction would have been an increase in cash equal to the difference between the purchase price of the Acquisition and the proceeds of the post balance sheet term facility of £73.8 million less the repayment of the outstanding balance (as at that date) on Chesnara's current term facility of £30.0 million, a decrease in net assets equal to the estimated transaction costs and an increase in net assets equal to the fair value, net of post balance sheet capital extractions, of Direct Line Life. Unaudited pro forma financial information (assuming the Acquisition took place on 30 June 2013) has been included in Part IV of this document to illustrate the impact of the Acquisition on the consolidated net assets of Chesnara.

Current trading, trends and prospects

Since 30 June 2013, being the most recently published financial information for Chesnara, the Group has traded in line with expectations. One of the key drivers of the performance and position of the Group is the economic environment, with key levers being gilt yields, equity markets and the Swedish Krona to Sterling exchange rate. Gilt yields have increased since 30 June 2013 and the FTSE 100, being a useful barometer for equity performance, has continued to rise in the same period, being 5.8 per cent. higher at 17 October 2013 when compared with 30 June 2013. These underlying economic factors have contributed positively to the underlying results of the Group. Sterling has strengthened slightly against Swedish Krona in the same period.

CA, the Group's principal operating subsidiary in the UK, has been in run-off for a number of years. The non-economic drivers of the business can be predicted with a reasonable degree of certainty, with expenses being controlled and persistency remaining within the Company's long-term assumptions. Movestic, Chesnara's Swedish subsidiary, has also traded satisfactorily and continues to steadily recover market share in its targeted profitable business segments.

The results of Direct Line Life since 31 December 2012, being the most recently published financial information, have been satisfactory. As with the existing CA business, Direct Line Life is in run off, with key drivers such as policy attrition and operational costs being reasonably predictable. This has resulted in the performance of the business being in line with plans.

Dividend policy

The Group is committed to offering its Shareholders an attractive income stream arising from the profits of its life assurance business. In its interim results, which were announced on 30 August 2013, the Group declared an interim dividend of 6.25p per share, an increase of 2.5 per cent. over the dividend of 6.1p declared for the comparable period in 2012.

Risk factors

Shareholders should consider fully the risk factors associated with the Enlarged Group. Your attention is drawn to the risk factors set out in Part II of this document.

General Meeting

A notice convening a general meeting of the Company to be held at 11.00 a.m. on 7 November 2013 at the offices of Canaccord Genuity Limited, 41 Lothbury, London, EC2R 7AE is set out at the end of this document. A Form of Proxy to be used in connection with the General Meeting is enclosed. The purpose of the General Meeting is to seek Shareholders approval for the Acquisition.

As permitted by the Articles and resolution 15 passed at the Company's annual general meeting of 17 May 2013, the Board is calling the General Meeting on 14 days' notice. The Board believes this to be in the best commercial interests of the Company and of Shareholders as a whole.

Action to be taken

You will find enclosed a form of proxy for use at the General Meeting. Whether or not you intend to be present at that meeting, you are requested to complete the Form of Proxy (in accordance with the instructions printed thereon) and return it to the Company's registrars, Capita Asset Services at 34 Beckenham Road, Beckenham, Kent BR3 4TU as soon as possible and, in any event, so as to arrive by 11.00 a.m. on 5 November 2013. Alternatively, you may submit your proxy vote electronically using the Share Portal Service at www.capitashareportal.com by the same deadline. Completion and return or submission of a Form of Proxy will not preclude you from attending that meeting and voting in person if you so wish.

Further information

Your attention is drawn to the further information contained in Parts II to VII of this document.

You are advised to read the whole of this document and not to rely solely on the information contained in this letter.

Recommendation

The Board of the Company, which has received financial advice from Canaccord, considers the Acquisition to be in the best interests of Shareholders as a whole. In providing its advice, Canaccord has placed reliance on the Board's commercial assessment of the Acquisition.

Accordingly, the Board of the Company unanimously recommends that Shareholders vote in favour of the Resolution to be proposed at the General Meeting, as they intend to do in respect of their own beneficial holdings amounting (as at 17 October 2013, being the latest practicable date prior to the posting of this document) to an aggregate of 165,827 Ordinary Shares, representing approximately 0.14 per cent. of the Company's current issued share capital.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'P. Mason', is written over a horizontal line. Below the signature, there is a large, sweeping, curved line that extends from the left towards the right, possibly indicating a signature or a mark.

Peter Mason
Chairman

PART II – RISK FACTORS

Prior to making any decision to vote in favour of the Resolution at the General Meeting, Shareholders should carefully consider, together with all other information included or incorporated by reference into this document, the specific factors and risks described below. The Company considers these to be the known material risk factors relating to the Acquisition.

The risks described below relate only to the Acquisition and are not set out in any particular order of priority.

There may be other risks which the Board is not aware of or which it believes to be immaterial which may, in the future, be connected to Direct Line Life and/or the Enlarged Group and have a material and adverse effect on the business, financial condition, results of operations or future prospects of the Enlarged Group. In such case, the market price of the Ordinary Shares could decline and you may lose all or part of your investment.

The following risks should be read in conjunction with all other information contained in this Circular:

1. RISK FACTORS RELATING TO THE ACQUISITION

1.1 Failure to complete the Acquisition

Completion remains conditional upon approval of the Resolution. If Shareholders do not approve the Acquisition at the General Meeting, or the PRA approval to the change of control of Direct Line Life is not forthcoming, the Acquisition will not complete. If the Acquisition does not complete, the Company would nonetheless be obliged to pay approximately £1.5 million of costs (primarily due diligence and advisory fees) incurred in connection with the Acquisition. Failure to complete the Acquisition may materially adversely affect the trading price of the Ordinary Shares.

1.2 Adverse change in the financial condition of Direct Line Life prior to completion of the Acquisition

Pursuant to the terms of the Acquisition Agreement, the Company may only terminate the Acquisition Agreement prior to Completion in certain circumstances (details of which are set out in paragraph 6 of Part V). Completion is expected to occur on or before 31 December 2013. Until Completion, the Company will not own Direct Line Life and it is possible that there could be an adverse event affecting Direct Line Life which would not give rise to a right of the Company to terminate the Acquisition Agreement. In such an event, the value of Direct Line Life may be less than the consideration paid by the Company and, accordingly, the net assets of the Enlarged Group could be reduced. This could have an adverse effect on the business, financial condition and operating results of the Enlarged Group.

1.3 Failure to realise benefits of the Acquisition

The Enlarged Group may not realise the expected benefits from the Acquisition or succeed in addressing any problems encountered in connection with the Acquisition. Such unforeseen costs could include integration costs and regulatory costs in the jurisdictions in which Direct Line Life's business is written or in which Direct Line Life's policyholders are located. Further, the investment performance of Direct Line Life's funds or its historical handling of insurance risk may not be as sound as the Company had previously assessed. Any such issues would adversely affect the financial position of the Enlarged Group and, ultimately, the trading price of the Ordinary Shares. In addition, the realisation of value is dependent upon an effective migration of the policy administration from Direct Line Life to HCL, the outsource provider to Chesnara.

2. RISKS RELATING TO THE ENLARGED GROUP

2.1 Insurance Risk – adverse mortality, morbidity and longevity experience

The primary insurance activity carried out by the Group and Direct Line Life comprises the assumption of risks relating to life, accident, health and financial perils that may arise from an insurable event. As such, the Acquisition increases the exposure of the Enlarged Group to the uncertainty surrounding the timing and severity of claims under contracts where death or critical illness is the insured risk. Under such contracts, the most significant factors that could increase the overall frequency of claims include epidemics or wide spread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected and resulting in a materially adverse affect on the profitability of the Enlarged Group.

For contracts with fixed benefits and fixed future premiums, there are no mitigating terms and conditions that could reduce the insurance risk accepted by Direct Line Life or the Group. Such contracts where the benefits and also future premiums are fixed leave no scope for Direct Line Life or the Group to mitigate their insurance risk, and any changes to the original assumptions on which such contracts were priced could have an adverse effect on the profitability of the Enlarged Group.

Where the Group or Direct Line Life has the ability to mitigate the insurance risk through changing charges and premiums, failure to act in a timely manner to changing information could adversely affect the profitability of the Enlarged Group and in the case of a major epidemic it may be impossible to recoup the costs of resulting claims.

Adverse morbidity, mortality and longevity is a risk to the Enlarged Group. To the extent that actual mortality or morbidity rates vary from the assumptions underlying product pricing, the Group will accrue less profit. Direct Line Life, as a stand-alone entity, is exposed to mortality and morbidity risk and therefore to fluctuations in the timing, frequency and severity of insured events and their ultimate settlement, relative to the expectations at the time of underwriting, though these risks are materially reduced through reinsurance. Such expectations include those driven by inaccurate pricing, inappropriate underwriting guidelines and terms and conditions and holding inadequate reserves. As a result, adverse longevity remains a significant risk to the Enlarged Group.

The exposure of Direct Line Life to changes in assurance mortality and morbidity rates are quantified in Part III of this Circular.

2.2 Counterparty failure

The Group carries significant inherent risk that a counterparty will be unable to pay amounts in full when due. Key areas where the Group is exposed to counterparty risk are:

- reinsurers share of insurance liabilities;
- amounts deposited with reinsurer in relation to investment contracts;
- amounts due from reinsurers in respect of claims already paid; and
- counterparty risk with respect to its fixed interest security portfolio.

The proposed acquisition of Direct Line Life would increase the Enlarged Group's exposure to counterparty failure risk in respect of both the holding of fixed interest securities and amounts due from a reinsurer. Such a risk could have a material adverse effect on the business and profitability of the Enlarged Group.

CA has a reinsurance exposure to Guardian and Direct Line Life has reinsurance exposure to Swiss Re. Although the ICA regime aims to ensure that companies can meet their obligations with a confidence level of 99.5 per cent over one year, the Enlarged Group would be exposed to the risk of the reassurers default which could materially adversely impact the profitability of the Enlarged Group.

2.3 Adverse regulatory and legal changes

The Group operates in jurisdictions which are currently subject to significant change arising from regulatory and legal requirements. These may either be of a local nature, or of a wider nature, following from EU-based regulation and law. This includes the uncertainty surrounding the full impact on the Group of implementing the requirements of Solvency II, coupled with any further potential change in the regulatory environment in the UK and Sweden.

Direct Line Life is governed by the same regulatory framework as Chesnara and hence the Enlarged Group will be subject to the broad administrative power of regulatory agencies, including the PRA and FCA, over many aspects of insurance business which may include capital adequacy, premium rates, marketing and selling practices, advertising, licensing agents, policy forms and permitted investments. Government regulators are concerned primarily with the protection of policyholders rather than shareholders or creditors. In addition, the Financial Ombudsman Service is empowered to settle disputes between the Enlarged Group and individual policy holders up to an amount of £150,000. The Enlarged Group also faces the risk that the PRA, FCA, FI or another governmental or regulatory body could find it has failed to comply with applicable regulations or has not undertaken corrective action as required which may result in public reprimand and/or monetary fines, adverse

publicity for or negative perceptions regarding the Enlarged Group as well as diverting management's attention from the day-to-day operations of the business.

As a result, such insurance laws, regulations, policies and any pursuant action affecting the Enlarged Group could have a material adverse effect on its business, result of operations and/or financial condition.

2.4 Adverse movements in yields on fixed interest securities

The Group and Direct Line Life maintain portfolios of fixed interest securities (i) in order to match its insurance contract liabilities in terms of yield and cash flow characteristics, and (ii) as an integral part of the investment funds it manages on behalf of policyholders and investors. The Group and Direct Line Life are exposed to the risk of mismatch losses arising from either a failure to match insurance contract liabilities or from the fact that sharp and discrete fixed interest yield movements may not be associated fully and immediately with corresponding changes in actuarial valuation interest rates. The Enlarged Group's exposure to movements in yields on fixed interest securities would therefore be slightly increased as a result of the Acquisition.

2.5 Adverse persistency experience

Persistency risk is the risk that the policyholder cancels the contract or discontinues paying new premiums into the contract, thereby exposing the Enlarged Group to losses resulting from adverse movements in actual experience compared to that expected in product pricing or from lower future levels of management fees. There remains uncertainty as to whether the Group's core assumptions relating to policy persistency will prove to be sufficient, as rates of persistency may be impacted by unexpected or unforeseen events. The nature of the Direct Line Life insurance policies is such that the Acquisition would increase the risk of the Group to decreased persistency rates. Such a decrease could materially affect the financial results of the Group and may ultimately affect the trading price of the Ordinary Shares.

2.6 Key man dependency

The continued success of the Enlarged Group depends on its ability to attract, motivate and retain highly skilled managers and finance, actuarial, compliance, IT and customer services personnel. The loss of key personnel from the business may have a material adverse effect on its ability to manage the substantially closed books of the business because it may result in the loss of their technical and management skills, as well as their knowledge of the legacy issues of the business. The Enlarged Group will be reliant on key personnel of Direct Line Life pending full and effective migration following completion of the Acquisition. The inability to attract and/or retain the necessary highly skilled personnel could have a material adverse effect on the Enlarged Group's operations, results of operations and/or financial condition.

3. FAILURE OF OUTSOURCED SERVICE PROVIDERS TO FULFIL CONTRACTUAL OBLIGATIONS

The operating model of the Group's UK life and pensions businesses is heavily dependent on outsourced service providers to fulfil a significant number of their core functions.

Upon completion of the Acquisition, it is the intention of the Company to migrate the administration of the Direct Line Life business to HCL as one of the existing Group outsource partners. The Enlarged Group would therefore be exposed to a migration risk in that HCL would be required to implement the effective migration of policy administration services from Direct Line Life.

In the event of failure by either or both service providers to fulfil their contractual obligations, in whole or in part, to the requisite standards specified in the contracts, the Group may suffer loss as its functions degrade.

PART III – FINANCIAL INFORMATION ON DIRECT LINE LIFE

(A) Accountants report on the financial information

Deloitte.

Deloitte LLP
2 Hardman Street
Manchester
M3 3HF

The Board of Directors
Chesnara plc
Harbour House
Portway
Ashton-on-Ribble
Preston
Lancashire
PR2 2PR

Canaccord Genuity Limited
88 Wood Street
London
EC2V 7QR

21 October 2013

Dear Sirs

Chesnara plc proposed acquisition of Direct Line Life Insurance Company Limited (“Direct Line Life”)

We report on the financial information of Direct Line Life for the three years ended 31 December 2012 set out in Part III of the Class 1 Circular relating to the acquisition of Direct Line Life dated 21 October 2013 by Chesnara Plc (the “**Company**” and, together with its subsidiaries, the “**Group**”), (the “**Circular**”). This financial information has been prepared for inclusion in the Circular on the basis of the accounting policies set out in Note 2 to the Financial Information. This report is required by Listing Rule 13.5.21R and is given for the purpose of complying with that requirement and for no other purpose.

Responsibilities

The Directors of the Company are responsible for preparing the financial information in accordance with International Financial Reporting Standards as adopted by the European Union.

It is our responsibility to form an opinion on the financial information and to report our opinion to you.

Save for any responsibility which we may have to those persons to whom this report is expressly addressed and which we may have to ordinary shareholders as a result of the inclusion of this report in the Circular, to the fullest extent permitted by law we do not assume any responsibility and will not accept any liability to any other person for any loss suffered by any such other person as a result of, arising out of, or in connection with this report or our statement, required by and given solely for the purposes of complying with Listing Rule 13.4.1R(6), consenting to its inclusion in the Circular.

Basis of opinion

We conducted our work in accordance with Standards for Investment Reporting issued by the Auditing Practices Board in the United Kingdom. Our work included an assessment of evidence relevant to the amounts and disclosures in the financial information. It also included an assessment of significant estimates and judgments made by those responsible for the preparation of the financial information and whether the accounting policies are appropriate to the entity’s circumstances, consistently applied and adequately disclosed.

We planned and performed our work so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial information is free from material misstatement whether caused by fraud or other irregularity or error.

Our work has not been carried out in accordance with auditing or other standards and practices generally accepted in jurisdictions outside the United Kingdom, including the United States of America, and accordingly should not be relied upon as if it had been carried out in accordance with those standards and practices.

Opinion on financial information

In our opinion, the financial information gives, for the purposes of the Circular, a true and fair view of the state of affairs of Direct Line Life as at the 31 December 2012, 31 December 2011 and 31 December 2010 and of its profits, cash flows and changes in equity for the periods then ended in accordance with International Financial Reporting Standards as adopted by the European Union, and has been prepared in a form that is consistent with the accounting policies adopted in the Company's latest annual accounts.

Yours faithfully

Deloitte LLP
Chartered Accountants

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(B) Historical financial information for the period ended 31 December 2012

Direct Line Life Insurance Company Limited

Statement of Comprehensive Income

	Note	Year ended 31 December		
		2012	2011	2010
		£000	£000	£000
Insurance premium revenue		46,609	48,056	52,262
Insurance premium ceded to reinsurers		(24,727)	(25,410)	(26,282)
Net insurance premium revenue		21,882	22,646	25,980
Net investment return	7	1,424	2,776	3,112
Total revenue net of reinsurance payable		23,306	25,422	29,092
Other operating income	8	—	1	2
Total income net of investment return		23,306	25,423	29,094
Insurance contract claims and benefits incurred:				
Claims and benefits paid to insurance contract holders		(22,935)	(22,481)	(24,459)
Net (increase)/decrease in insurance contract provisions		(9,921)	(24,662)	13,849
Reinsurers' share of claims and benefits		30,797	41,499	11,910
Net insurance contract claims and benefits	9	(2,059)	(5,644)	1,300
Fees, commission and other acquisition costs	10	(3,825)	(2,136)	(2,571)
Administrative expenses	11	(1,832)	(4,005)	(4,898)
Other operating expenses	12	(6,233)	(4,587)	(8,913)
Total expenses net of change in insurance contract provisions . .		(13,949)	(16,372)	(15,082)
Total income less expenses		9,357	9,051	14,012
Operating profit before income taxes		9,357	9,051	14,012
Income tax expense	13	(2,423)	(2,077)	(5,194)
Profit for the period attributable to equity owners, being the total comprehensive income for the period		6,934	6,974	8,818

Balance Sheet

	Note	31 December		
		2012	2011	2010
		£000	£000	£000
Assets				
Property and equipment	14	–	3	7
Deferred tax asset	21	19	25	33
Reinsurers' share of insurance contract provisions	19	91,144	78,632	53,292
Financial assets:				
Debt securities at fair value through income	15	31,120	41,514	50,274
Insurance and other receivables	15	16,467	48,958	17,021
Prepayments	16	5	12	27
Total financial assets		47,592	90,484	67,322
Reinsurers' share of accrued policyholder claims	23	3,587	4,130	5,021
Cash and cash equivalents	17	35,233	18,576	63,124
Total assets		177,575	191,850	188,799
Liabilities				
Insurance contract provisions	19	102,934	93,013	68,351
Financial liabilities – borrowings	20	3,500	–	–
Reinsurance payables	22	30	34	39
Payables related to direct insurance and investment contracts . .	23	5,268	6,104	6,877
Income taxes	24	2,066	2,204	4,239
Other payables	25	3,914	34,066	9,838
Total liabilities		117,712	135,421	89,344
Net assets		59,863	56,429	99,455
Shareholders' equity				
Share capital		44,000	44,000	44,000
Other reserves	28	–	3,500	3,500
Retained earnings	27	15,863	8,929	51,955
Total shareholders' equity		59,863	56,429	99,455

Statement of Cash Flows

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Profit for the period	6,934	6,974	8,818
Adjustments for:			
Depreciation of property and equipment	3	4	13
Tax (recovery)/expense	2,423	2,077	5,194
Interest receivable	(1,748)	(2,467)	(2,753)
Fair value losses/(gains) on financial assets	324	(309)	(359)
Interest received	2,199	2,487	2,556
Changes in operating assets and liabilities:			
Decrease/(increase) in financial assets	40,083	(20,890)	4,896
(Increase)/decrease in reinsurers' share of insurance contract provisions	(12,512)	(25,340)	5,021
Decrease/(increase) in insurance and other receivables	2,073	(1,956)	(767)
Decrease in prepayments	7	15	1
Increase/(decrease) in insurance contract provisions	9,921	24,662	(13,849)
Increase/(decrease) in reinsurers' share of accrued policyholder claims .	543	891	(1,167)
(Decrease)/increase in reinsurance payables	(4)	(5)	17
(Decrease)/increase in payables related to direct insurance contracts . .	(836)	(773)	2,406
(Decrease)/increase in other payables	(30,152)	24,228	(252)
Cash generated by operations	19,258	9,598	9,775
Income tax paid	(2,572)	(4,123)	(5,546)
Other operating activities	—	(4)	7
Net cash generated from operating activities	16,686	5,471	4,236
Cash flows from financing activities			
Interest paid	(29)	(19)	(9)
Dividends paid	—	(50,000)	—
Net cash utilised from financing activities	(29)	(50,019)	(9)
Net increase/(decrease) in cash and cash equivalents	16,657	(44,548)	4,227
Cash and cash equivalents at beginning of the period	18,576	63,124	58,897
Cash and cash equivalents at end of the period	35,233	18,576	63,124

Statement of Changes in Equity

	Year ended 31 December 2012			
	£000	£000	£000	£000
Equity shareholders' funds at 1 January 2012	44,000	3,500	8,929	56,429
Profit for the year attributable to shareholders	—	—	6,934	6,934
Reclassification to subordinated liabilities	—	(3,500)	—	(3,500)
Equity shareholders' funds at 31 December 2012	44,000	—	15,863	59,863
	Year ended 31 December 2011			
	£000	£000	£000	£000
Equity shareholders' funds at 1 January 2011	44,000	3,500	51,955	99,455
Profit for the year attributable to shareholders	—	—	6,974	6,974
Dividends paid	—	—	(50,000)	(50,000)
Equity shareholders' funds at 31 December 2011	44,000	3,500	8,929	56,429
	Year ended 31 December 2010			
	£000	£000	£000	£000
Equity shareholders' funds at 1 January 2010	44,000	3,500	43,137	90,637
Profit for the year attributable to shareholders	—	—	8,818	8,818
Equity shareholders' funds at 31 December 2010	44,000	3,500	51,955	99,455

Notes to the historical financial information

1. General information

Direct Line Life Insurance Company Limited (“**Direct Line Life**”) is a private company incorporated in the UK. The address of the registered office is Churchill Court, Westmoreland Road, Bromley, Kent, England, BR1 1DP. Direct Line Life underwrites primarily life insurance risks and was effectively closed to new business with effect from 5 July 2011.

2. Significant accounting policies

(a) Statement of compliance

The financial information for the three year period ended 31 December 2012 has been prepared in accordance with International Financial Reporting Standards (“**IFRSs**”) as adopted by the European Union (“**Adopted IFRSs**”) and therefore comply with Article 4 of the EU IAS Regulation. The financial information has been prepared and approved by the Directors in accordance with Adopted IFRSs. The standards are those to be applied to the next reporting period (being 31 December 2013). Those standards have been applied consistently to the historical period. The following standards are now effective and have therefore been applied:

Title	Subject
IAS 1 (amended June 2011)	Presentation of Items of Other Comprehensive Income
IFRS 13	Fair Value Measurement
IAS 19 (revised June 2011)	Employee Benefits

The amendments to IAS 1 require items of other comprehensive income to be grouped by those items that will be reclassified subsequently to profit or loss and those that will never be reclassified, together with their associated income tax. The adoption of this accounting standard does not materially impact this financial information.

IAS 19 (revised 2011) and the related consequential amendments have had no impact upon these financial statements.

The adoption of IFRS 13 has had no material impact upon the measurement of fair value for financial assets and financial liabilities, as the application of the credit risk of the Group has no material impact upon the associated fair values of the financial liabilities it holds.

At the date of authorisation of this financial information the following Standards and Interpretations, which are applicable to Direct Line Life and which have not been applied in this financial information, were in issue but not yet effective (and in some cases have not been adopted by the EU):

Title	Subject
Annual Improvements to IFRS	2009-2011 Cycle
IFRS 7 (amended December 2011)	Disclosures – Offsetting Financial Assets and Financial Liabilities
IFRS 9	Financial Instruments
IAS 12 (amended December 2010)	Deferred Tax: Recovery of Underlying Assets
IAS 27 (revised May 2011)	Separate Financial Statements
IAS 32 (amended December 2011)	Offsetting Financial Assets and Financial Liabilities

The Directors do not expect that the adoption of the standards listed above will have a material impact on the financial information of Direct Line Life in future periods, except as follows:

- IFRS 7 (amended) will increase the disclosure requirements where netting arrangements or the right of set-off are in place for financial assets and financial liabilities. The amendment does not have a significant impact on profit or loss, financial condition or cash flows; and
- IFRS 9 will impact both the measurement and disclosures of Financial Instruments.

Beyond the information above, it is not practicable to provide a reasonable estimate of the effect of these standards until a detailed review has been completed.

(b) Basis of preparation

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

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

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

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

The accounting policies set out below, unless otherwise stated, have been applied consistently to all years presented in this financial information.

This financial information has also been prepared in accordance with the disclosure provisions of FRS 27 'Life Assurance', which was issued by the UK's Accounting Standards Board (ASB) in December 2004. FRS 27 adds to the requirements of IFRS but does not vary them in any way.

(c) Contract classification

Insurance contracts are defined as those containing significant insurance risk if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance, at the inception of the contract. Such contracts remain insurance contracts until all rights and obligations are extinguished or expire. Contracts can be reclassified as insurance contracts after inception if insurance risk becomes significant.

A liability for contractual benefits that are expected to be incurred in the future is recorded when the premiums are recognised. For contracts other than credit insurance business the liability is determined as the sum of the expected discounted value of future benefit payments and future administration expenses that are directly related to the insurance contract less the expected discounted value of premiums payable under the contract, based on the valuation assumptions used. For regular premium credit insurance business the liability is taken as a multiple of premium. For single premium credit insurance business the liability is taken as a proportion of the single premium, where the proportion reflects the outstanding term remaining on the contract.

The liability is based on assumptions as to mortality, morbidity, maintenance expenses and investment income. A margin for adverse deviations is included in the assumptions.

Where contracts have a single premium the excess of the premiums payable over the valuation premium is deferred and recognised as income in line with the decrease of unexpired insurance risk of the contract in force.

(d) Revenue recognition

Insurance premium revenue

Direct Line Life's long-term assurance contracts include whole-life and term assurance contracts and the life cover associated with the creditor business underwritten by Direct Line Life Insurance Group plc's general insurance business. These contracts insure events associated with human life (for example death or the occurrence of a critical illness). Premiums are recognised as revenue when they become payable by the contract holder. Premiums are shown before the deduction of commission.

(e) Reinsurance

Direct Line Life has reinsurance treaties and other reinsurance contracts that transfer significant insurance risk.

Direct Line Life cedes insurance risk by reinsurance in the normal course of business, with the arrangement and retention limits varying by book of business. Outward reinsurance premiums are generally accounted for in the same accounting period as the premiums for the related direct business being reinsured. Outward reinsurance recoveries are accounted for in the same accounting period as the direct claims to which they relate.

Reinsurance assets include balances due from reinsurance companies for ceded insurance liabilities. Amounts recoverable from reinsurers are estimated in a consistent manner with the outstanding claims provisions or settled claims associated with the reinsured policies and in accordance with the relevant reinsurance contract.

A reinsurance bad debt provision is assessed in respect of reinsurance debtors, to allow for the risk that the reinsurance asset may not be collected or where the reinsurer's credit rating has been downgraded significantly. This also includes an assessment in respect of the ceded part of claims reserves to reflect the credit risk exposure to long-term reinsurance assets particularly in relation to periodical payments. This is effected by Direct Line Life reducing the carrying value of the asset accordingly and the impairment loss is recognised in the statement of comprehensive income. At 31 December 2012 no reinsurance bad debt provision was deemed necessary.

(f) Investment income

Investment income comprises income from financial assets.

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

(g) Expenses

(i) Operating lease payments

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

(ii) Financing costs

Financing costs comprise interest payable on borrowings and on reinsurance claims deposits included within reinsurance payables, calculated using the effective interest rate method.

(h) Insurance benefits

Benefits are recorded as an expense when Direct Line Life becomes aware of the claim. Provision is made for the full cost of settling outstanding claims at the balance sheet date. Costs for both direct and indirect claims handling costs are also included.

(i) Income taxes

Income tax on the profit or loss for the year comprises current and deferred tax and is recognised in the income statement. Tax that relates directly to transactions reflected within equity is also presented within equity.

(i) Current tax

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

(ii) Deferred tax

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

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

(j) Property and equipment

Items of property and equipment are stated at cost less accumulated depreciation and impairment losses. Depreciation is charged to the income statement on a straight-line basis over the estimated useful economic lives of the property and equipment on the following basis:

Computers and similar equipment – 3 years

Fixtures and other equipment – 5 years

Assets held under finance leases are depreciated over their useful economic lives on the same basis as owned assets, or where shorter, over the term of the relevant lease.

(k) Financial assets

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

All financial assets held for investment purposes are designated as at fair value through income on initial recognition since they are managed, and their performance is evaluated, on a fair value basis in accordance with documented investment and risk management strategies.

Purchases and sales of ‘regular way’ financial assets are recognised on the trade date, which is when Direct Line Life commits to purchase, or sell, the assets.

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

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

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

Financial assets classified as loans and receivables are stated at amortised cost less impairment losses. A provision for the impairment of loans and receivables is established when there is objective evidence that Direct Line Life will not be able to collect all the amounts due according to the original contract terms after the date of the initial recognition of the asset and when the impact on the estimated cash flows of the financial asset can be reliably measured.

Financial assets classified as prepayments are held at cost and are amortised over the relevant time period.

Financial assets not recognised at fair value through income are regularly reviewed for objective evidence of impairment. In determining whether objective evidence exists, Direct Line Life considers, among other factors, the financial stability of the counterparty, current market conditions and fair value volatility.

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

If the market for a financial asset is not active, Direct Line Life establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, Direct Line Life uses that technique.

The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument are reliably measurable if:

- (i) the variability in the range of reasonable fair value estimates is not significant for that instrument; or
- (ii) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

(l) Cash and cash equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks and other short-term highly liquid investments. Highly liquid is defined as having a short maturity of three months or less at their acquisition.

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

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

(n) Capital instruments

Direct Line Life classifies a financial instrument that it issues as a financial liability or an equity instrument in accordance with the substance of the contractual arrangement. An instrument is classified as a liability if it is a contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities on potentially unfavourable terms, or as equity if it evidences a residual interest in the assets of Direct Line Life after the deduction of liabilities.

Borrowings comprise bank overdrafts.

Borrowings are recognised initially at fair value, less transaction costs, and are subsequently measured at amortised cost using the effective interest method, with interest expense recognised in the income statement on an effective yield basis. The effective interest method is a method of calculating the amortised cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts future cash payments through the expected life of the financial liability.

3. Critical accounting judgements and key sources of estimation and certainty

The reported results of Direct Line Life are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial information. Direct Line Life's significant accounting policies are set out in note 2. UK Company law and IFRS require the directors, in preparing the Direct Line Life's financial information, to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent. In the

absence of an applicable standard or interpretation, IAS 8 requires management to develop and apply an accounting policy that results in relevant and reliable information in the light of the requirements and guidance in IFRS dealing with similar and related issues and the IASB's Framework for the Preparation and Presentation of Financial Statements.

The judgements and assumptions involved in Direct Line Life's accounting policies that are considered by the Board to be the most important to the portrayal of its financial condition are discussed below. The use of estimates, assumptions or models that differ from those adopted by Direct Line Life would affect its reported results.

(a) Life insurance: Liabilities under long-term insurance contracts

Liabilities under long term insurance contracts are dependent on estimates made by Direct Line Life. Estimates are made regarding the expected number of deaths or critical illness claims for each of the years for which Direct Line Life is exposed to the risk. These estimates are based on standard industry and national mortality and morbidity tables which reflect recent historical mortality and morbidity experience. Adjustments to these tables are then made to reflect Direct Line Life's own recent experience. The estimated number of deaths or critical illness claims determine the value of the benefit payments. The main source of uncertainty being the effect of epidemics and wide ranging lifestyle changes such as eating, smoking and exercise habits on future mortality and morbidity. Such factors could result in future mortality being significantly worse than in the past for age groups in which Direct Line Life has significant exposure.

In determining the liabilities under long-term insurance contracts assumptions are also made regarding the level of expenses and the investment return on the assets backing the liabilities.

(b) Fair value

Financial assets are recognised in the financial information at fair value.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's length transaction. Fair values are determined by reference to observable market prices where available and reliable. Where representative market prices for an instrument are not available or are unreliable because of poor liquidity, the fair value is derived from prices for its components using appropriate pricing or valuation models that are based on independently sourced market parameters.

Direct Line Life closely monitors the valuation of assets in markets that have become less liquid. Determining whether a market is active requires the exercise of judgement and is determined based upon the facts and circumstances of the market for the instrument being measured. Where it is determined that there is no active market, fair value is established using a valuation technique as described in the note above. The techniques applied incorporate relevant information available and reflect appropriate adjustments for credit and liquidity risks. The relative weightings given to differing sources of information and the determination of non-observable inputs to valuation models can require the exercise of significant judgement. Where possible, Direct Line Life seeks at least external quotations for each bond and considers whether these are representative of fair value in the light of current traded levels, and in comparison to the internal Direct Line Life valuation models. Where this information is not available or where it is considered to be not representative of fair value, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

The fair value of certain asset backed securities has been determined by use of an internal model which predicts the future cash flows from the instruments in a number of projected economic scenarios. These economic scenarios are probability weighted based on recent economic forecasts and the resulting cash flows are discounted using risk adjusted discount rates determined by reference to currently observable market discount rates adjusted to take account of the risk characteristics of the securities being valued. There is significant subjectivity in this valuation as there is little recent market activity in these or other similar instruments.

4. Management of insurance risk

Insurance risk can arise from fluctuations in the timing, frequency and severity of insured events and their ultimate settlement, relative to the expectations of Direct Line Life at the time of underwriting,

including those driven by inaccurate pricing, inappropriate underwriting guidelines and terms and conditions, and holding inadequate reserves.

Until 5 July 2011, Direct Line Life underwrote long term insurance falling within business classes of life and annuity and permanent health. The products provided were fixed term life cover, mortgage life cover, fixed term life cover with critical illness, mortgage life cover with critical illness, over 50's life cover and the life cover associated with the creditors business underwritten by Direct Line Insurance Group's general insurance business. Contracts were issued typically on a long-term basis, which means that Direct Line Life's liability can extend for a period ranging from five years up to fifty-two years.

For creditor insurance, contracts are issued either on a monthly renewable basis (regular premium) and can be amended or cancelled by the customer at any point during the contract or cover period of a loan (single premium). In the former case, Direct Line Life can cancel or amend the policy following a 90 day written notice period. In the latter case, (these policies were withdrawn from sale in December 2008) the customer has the option to cancel the contract at any point but generally Direct Line Life is obligated for the full term of up to a maximum of 10 years but typically 3 to 5 years.

This risk is managed according to the following separate components:

- (i) underwriting, pricing and reserving risk;
- (ii) claims management risk; and
- (iii) reinsurance risk.

Underwriting, pricing and reserving risk

Underwriting and pricing risk is the risk that inappropriate business will be written and/or inappropriate prices charged. The classes and sectors of business written, underwriting criteria and relevant limits, define underwriting risk appetite. This was only applicable to Direct Line Life until 5 July 2011 when Direct Line Life closed to new business.

Reserving risk is the risk that the reserves have been calculated incorrectly, or the assumptions used in the calculation turn out to be inappropriate.

Long term insurance contracts

Direct Line Life manages this risk through a wide range of processes and forums, some of which include:

- comprehensive internal quality review audit programmes;
- central control, within underwriting, of policy wordings and subsequent changes;
- weekly monitoring within the business of key performance indicators by product and brand;
- formal monthly monitoring and reporting to the Executive, by product and brand;
- annual budgeting and quarterly re-forecasting, signed off by the Executive; and
- reserves are calculated by an independent consulting firm of actuaries.

Until 5 July 2011, the following risk management was undertaken:

- underwriting guidelines existed for all business transacted restricting the types and classes of business that may be accepted;
- medical selection was included in Direct Line Life's underwriting procedures and premiums vary to reflect the lifestyle, health and family medical history of the applicant; and
- pricing policies which were set by management and implemented through pricing committees by product line and by brand.

(a) Frequency and severity of specific risks – long term insurance contracts

For contracts where death or critical illness is the insured risk, the most significant factors that could increase the overall frequency of claims are epidemics or wide spread changes in lifestyle, such as eating, smoking and exercise habits, resulting in earlier or more claims than expected.

For contracts with fixed benefits and fixed future premiums, there are no mitigating terms and conditions that reduce the insurance risk accepted.

For contracts with renewable premiums a mitigating factor is the renewable nature of the premium. Under the terms of the policy the retail premium can be adjusted to reflect the claims experience, developments in medical technology and diagnosis and other related expenses.

The table below presents the concentration of insured benefits across four bands per individual life assured. The benefit insured figures are shown gross and net of reinsurance contracts described above.

Benefits assured per life assured at the end of 2012	Total benefits insured			
	Before reinsurance		After reinsurance	
	£000		£000	
0–99	4,296	28.8%	703	36.8%
100–199	7,333	49.2%	862	45.2%
200–299	2,379	16.0%	252	13.2%
300+	894	6.0%	91	4.8%
Total	14,902		1,908	

Benefits assured per life assured at the end of 2011	Total benefits insured			
	Before reinsurance		After reinsurance	
	£000		£000	
0–99	4,626	28.7%	762	36.9%
100–199	7,948	49.3%	930	45.1%
200–299	2,573	16.0%	272	13.2%
300+	971	6.0%	99	4.8%
Total	16,118		2,063	

Benefits assured per life assured at the end of 2010	Total benefits insured			
	Before reinsurance		After reinsurance	
	£000		£000	
0–99	4,993	28.9%	823	37.1%
100–199	8,550	49.4%	998	45.1%
200–299	2,735	15.8%	290	13.1%
300+	1,020	5.9%	104	4.7%
Total	17,298		2,215	

(b) **Sources of uncertainty in the estimation of future benefit payments and premium receipts**

Uncertainty in the estimation of future benefits and premium receipts for long-term insurance contracts arises from the unpredictability of long-term changes in overall levels of mortality and morbidity.

Direct Line Life uses appropriate base tables of standard mortality and morbidity according to the type of contract being written and the territory in which the insured person resides. An investigation into Direct Line Life's recent experience, in conjunction with a review of the continuous mortality and morbidity investigations performed by independent actuarial bodies, is carried out and a best estimate of expected mortality and morbidity for the future is derived.

The assumptions and sensitivities relating to insurance contract provisions are set out in Note 19 Insurance contract provisions.

(c) **Reinsurance risk**

Direct Line Life uses reinsurance:

- To protect the insurance results against unforeseen volumes of, or adverse trends in, large individual claims, in order to reduce volatility and to improve stability of earnings;
- To reduce Direct Line Life's capital requirements; and

- Transfer risk that is not within Direct Line Life's current risk retention strategy.

Reinsurance is essentially a swap whereby Direct Line Life will cede away insurance risk to reinsurers but in return assume back credit risk against which a reinsurance bad debt provision is assessed. The financial security of Direct Line Life's panel of reinsurers is therefore extremely important and both the quality and quantum of the assumed credit risk are subject to a credit risk approval process. Direct Line Life's leading counterparty exposures are analysed on a monthly basis where utilisation is monitored against agreed individual reinsurer limits. These limits represent the accumulated credit risk for all underwriting entities. Direct Line Life aims to contract with a diverse range of reinsurers on its contracts to mitigate the credit and/or non payment risks associated with its reinsurance exposures.

Reinsurance risk arises from:

- A failure of reinsurance to control exposure to losses, to reduce volatility or to protect capital; and/or
- An inability to place reinsurance cost effectively or on acceptable terms; and/or
- Reinsurer defaults.

5. Management of financial risk

Direct Line Life is exposed to a financial risk through its financial assets and financial liabilities. Direct Line Life's financial risk is concentrated within its investment portfolio and reinsurance.

The strategic asset allocation within the investment portfolio is agreed by the investment committee. The investment committee determines high level policy and controls, covering such areas as safety, liquidity and performance. They meet at least half-yearly to evaluate risk exposure, the current strategy, associated policies and investment guidelines and to consider investment recommendations submitted to it. Oversight of the implementation of decisions taken by the investment committee is via various risk fora.

The objectives set out in the investment management minimum standard are:

- to maintain the safety of the portfolio's principal both in economic terms and from an accounting and reporting perspective;
- to maintain sufficient liquidity to provide cash requirements for operations; and
- to maximise the portfolio's total return within the constraints of the other objectives and the limits defined by the investment guidelines.

Market risk

Market risk encompasses any adverse movement in the value of assets as a consequence of market movements such as interest rates, credit spreads, foreign exchange rates and equity, property and inflation valuations.

Direct Line Life is exposed to market risk in both the value of its liabilities and the value of assets held. Its market risk exposure is managed in accordance with the investment strategy approved by the Board, which considers the prudence principle of asset liability management. Direct Line Life does not hold investments for trading purposes.

Governance is provided via a monthly market risk forum, which is held with the following objectives:

- to ensure that the market risk exposure is aligned with the risk appetite approved by the Board;
- to ensure adherence to the market risk policy, supporting the operating and governance frameworks, including the delegation of authorities as well as effective monitoring and reporting; and
- to provide assistance and advise the business on the management of the risk exposure.

Direct Line Life assesses its market risk exposure through value at risk measures, sensitivity measures and stress testing within its business as usual. These tests are designed to consider the impact on capital arising from 'severe but plausible' scenarios.

Interest rate risk

Interest rate risk arises primarily from Direct Line Life's investment in long term debt and fixed income securities, which are exposed to fluctuations in interest rates.

A table showing the sensitivity of profits to changes in interest rates is included in Note 19(d).

Credit risk

Credit risk arises from the potential that losses are incurred from the failure of a counterparty to meet its credit obligations, either due to their failure and/or their inability to pay or their unwillingness to pay amounts due.

The objective of the credit risk policy and supporting minimum standards is to document the control processes by which Direct Line Life is able to identify, monitor, measure, manage, control and mitigate the level of credit risk to which it is exposed effectively. The credit risk control environment is summarised below:

Credit risk and investment forum

The primary responsibility of this forum is to ensure that all material aspects of credit risk within Direct Line Life are identified, monitored and measured.

Credit risk sanctioning committee

The primary responsibility of this committee is to approve new and increased credit risk limits in excess of business area credit authorities but within the committee's credit authority.

Monitoring and reporting

Relevant business units monitor the level of their actual credit exposure and measure this against approved credit terms and limits.

The main sources of credit risk for Direct Line Life are as follows:

- investment counterparty – this arises from the investment of monies in the range of investment vehicles permitted by the investment policy.
- reinsurance recoveries – credit exposure to reinsurance counterparties arises in respect of reinsurance claims against which a reinsurance bad debt provision is assessed.

The following table presents the assets of Direct Line Life which are subject to credit risk and a reconciliation to the balance sheet carrying value of each item:

31 December 2012	Amount not subject to credit risk	Amount subject to credit risk	Balance sheet carrying value
	£000	£000	£000
Debt securities	–	31,120	31,120
Cash and cash equivalents	–	35,233	35,233
Reinsurers' share of insurance contract liabilities	–	91,144	91,144
Insurance and other receivables	–	16,467	16,467
Prepayments	–	5	5
Reinsurers' share of accrued policyholder claims	–	3,587	3,587
Total	–	177,556	177,556

31 December 2011	Amount not subject to credit risk	Amount subject to credit risk	Balance sheet carrying value
	£000	£000	£000
Debt securities	–	41,514	41,514
Cash and cash equivalents	–	18,576	18,576
Reinsurers' share of insurance contract liabilities	–	78,632	78,632
Insurance and other receivables	–	48,958	48,958
Prepayments	–	12	12
Reinsurers' share of accrued policyholder claims	–	4,130	4,130
Total	–	191,822	191,822

31 December 2010	Amount not subject to credit risk	Amount subject to credit risk	Balance sheet carrying value
	£000	£000	£000
Debt securities	–	50,274	50,274
Cash and cash equivalents	–	63,124	63,124
Reinsurers' share of insurance contract liabilities	–	53,292	53,292
Insurance and other receivables	–	17,021	17,021
Prepayments	–	27	27
Reinsurers' share of accrued policyholder claims	–	5,021	5,021
Total	–	188,759	188,759

Direct Line Life's exposure to credit risk is summarised below:

As at 31 December 2012	Credit rating					Total £000
	AAA	AA	A	Below A	Unrated	
	£000	£000	£000	£000	£000	
Debt securities	31,120	–	–	–	–	31,120
Reinsurers' share of insurance contract provisions .	–	91,144	–	–	–	91,144
Insurance and other receivables	–	10,410	–	–	6,057	16,467
Prepayments	–	5	–	–	–	5
Reinsurers' share of accrued policyholder claims . .	–	3,587	–	–	–	3,587
Cash and cash equivalents	35,046	–	187	–	–	35,233
Total	66,166	105,146	187	–	6,057	177,556

As at 31 December 2011	Credit rating					Total £000
	AAA	AA	A	Below A	Unrated	
	£000	£000	£000	£000	£000	
Debt securities	41,514	–	–	–	–	41,514
Reinsurers' share of insurance contract provisions .	–	78,632	–	–	–	78,632
Insurance and other receivables	–	41,618	–	–	7,340	48,958
Prepayments	–	12	–	–	–	12
Reinsurers' share of accrued policyholder claims . .	–	4,130	–	–	–	4,130
Cash and cash equivalents	–	13,000	5,576	–	–	18,576
Total	41,514	137,392	5,576	–	7,340	191,822

As at 31 December 2010	Credit rating					Total £000
	AAA	AA	A	Below A	Unrated	
	£000	£000	£000	£000	£000	
Debt securities	50,274	–	–	–	–	50,274
Reinsurers' share of insurance contract provisions .	–	53,292	–	–	–	53,292
Insurance and other receivables	–	11,900	–	–	5,121	17,021
Prepayments	–	27	–	–	–	27
Reinsurers' share of accrued policyholder claims . .	–	5,021	–	–	–	5,021
Cash and cash equivalents	–	23,500	39,624	–	–	63,124
Total	50,274	93,740	39,624	–	5,121	188,759

No credit limits were exceeded during the twelve month period ended 31 December 2012. No financial assets are past due or impaired at the reporting date and management expects no significant losses from non-performance by these counterparties. No assets have been pledged as collateral.

Liquidity risk

Liquidity risk is the potential that obligations cannot be met as they fall due as a consequence of having a timing mismatch and/or an inability to raise sufficient liquid assets/cash without suffering a substantial loss on realisation.

The measurement and management of liquidity risk within Direct Line Life is undertaken within the limits and other policy parameters of Direct Line Life's liquidity risk appetite. Compliance is monitored both in respect of the internal policy and the regulatory requirements of local regulators.

Direct Line Life performs liquidity risk stress testing as part of its ICA process. These tests are designed to assess Direct Line Life's liquidity requirement in order to meet claims and other liabilities in a number of different extreme event scenarios and compare this requirement against the liquidity available from its investment portfolio and other assets. In all of the events considered Direct Line Life is comfortably able to meet its liabilities as they fall due.

In the event that one or more liquidity stresses or scenarios crystallises, or should any other event that may impact liquidity occur, Direct Line Life seeks to ensure that the event has a rapid and controlled response. In such an event, a liquidity crisis management team will be formed to assess the nature and extent of the threat and to develop an appropriate response.

An independent consulting firm of actuaries analyse the term of liabilities and determine matching assets to ensure that liquidity risk is minimised. In the investment guidelines it is recommended that the current liabilities, free assets and half the assets backing the creditor liability are invested in cash and short dated deposits.

Analysis of maturity of debt securities

For each category of insurance and financial liabilities, the following table shows the gross liability analysed by remaining duration. The total liability is split by remaining duration in proportion to the cash-flows expected to arise during the period.

As at 31 December 2012	Total	Within one year	After one but not more than three years	After three but not more than five years	After five but not more than ten years	Over ten years
	£000	£000	£000	£000	£000	£000
Financial liabilities	3,500	3,500	–	–	–	–
Insurance contract liabilities	102,934	1,075	4,935	10,513	64,028	22,383
Other liabilities	9,212	9,212	–	–	–	–
Total	115,646	13,787	4,935	10,513	64,028	22,383

As at 31 December 2011	Total	Within one year	After one but not more than three years	After three but not more than five years	After five but not more than ten years	Over ten years
	£000	£000	£000	£000	£000	£000
Insurance contract liabilities	93,013	2,280	6,151	7,437	54,869	22,276
Other liabilities	40,204	40,204	–	–	–	–
Total	133,217	42,484	6,151	7,437	54,869	22,276

As at 31 December 2010	Total	Within one year	After one but not more than three years	After three but not more than five years	After five but not more than ten years	Over ten years
	£000	£000	£000	£000	£000	£000
Insurance contract liabilities	68,351	2,498	9,268	5,340	36,511	14,734
Other liabilities	16,754	16,754	–	–	–	–
Total	85,105	19,252	9,268	5,340	36,511	14,734

Sensitivities

Life insurance results are inherently uncertain, due to actual experience being different to modelled assumptions. Sensitivity analysis is provided below to illustrate the impact of changes in key assumptions:

Sensitivity	Description of sensitivity analysis
Debt securities	The method used in calculating this sensitivity is to apply a 20% change to market values to the debt security portfolios.
Interest rate and investment return	The impact of a change in market interest rates by +/– 1% (e.g. if a current interest rate is 2%, the impact of an immediate change to 1% or 3%).

The table below shows the impact of movements in market risk on profit after tax and on shareholder equity as at the balance sheet date.

<u>Sensitivity as at 31 December 2012</u>	<u>Variability</u>	<u>Impact on value of investments £000</u>	<u>Impact on profit after tax £000</u>	<u>Impact on shareholders equity £000</u>
Debt securities	+20%	6,224	–	6,224
Debt securities	–20%	(6,224)	–	(6,224)
Interest rates	+1.0%	(1,072)	1,215	405
Interest rates	–1.0%	1,109	(1,554)	(717)

<u>Sensitivity as at 31 December 2011</u>	<u>Variability</u>	<u>Impact on value of investments £000</u>	<u>Impact on profit after tax £000</u>	<u>Impact on shareholders equity £000</u>
Debt securities	+20%	8,303	–	8,303
Debt securities	–20%	(8,303)	–	(8,303)
Interest rates	+1.0%	(1,386)	1,152	133
Interest rates	–1.0%	1,418	(1,496)	(453)

<u>Sensitivity as at 31 December 2010</u>	<u>Variability</u>	<u>Impact on value of investments £000</u>	<u>Impact on profit after tax £000</u>	<u>Impact on shareholders equity £000</u>
Debt securities	+20%	10,055	–	10,055
Debt securities	–20%	(10,055)	–	(10,055)
Interest rates	+1.0%	(1,685)	551	(662)
Interest rates	–1.0%	1,772	(892)	(384)

6. Operating segments

In the opinion of the Directors of Chesnara plc, Direct Line Life operates in a single business segment, being that of long-term insurance business in the UK, as the management information available to the chief decision makers (being the Board of Directors) is not segmented.

7. Net investment return

	<u>Year ended 31 December</u>		
	<u>2012</u>	<u>2011</u>	<u>2010</u>
	<u>£000</u>	<u>£000</u>	<u>£000</u>
Interest income	1,752	2,475	2,753
Investment fees	(5)	(8)	–
Other investment income	1	–	–
	<u>1,748</u>	<u>2,467</u>	<u>2,753</u>
Net fair value gains and (losses)			
Debt securities designated as at fair value through income	(324)	309	359
Net investment return	<u>1,424</u>	<u>2,776</u>	<u>3,112</u>

8. Other operating income

	<u>Year ended 31 December</u>		
	<u>2012</u>	<u>2011</u>	<u>2010</u>
	<u>£000</u>	<u>£000</u>	<u>£000</u>
Income from call charges	–	1	2
Other operating income	<u>–</u>	<u>1</u>	<u>2</u>

9. Insurance contract claims and benefits

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Claims and benefits paid to insurance contract holders	22,935	22,481	24,459
Net increase/(decrease) in insurance contract provisions	9,921	24,662	(13,849)
Total insurance claims and benefits	32,856	47,143	10,610
Recoveries from reinsurers	(30,797)	(41,499)	(11,910)
Net insurance contract claims and benefits incurred	2,059	5,644	(1,300)

10. Fees, commission and other acquisition costs

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Directly expensed costs:			
Insurance contracts-commission	3,825	2,136	2,571
Total	3,825	2,136	2,571

11. Administrative expenses

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Personnel-related costs	424	1,138	1,490
Fees for Actuarial services	435	446	460
Depreciation charge on property and equipment	3	4	13
Other goods and services	970	2,417	2,935
Total	1,832	4,005	4,898

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

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Fees payable to Direct Line Life's Auditor for the audit of Direct Line Life's annual accounts	50	5	50
Fees payable to Direct Line Life's Auditor for other services:			
Audit related assurance services*	67	64	63
All other services	8	8	8
Total	125	77	121

* Includes the audit of regulatory returns submitted to the UK regulator.

12. Other operating expenses

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Expenses incurred under profit participation	6,233	4,587	8,913
Total	6,233	4,587	8,913

13. Income tax expense

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Current tax expense			
Current year	(2,230)	(2,363)	(4,172)
Adjustment to prior years	(187)	294	(1,017)
Net expense	(2,417)	(2,069)	(5,189)
Deferred tax charge			
Origination and reversal of temporary differences	(6)	(8)	(5)
Total income tax expense	(2,423)	(2,077)	(5,194)
Reconciliation of effective tax rate on profit before tax			
Profit before tax	9,357	9,051	14,012
Income tax using the UK corporation tax rate of 24.5% (2011: 26.5%, 2010: 28%)	(2,292)	(2,399)	(3,923)
(Overprovided)/underprovided in prior years	(125)	329	(1,050)
Other timing differences	(6)	(7)	(221)
Total income tax (credit)/expense	(2,423)	(2,077)	(5,194)

14. Property and equipment

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Cost			
Balance at 1 January	670	670	670
Disposals	(512)	–	–
Balance at 31 December	158	670	670
Amortisation and impairment losses			
Balance at 1 January	(667)	(663)	(650)
Amortisation charge for the year	(3)	(4)	(13)
Disposals	512	–	–
Balance at 31 December	(158)	(667)	(663)
Carrying amounts at 31 December			
Current	–	3	4
Non-current	–	–	3
Total	–	3	7

15. Financial assets

	As at 31 December		
	2012	2011	2010
	£000	£000	£000
Financial assets by measurement category			
Fair value through income			
Debt securities	31,120	41,514	50,274
Insurance and other receivables			
– Deposits with credit institutions with maturities in excess of 3 months	–	30,000	–
– Other – see Note 16	16,467	18,958	17,021
Total insurance and other receivables	16,467	48,958	17,021
Prepayments and accrued income	5	12	27
Total	47,592	90,484	67,322

Fair value is the amount for which an asset could be exchanged between willing parties in an arms' length transaction. The tables below show the determination of fair value according to a three-level valuation hierarchy. Fair values are generally determined at prices quoted in active markets (Level 1). However, where such information is not available, Direct Line Life applies valuation techniques to measure such instruments. These valuation techniques make use of market-observable data for all significant inputs where possible (Level 2), but, in some cases it may be necessary to estimate other than market-observable data within a valuation model for significant inputs (Level 3).

Financial assets at fair value through income

	Fair value measurement as at 31 December 2012			
	Level 1	Level 2	Level 3	Total
	£000	£000	£000	£000
Financial assets				
Debt securities	10,316	20,804	–	31,120
Total	10,316	20,804	–	31,120

	Fair value measurement as at 31 December 2011			
	Level 1	Level 2	Level 3	Total
	£000	£000	£000	£000
Financial assets				
Debt securities	10,460	31,054	–	41,514
Total	10,460	31,054	–	41,514

	Fair value measurement as at 31 December 2010			
	Level 1	Level 2	Level 3	Total
	£000	£000	£000	£000
Financial assets				
Debt securities	13,955	36,319	–	50,274
Total	13,955	36,319	–	50,274

Direct Line Life held no Level 3 securities as at 31 December 2012, 31 December 2011 or at 31 December 2010.

16. Insurance and other receivables and prepayments

	31 December		
	2012	2011	2010
	£000	£000	£000
Insurance and other receivables			
Receivables arising from insurance contracts			
Policyholders	1,244	1,565	1,296
Reinsurance receivables	10,415	11,630	11,927
Other receivables			
Accrued interest income	638	1,056	1,075
Receivables from related parties	4,170	3,916	2,723
Other	–	791	–
Total	16,467	18,958	17,021

All insurance and other receivables are classified as current liabilities. The carrying amount is a reasonable approximation of fair value.

	31 December		
	2012	2011	2010
	£000	£000	£000
Prepayments			
Prepayments	5	12	27

All prepayments are classified as current liabilities. The carrying amount is a reasonable approximation of fair value.

17. Cash and cash equivalents

	31 December		
	2012	2011	2010
	£000	£000	£000
Bank and cash balances	107	91	117
Short term deposits	35,126	18,485	63,007
Cash and cash equivalents in the statement of cash flows	35,233	18,576	63,124

The effective interest rate on short term bank deposits as at 31 December 2012 was 0.25% (31 December 2011: 0.40%; 31 December 2010: 0.35-0.70%), with an average maturity of 1 day (31 December 2012: 4 days; 31 December 2011: 2 days; 31 December 2010: 2 days). All deposits included in cash and cash equivalents are capable of being realised as cash within three months.

18. Capital management

(a) Objective

Direct Line Life's capital management framework is designed to provide security for all stakeholders, while meeting the expectations of policyholders and shareholders. Accordingly it:

- (i) safeguards policyholders interests by meeting regulatory requirements established by the regulators of the insurance markets in which Direct Line Life operates, while not retaining unnecessary excess capital;
- (ii) seeks to meet the dividend expectations of shareholders and to optimise the gearing ratio to ensure an efficient capital base;
- (iii) ensures there is sufficient liquidity to meet obligations to policyholders, debt financiers and creditors as they fall due; and
- (iv) maintains Direct Line Life as a going concern so that it continues to provide returns and to meet obligations to all stakeholders.

Throughout the period 1 January 2010 to 31 December 2012 Direct Line Life operated exclusively in the UK and Direct Line Life's regulatory capital requirements were, accordingly, determined by the regulations established by the Financial Services Authority ('FSA') in the UK.

(b) **Operation of the UK regulatory regime**

The operation of regulation with respect to the business is such as to specify the minimum amount of capital that must be held in addition to the insurance liabilities as determined for regulatory purposes. This is established by reference to two calculations, being:

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

For the whole of the period covered by this financial information, the minimum regulatory capital requirement was determined by the first calculation, as this gave rise to the lesser measure of surplus capital. This calculation is set out below in Section (c) Regulatory Capital Resources and Requirements.

(c) **Regulatory capital resources and requirements**

The following table summarises the capital resources and requirements of Direct Line Life, as determined for UK regulatory purposes (Pillar 1):

	31 December		
	2012	2011	2010
	£m	£m	£m
Available capital resources (CR)	52.8	56.4	98.8
Long-term insurance capital requirement (LTICR)	27.6	30.4	32.6
Total capital resource requirements (CRR)	27.6	30.4	32.6
Excess of CR over CRR (solvency surplus)	25.2	26.0	66.2
Ratio of available CR to CRR	191%	186%	303%

For each of the periods reported on, the excess of the CR of Direct Line Life was significantly in excess of its CRR.

The Board of Direct Line Life has not established formal targets for CR cover for total CRR. The high level of capital retention within the regulated entity has given rise to significant excesses of CR over CRR for each reported period.

(d) **Technical provisions net of reinsurance**

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

	31 December		
	2012	2011	2010
	£000	£000	£000
Technical provisions			
Non-participating:			
Insurance contracts	11,790	14,380	15,659
Total	11,790	14,380	15,659

- (ii) Process used to determine assumptions underlying the calculation of technical provisions.

The process used to determine the assumptions underlying the calculation of technical provisions, which are checked to ensure that they are consistent with observed market prices or other published information, is intended to result in conservative estimates of the most likely, or expected, outcome. The assumptions which are considered include the expected number and timing of deaths, other claims and investment returns over the period of risk exposure. A reasonable allowance is made for the level of uncertainty within the contracts.

(iii) The basis for establishing technical provisions is:

The technical provisions for all contracts, with the exception of the group credit life business, are calculated on a gross premium basis. The provision is calculated by subtracting the present value of future premiums from the present value of the benefits payable under the policy, until it ceases at maturity, or death if earlier. The gross premium method makes explicit allowance for future policy maintenance costs. If the net present value of the future discounted cash flows is positive, no asset is recognised.

For the group credit life business, the methods of calculating the technical provision vary by scheme, and are listed below:

DLFS Mastercard credit card scheme: technical provisions are set to twice the monthly premium (net of commission) payable in the month ending on the valuation date.

Other credit card schemes: Technical provisions are set equal to the monthly premium (net of commission) payable in the month ending on the valuation date.

Natwest Personal Loans and Business Loans schemes: Technical provisions are taken as 95% of a proportion of the single premium (net of commission where applicable). The proportion is calculated by dividing the outstanding term of the loan by the original term. The original term is between one and ten years.

Other single premium loan schemes: Technical provisions have been taken as 100% of a proportion of the single premium (net of commission where applicable). The proportion is calculated by dividing the outstanding term of the loan by the original term.

Natwest Regular Premium Loans Schemes: For these schemes a regular premium is payable to cover, in the event of death or sickness, the balance outstanding under a loan repaid by level instalments. The technical provisions are calculated as 100% of one month's forecast premiums based on the most recent months actual.

Decreasing term assurance, fixed term assurance or whole of life policy providing a waiver of premium benefit subject to an extra premium: the technical provisions have been increased by the annual amount of such a premium less the proportion of benefit reassured. Technical provisions in respect of premiums currently being waived are calculated as for outstanding claims under income protection contracts, by taking the annual claim amount and multiplying by an annuity factor calculated over the outstanding term of the policy.

(iv) Assumptions

Direct Line Life writes only non-profit long-term business where shareholders are entitled to 100% of the profits. The gross premium method of actuarial valuation is used. This makes explicit assumptions for interest and discount rates, mortality and morbidity, persistency and future expenses. Assumptions are reviewed annually against actual experience and industry and economic trends.

Mortality and morbidity

Appropriate base tables of standard mortality and morbidity are chosen depending on the type of contract. An investigation into Direct Line Life's recent experience, in conjunction with a review of the continuous mortality investigations performed by independent actuarial bodies, is carried out and an appropriate level of the base table is derived.

Persistency

Allowance is made for lapses or surrenders within the valuation of insurance contract liabilities. The table below shows the average lapse rates used. Where two rates are shown,

the lower rate is assumed when projected cash flows are negative and the higher rate when positive.

<u>Rate of lapse</u>	<u>31 December 2012</u>	<u>31 December 2011</u>	<u>31 December 2010</u>
Level term	1.5%/12.5%	1.5%/12.5%	1.5%/12.5%
Decreasing term	1.5%/12.5%	1.5%/12.5%	1.5%/12.5%
Accelerated critical illness	4.5%/15.5%	4.5%/15.5%	4.5%/15.5%
Whole Life GAP	0%	0%	0%
Income protection	1.5%/12.5%	1.5%/12.5%	1.5%/12.5%

Discount rates

Direct Line Life uses an appropriate rate of interest in discounting projected liabilities. At 31 December 2012 a rate of 1.0% was used (31 December 2011: 1.2%, 31 December 2010: 2.5%).

The rates of interest shown above have been set after consideration of the risk of default on non-government bonds by applying a deduction of 0.1% to the earned yield.

For many of the life insurance products the interest rate risk is managed through asset/liability management strategies that seek to match the interest rate sensitivity of the assets to that of the underlying liabilities. The overall objective of these strategies is to limit the net change in value of assets and liabilities arising from interest rate movements.

Renewal expense level and inflation

Direct Line Life's current level of expenses, together with a margin for prudence, is taken as an appropriate expense base and an expense inflation rate of 5.5% (2011: 5.5%, 2010: 4.0%) is applied.

For regular premium credit insurance business we hold a multiple of premium as the reserve. For single premium credit insurance business the reserve is taken as a proportion of the single premium, where the proportion reflects the outstanding term remaining on the contract.

Taxation

It has been assumed that current tax legislation and tax rates will not change.

(e) Valuation of options and guarantees – UK businesses

There are no material options or guarantees within Direct Line Life, and no reserve has been set up for any options or guarantees.

19. Insurance contract provisions

(a) Analysis of insurance contract provisions

31 December 2012			
	Gross	Reinsurance	Net
	£000	£000	£000
Insurance contract provisions	102,934	91,144	11,790
Total insurance contract provisions	102,934	91,144	11,790
Current	22,375	18,562	3,813
Non-current	80,559	72,582	7,977
Total	102,934	91,144	11,790

31 December 2011			
	Gross	Reinsurance	Net
	£000	£000	£000
Insurance contract provisions	93,013	78,632	14,381
Total insurance contract provisions	93,013	78,632	14,381
Current	23,874	18,779	5,095
Non-current	69,139	59,853	9,286
Total	93,013	78,632	14,381

31 December 2010			
	Gross	Reinsurance	Net
	£000	£000	£000
Insurance contract provisions	68,351	53,292	15,059
Total insurance contract provisions	68,351	53,292	15,059
Current	25,497	19,967	5,530
Non-current	42,854	33,325	9,529
Total	68,351	53,292	15,059

(b) Analysis of movement in insurance contract provisions

Year ended 31 December 2012			
	Gross	Reinsurance	Net
	£000	£000	£000
Balance at 1 January	93,013	78,632	14,381
Premiums received	42,784	24,727	18,057
Fees deducted	(8,092)	–	(8,092)
Reserves released in respect of benefits paid	(20,344)	(18,285)	(2,059)
Investment return	312	–	312
Other movements	(4,739)	6,070	(10,809)
Balance at 31 December	102,934	91,144	11,790

Year ended 31 December 2011			
	Gross	Reinsurance	Net
	£000	£000	£000
Balance at 1 January	68,351	53,292	15,059
Premiums received	45,920	25,410	20,510
Fees deducted	(8,560)	–	(8,560)
Reserves released in respect of benefits paid	(21,803)	(16,159)	(5,644)
Investment return	324	–	324
Other movements	8,781	16,089	(7,308)
Balance at 31 December	93,013	78,632	14,381

	Year ended 31 December 2010		
	Gross	Reinsurance	Net
	£000	£000	£000
Balance at 1 January	82,200	58,313	23,887
Premiums received	49,691	26,282	23,409
Fees deducted	(13,163)	–	(13,163)
Reserves released in respect of benefits paid	(15,391)	(16,931)	1,540
Investment return	702	–	702
Other movements	(35,688)	(14,372)	(21,316)
Balance at 31 December	68,351	53,292	15,059

(c) **Process, basis and assumptions for establishing insurance contract provisions**

The process, basis and assumptions for establishing insurance contract provisions for the UK businesses are materially the same as those stated in Note 18 (d) (ii), (iii) and (iv) for establishing technical provisions.

(d) **Sensitivity analysis**

Life insurance results are inherently uncertain, due to actual experience being different to modelled assumptions. Sensitivity analysis is provided below to illustrate the impact of changes in key assumptions.

Sensitivity	Description of sensitivity analysis
Debt securities	The method used in calculating this sensitivity is to apply a 20% change to market values to the debt security portfolios.
Interest rate and investment return . .	The impact of a change in market interest rates by +/– 1% (e.g. if a current interest rate is 2%, the impact of an immediate change to 1% or 3%).
Expenses	The impact of an increase in ongoing administrative expenses and the claims handling expenses provision by 10%.
Assurance mortality/morbidity	The impact of an increase in mortality/morbidity rates for assurance contracts by 5%.
Lapse rates	The impact of an increase in lapse rates by 0.5%.

The table below demonstrates the effect of a change in a key assumption whilst other assumptions remain unaffected. In reality, such an occurrence is unlikely due to the correlation between the assumptions and other factors. It should also be noted that these sensitivities are non-linear, and larger or smaller impacts should not be interpolated from these results. The sensitivity analyses do not take into consideration that our assets and liabilities are actively managed and may vary at the time that any actual market movement occurs.

Sensitivity at 31 December 2012		Variability	Impact on value of investments £000	Impact on profit after tax £000	Impact on shareholders equity £000
Debt securities	+20%		6,224	–	6,224
Debt securities	–20%		(6,224)	–	(6,224)
Interest rates	+1.0%		(1,072)	1,215	405
Interest rates	–1.0%		1,109	(1,554)	(717)
Expenses	+10.0%		–	(725)	(725)
Assurance mortality/morbidity	+5.0%		–	(742)	(742)
Increase in lapse rate	+0.5%		–	233	233

Sensitivity at 31 December 2011		Variability	Impact on value of investments £000	Impact on profit after tax £000	Impact on shareholders equity £000
Debt securities	+20%		8,303	–	8,303
Debt securities	–20%		(8,303)	–	(8,303)
Interest rates	+1.0%		(1,386)	1,152	133
Interest rates	–1.0%		1,418	(1,496)	(453)
Expenses	+10.0%		–	(678)	(678)
Assurance mortality/morbidity	+5.0%		–	(687)	(687)
Increase in lapse rate	+0.5%		–	224	224

Sensitivity at 31 December 2010		Variability	Impact on value of investments £000	Impact on profit after tax £000	Impact on shareholders equity £000
Debt securities	+20%		10,055	–	10,055
Debt securities	–20%		(10,055)	–	(10,055)
Interest rates	+1.0%		(1,685)	551	(662)
Interest rates	–1.0%		1,772	(892)	384
Expenses	+10.0%		–	(210)	(210)
Assurance mortality/morbidity	+5.0%		–	(472)	(472)
Increase in lapse rate	+0.5%		–	111	111

Claims management risk is the risk that claims are paid or handled inappropriately.

Claims are managed utilising a range of IT system driven controls coupled with manual processes outlined in detailed policies and procedures to ensure claims are handled in an appropriate, timely and accurate manner.

Each member of staff has a specified handling authority, with controls preventing them handling or paying claims outside of their authorities, as well as controls to mitigate the risk of paying invalid claims. In addition, there are various outsourced claims handling arrangements all of which are monitored closely by management, with similar principles applying in terms of the controls and procedures.

20. Financial liabilities – borrowings

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Subordinated debt	3,500	–	–
Total	3,500	–	–

All financial liabilities are classified as current liabilities. The carrying value of borrowings is not materially different from their fair value.

Direct Line Life held an undated subordinated debt with Tesco Personal Finance Limited, which due to its undated nature did not meet the liability recognition criteria and was previously held within equity reserves. An agreement to repay this subordinated debt was reached during 2012, at which point it became dated. As a result, this subordinated debt has been reclassified from other reserves to

subordinated liabilities. The subordinated debt of £3,500,000 was repaid to Tesco Personal Finance Limited in January 2013.

21. Deferred tax assets and liabilities

(a) Recognised deferred tax assets and liabilities

	Assets £000	Liabilities £000	Net £000
As at 31 December 2012			
Insurance contract provisions	—	—	—
Unrealised gains	—	—	—
Property and equipment	19	—	19
Total	19	—	19
Current	6	—	6
Non-current	13	—	13
Total	19	—	19
	Assets £000	Liabilities £000	Net £000
As at 31 December 2011			
Insurance contract provisions	—	—	—
Unrealised gains	—	—	—
Property and equipment	25	—	25
Total	25	—	25
Current	6	—	6
Non-current	19	—	19
Total	25	—	25
	Assets £000	Liabilities £000	Net £000
As at 31 December 2010			
Insurance contract provisions	—	—	—
Unrealised gains	—	—	—
Property and equipment	33	—	33
Total	33	—	33
Current	8	—	8
Non-current	25	—	25
Total	33	—	33

(b) Movement in temporary differences during the year

	2012		
	Balance at 1 January £000	Recognised in income £000	Balance at 31 December £000
Property and equipment	25	(6)	19
Total	25	(6)	19
	2011		
	Balance at 1 January £000	Recognised in income £000	Balance at 31 December £000
Property and equipment	33	(8)	25
Total	33	(8)	25

	2010		
	Balance at 1 January	Recognised in income	Balance at 31 December
	£000	£000	£000
Property and equipment	38	(5)	33
Total	38	(5)	33

22. Reinsurance payables

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Payables in respect of insurance contracts	30	34	39
Total	30	34	39

All reinsurance payables are classified as current liabilities. Their carrying value is a reasonable approximation of fair value.

23. Payables related to direct insurance contracts

	31 December 2012		
	Gross	Reinsurance	Net
	£000	£000	£000
Accrued claims	4,220	3,587	633
Other	1,048	—	1,048
Total	5,268	3,587	1,681
Current	5,268	3,587	1,681
Non-current	—	—	—
Total	5,268	3,587	1,681

	31 December 2011		
	Gross	Reinsurance	Net
	£000	£000	£000
Accrued claims	4,867	4,130	737
Other	1,237	—	1,237
Total	6,104	4,130	1,974
Current	6,104	4,130	1,974
Non-current	—	—	—
Total	6,104	4,130	1,974

	31 December 2010		
	Gross	Reinsurance	Net
	£000	£000	£000
Accrued claims	5,814	5,021	793
Other	1,063	—	1,063
Total	6,877	5,021	1,856
Current	6,877	5,021	1,856
Non-current	—	—	—
Total	6,877	5,021	1,856

All payables related to direct insurance contracts are classified as current liabilities. Their carrying value is a reasonable approximation of fair value.

24. Income tax liabilities

	31 December		
	2012	2011	2010
	£000	£000	£000
Corporation tax	2,066	2,204	4,239
	<u>2,066</u>	<u>2,204</u>	<u>4,239</u>

All income tax liabilities are classified as current liabilities. Their carrying value is a reasonable approximation of fair value.

25. Other payables

	31 December		
	2012	2011	2010
	£000	£000	£000
Due to related parties	3,661	33,801	8,534
Trade creditors and accruals	249	259	1,298
Other creditors	4	6	6
Total	<u>3,914</u>	<u>34,066</u>	<u>9,838</u>

All other payables are classified as current liabilities. Their carrying value is a reasonable approximation of fair value.

26. Share capital

	31 December 2012, 2011 and 2010	
	Number of Shares	Share Capital
Authorised	44,000	44,000
Issued and fully paid	<u>44,000</u>	<u>44,000</u>

There have been no changes in the share capital of Direct Line Life during the years ended 31 December 2012, 31 December 2011 and 31 December 2010.

27. Retained earnings

	31 December		
	2012	2011	2010
	£000	£000	£000
Balance at 1 January	8,929	51,955	43,137
Profit for the period/year	6,934	6,974	8,818
Dividends			
Dividends paid – 2011	–	(50,000)	–
Balance at 31 December	<u>15,863</u>	<u>8,929</u>	<u>51,955</u>

No dividends were paid in the year ended 31 December 2012 (2011: 113 pence per share; 2010: nil).

28. Other reserves

	31 December		
	2012	2011	2010
	£000	£000	£000
Balance at 1 January	3,500	3,500	3,500
Reclassification to subordinated liabilities (see Note 20)	(3,500)	–	–
Balance at 31 December	<u>–</u>	<u>3,500</u>	<u>3,500</u>

Direct Line Life held an undated subordinated debt with Tesco Personal Finance Limited. An agreement to repay this subordinated debt was reached during 2012. As a result, this subordinated debt has been reclassified from other reserves to subordinated liabilities. The undated subordinated debt of £3,500,000 was repaid to Tesco Personal Finance in January 2013.

29. Employee benefit expense

Direct Line Life has no employees.

Personnel costs are recharged from other Direct Line Insurance Group plc companies, which employ these personnel, on an allocation basis. Personnel costs are disclosed in Note 11 “Administrative expenses”.

These costs include salary and pension costs and the company has no further liability in respect of employee benefits.

30. Key management personnel

The Directors of Direct Line Life are employed by Direct Line Insurance Group plc. As such, all Directors emoluments are met by Direct Line Insurance Group plc. The Directors of Direct Line Life do not receive remuneration for specific services provided to Direct Line Life.

The aggregate remuneration of directors and other key management during the period was as follows:

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Other emoluments	–	197	126
Company pension contributions	–	21	10
	<u>–</u>	<u>218</u>	<u>136</u>

Fees paid to directors and other members of key management during the period amounted to £nil (2011: £263, 2010: £126).

31. Capital commitments

There were no capital commitments as at 31 December 2012, 31 December 2011 or 31 December 2010.

32. Related party transactions

(a) Ultimate controlling party

On 1 December 2008, the UK Government through HM Treasury became the ultimate controlling party of the Royal Bank of Scotland Group plc. The UK Government’s shareholding is managed by UK Financial Investments Limited, a company wholly owned by the UK Government.

Direct Line Life’s ultimate holding company was the Royal Bank of Scotland Group plc from 1 January 2010 to 31 December 2012 which is incorporated in the United Kingdom and registered in Scotland. On 13 March 2013, the ultimate holding company ceased to be The Royal Bank of Scotland Group plc and became Direct Line Insurance Group plc. Its immediate parent company is Direct Line Insurance Group plc which is incorporated in the United Kingdom.

As at 31 December 2012, the Royal Bank of Scotland Group plc headed the largest group in which Direct Line Life is consolidated. Copies of the consolidated accounts of The Royal Bank of Scotland Group plc may be obtained from The Secretary. The Royal Bank of Scotland Group plc, Gogarburn, PO Box 1000, Edinburgh, EH12 1HQ. Direct Line Insurance Group plc heads the smallest group in which Direct Line Life is consolidated. Copies of the consolidated accounts of Direct Line Insurance Group plc may be obtained from The Secretary, Churchill Court, Westmoreland Road, Bromley, Kent, BR1 1DP.

Remuneration for key management personnel is disclosed in Note 30 above.

The following transactions were carried out with related parties, who are all members of The Royal Bank of Scotland Group plc.

(i) **Sales of insurance contracts and other services**

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Sales of services:			
– UK Insurance Limited	4,701	4,840	6,118

Sales of services are provided between related parties on an arm's length basis.

Interest income received from deposits held with related parties between January 2012 and May 2012 (being the date at which these deposits were moved to non-related financial institutions) were at rates ranging from 0.40% to 1.04% (2011: 0.40% to 1.36%, 2010: 0.35% to 3.90%).

(ii) **Purchases of products and services**

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Purchases of services:			
– DL Insurance Services Limited	1,254	3,353	1,469
– UK Insurance Limited	5,739	5,395	7,114
	6,993	8,748	8,583

Purchases of services also include payments made between companies determined by the levels of business generated and as agreed between the parties, on an arm's length basis.

Throughout the period Direct Line Life was a subsidiary of Direct Line Insurance Group plc whose policy is for companies to bear the costs of their full time staff. The time and costs of executives and other staff who are primarily employed by the group are not specifically recharged. However, the group recharges subsidiaries for management fees which include an allocation of certain staff and administration support costs.

In Direct Line Life and the Direct Line Insurance Group, key management comprise directors of Direct Line Life and members of the Direct Line Insurance Group Executive Management Committee. The emoluments of the directors of Direct Line Life are met by the Direct Line Insurance Group.

The directors of Direct Line Life do not receive remuneration for specific services provided to Direct Line Life.

(iii) **Year end balances arising from sales and purchases of products/services**

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Short term deposits held with related parties			
– The Royal Bank of Scotland plc	80	18,485	19,507
	80	18,485	19,507

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Debt securities held with related parties			
– UK Government	–	–	13,955
	–	–	13,955

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Receivables from related parties			
– DL Insurance Services Limited	222	–	–
– UK Insurance Limited	3,948	3,916	2,723
– The Royal Bank of Scotland plc	–	12,000	–
	<u>4,170</u>	<u>15,916</u>	<u>2,723</u>

	Year ended 31 December		
	2012	2011	2010
	£000	£000	£000
Payables to related parties			
– DL Insurance Services Limited	2,642	7,336	6,161
– Direct Line Insurance Group plc	–	25,000	–
– UK Insurance Limited	1,011	1,457	2,347
– The One Account Limited	8	8	26
	<u>3,661</u>	<u>33,801</u>	<u>8,534</u>

33. Post balance sheet event

A dividend of £7,000,000 was paid on 25 January 2013. A further dividend of £8,000,000 was paid on 18 June 2013.

The undated subordinated debt of £3,500,000 was repaid to Tesco Personal Finance Limited on 8 January 2013. This was settled centrally by Direct Line Insurance Group plc. Direct Line Life subsequently settled this via intercompany recharge in February 2013.

PART IV – UNAUDITED PRO FORMA FINANCIAL INFORMATION ON CHESNARA

SECTION A

The unaudited pro forma financial information set out below has been prepared to illustrate the impact of the Acquisition on the consolidated net assets of Chesnara. The pro forma financial information has been prepared for illustrative purposes only and, because of its nature, addresses a hypothetical situation and, therefore, does not and will not represent Chesnara's actual financial position or results.

The unaudited pro forma financial information is compiled on the basis set out in the notes below and in accordance with the accounting policies applied in preparing the Group's 2013 consolidated IFRS interim financial statements. The pro forma financial information takes no account of the results or any other changes in the financial position of either Chesnara, post 30 June 2013 or Direct Line Life, post 31 December 2012, other than those referred to in the notes below.

	Chesnara consolidated net assets at 30 June 2013 ⁽¹⁾	Debt raising ⁽²⁾	Acquisition of Direct Line Life and transaction expenses ⁽³⁾	Net assets of Direct Line Life at 31 December 2012 ⁽⁴⁾	Pre acquisition dividends/ capital extraction ⁽⁵⁾	Intangible Assets ⁽⁶⁾	Chesnara pro forma consolidated net assets
	£ million	£ million	£ million	£ million	£ million	£ million	£ million
Assets							
Intangible assets							
Goodwill	–	–	–	–	–	7.2	7.2
Deferred acquisition costs	26.6	–	–	–	–	–	26.6
Acquired value of in-force business	74.0	–	–	–	–	10.2	84.2
Acquired value of customer relationships	1.8	–	–	–	–	–	1.8
Software assets	5.6	–	–	–	–	–	5.6
Property and equipment	0.6	–	–	–	–	–	0.6
Investment in associates	3.4	–	–	–	–	–	3.4
Investment properties	71.3	–	–	–	–	–	71.3
Deferred tax assets	0.4	–	–	–	–	–	0.4
Reinsurers' share of insurance contract provisions	285.2	–	–	91.1	–	–	376.3
Amounts deposited with reinsurers	32.0	–	–	–	–	–	32.0
Financial assets							
Equity securities at fair value through income	451.7	–	–	–	–	–	451.7
Holdings in collective investment schemes at fair value through income	3,205.3	–	–	–	–	–	3,205.3
Debt securities at fair value through income	349.5	–	–	31.1	–	–	380.6
Policyholders' funds held by the Group	95.5	–	–	–	–	–	95.5
Insurance and other receivables	34.8	–	–	16.5	–	–	51.3
Prepayments	3.7	–	–	–	–	–	3.7
Derivative financial instruments	2.0	–	–	–	–	–	2.0
Total financial assets	4,142.5	–	–	47.6	–	–	4,190.1
Reinsurers' share of accrued policyholder claims	8.0	–	–	3.6	–	–	11.6
Income taxes	2.4	–	–	–	–	–	2.4
Cash and cash equivalents	200.8	43.0	(41.6)	35.3	(38.0)	–	199.5
Total assets	4,854.6	43.0	(41.6)	177.6	(38.0)	17.4	5,013.0

	Chesnara consolidated net assets at 30 June 2013 ⁽¹⁾	Debt raising ⁽²⁾	Acquisition of Direct Line Life and transaction expenses ⁽³⁾	Net assets of Direct Line Life at 31 December 2012 ⁽⁴⁾	Pre acquisition dividends/capital extraction ⁽⁵⁾	Intangible Assets ⁽⁶⁾	Chesnara pro forma consolidated net assets
	£ million	£ million	£ million	£ million	£ million	£ million	£ million
Liabilities							
Insurance contract provisions	2,226.7	–	–	102.9	–	–	2,329.6
Other provisions	4.6	–	–	–	–	–	4.6
Financial liabilities							
Investment contracts at fair value through income	2,152.7	–	–	–	–	–	2,152.7
Liabilities relating to policyholders' funds held by the Group	95.5	–	–	–	–	–	95.5
Borrowings	50.1	43.0	–	3.5	–	–	96.6
Derivative financial instruments	0.6	–	–	–	–	–	0.6
Total financial liabilities	2,298.9	43.0	–	3.5	–	–	2,345.4
Deferred tax liabilities	7.8	–	–	–	–	–	7.8
Reinsurance payables	15.3	–	–	–	–	–	15.3
Payables related to direct insurance and investment contracts	38.7	–	–	5.3	–	–	44.0
Deferred income	8.4	–	–	–	–	–	8.4
Income taxes	2.5	–	–	2.1	–	–	4.6
Other payables	25.8	–	–	3.9	–	–	29.7
Bank overdrafts	1.6	–	–	–	–	–	1.6
Total liabilities	4,630.3	43.0	–	117.7	–	–	4,791.0
Net assets	224.3	–	(41.6)	59.9	(38.0)	17.4	222.0

Notes:

- The consolidated financial information of Chesnara has been extracted without adjustment from the unaudited consolidated interim financial statements of Chesnara for the six months ended 30 June 2013.
- £73.8 million will be raised as a result of an agreement for a new bank facility. £30.0 million of this will be used to settle the existing facility, resulting in an increase in borrowings of £43.8 million. This has been presented net of £0.8 million of arrangement fees.
- This represents the acquisition price of Direct Line Life of £39.3 million as disclosed in Part V of this document plus estimated transaction costs of £2.3 million.
- The net assets of Direct Line Life have been extracted without adjustment from the financial information included in Part III of this document.
- Dividends to the Seller post 31 December 2012 out of Direct Line Life's reserves are as follows:
 - an interim dividend of £7.0 million settled on 25 January 2013.
 - a further interim dividend of £8.0 million settled on 18 June 2013.
 - a further planned interim dividend of £23.0 million payable to the seller on completion of the Acquisition.
- The intangible assets adjustment of £17.4 million is made up of two components:
 - £10.2 million, representing an estimate of the fair value of the acquired value of Direct Line Life in-force business.
 - Goodwill arising on acquisition of £7.2 million, calculated as follows:

	£ million
Net assets per financial information	59.9
Less: dividends (note 5)	(38.0)
Add: Fair value of the acquired value of Direct Line Life in-force business	10.2
Net assets acquired	32.1
Purchase price	39.3
Goodwill	7.2

This calculation does not reflect the impact of any fair value adjustments in relation to the identifiable net assets acquired other than the acquired value of in-force business.

SECTION B

Accountants Opinion on Pro Forma Financial Information

Deloitte.

Deloitte LLP
2 Hardman Street
Manchester
M3 3HF

The Board of Directors
Chesnara plc
Harbour House
Portway
Ashton-on-Ribble
Preston
Lancashire
PR2 2PR

Canaccord Genuity Limited
88 Wood Street
London
EC2V 7QR

21 October 2013

Dear Sirs,

Chesnara plc (the “Company”)

We report on the pro forma financial information (the “**Pro forma financial information**”) set out in Part IV of the Class 1 circular dated 21 October 2013 (the “**Investment Circular**”), which has been prepared on the basis described on page 46, for illustrative purposes only, to provide information about how the transaction might have affected the financial information presented on the basis of the accounting policies adopted by the Company in preparing the financial statements for the period ended 30 June 2013. This report is required by Annex I item 20.2 of Commission Regulation (EC) No 809/2004 (the “**Prospectus Directive Regulation**”) as applied by Listing Rule 13.3.3R and is given for the purpose of complying with that requirement and for no other purpose.

Responsibilities

It is the responsibility of the directors of the Company (the “**Directors**”) to prepare the pro forma financial information in accordance with Annex I item 20.2 and Annex II items 1 to 6 of the Prospectus Directive Regulation as applied by Listing Rule 13.3.3R.

It is our responsibility to form an opinion, in accordance with Annex I item 20.2 of the Prospectus Directive Regulation, as to the proper compilation of the pro forma financial information and to report that opinion to you in accordance with Annex II item 7 of the Prospectus Directive Regulation as applied by Listing Rule 13.3.3R.

Save for any responsibility which we may have to those persons to whom this report is expressly addressed and which we may have to ordinary shareholders as a result of the inclusion of this report in the Investment Circular, to the fullest extent permitted by law we do not assume any responsibility and will not accept any liability to any other person for any loss suffered by any such other person as a result of, arising out of, or in connection with this report or our statement, required by and given solely for the purposes of complying with Listing Rule 13.4.1R (6), consenting to its inclusion in the Investment Circular.

In providing this opinion we are not updating or refreshing any reports or opinions previously made by us on any financial information used in the compilation of the Pro forma financial information, nor do we accept responsibility for such reports or opinions beyond that owed to those to whom those reports or opinions were addressed by us at the dates of their issue.

Basis of Opinion

We conducted our work in accordance with the Standards for Investment Reporting issued by the Auditing Practices Board in the United Kingdom. The work that we performed for the purpose of making this report, which involved no independent examination of any of the underlying financial information, consisted primarily of comparing the unadjusted financial information with the source documents, considering the evidence supporting the adjustments and discussing the pro forma financial information with the Directors.

We planned and performed our work so as to obtain the information and explanations we considered necessary in order to provide us with reasonable assurance that the pro forma financial information has been properly compiled on the basis stated and that such basis is consistent with the accounting policies of the Company.

Our work has not been carried out in accordance with auditing or other standards and practices generally accepted in jurisdictions outside the United Kingdom, including the United States of America, and accordingly should not be relied upon as if it had been carried out in accordance with those standards or practices.

Opinion

In our opinion:

- (a) the Pro forma financial information has been properly compiled on the basis stated; and
- (b) such basis is consistent with the accounting policies of the Company.

Yours faithfully

Deloitte LLP
Chartered Accountants

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Deloitte LLP is the United Kingdom member firm of Deloitte Touche Tohmatsu Limited ("DTTL"), a UK private company limited by guarantee, whose member firms are legally separate and independent entities. Please see www.deloitte.co.uk/about for a detailed description of the legal structure of DTTL and its member firms.

PART V – PRINCIPAL TERMS OF THE ACQUISITION AGREEMENT

1. DOCUMENT AND PARTIES

The Acquisition Agreement is dated 7 October 2013 and is made between the Seller and the Company.

2. ACQUISITION AND PURCHASE PRICE

The Company has agreed to purchase the entire issued share capital of Direct Line Life from the Seller for consideration of £39.3 million (the “**Purchase Price**”) payable in cash on completion of the Acquisition Agreement (“**Completion**”).

3. CONDITIONS AND CLOSING

3.1 Completion is conditional upon the satisfaction of the following conditions:

- (a) the passing, at a general meeting of the Company, of a resolution to approve the acquisition of Direct Line Life;
 - (b) the PRA having either approved or not absolutely objected to the Company acquiring control over Direct Line Life, in accordance with the provisions of FSMA 2000,
- each of (a) and (b) being a “**Condition**” and together, the “**Conditions**”.

3.2 If the Conditions have not been satisfied by the date six months from the date of the Acquisition Agreement, or such date as the parties have otherwise agreed (the “Long-Stop Date**”), the Acquisition Agreement shall terminate.**

4. WARRANTIES, INDEMNITIES AND CONTRIBUTIONS

4.1 The Acquisition Agreement contains customary warranties for an acquisition of this type.

4.2 The Seller will be giving the warranties as at the date of the Acquisition Agreement.

4.3 The Seller has agreed to indemnify the Company specifically in relation to:

- (a) claims made in respect of advice or a recommendation made by Direct Line Life in connection with the sale of payment protection insurance policies underwritten by Direct Line Life; and
- (b) claims by certain subsidiary banks of The Royal Bank of Scotland Group plc in connection with the single payment protection policies sold by such subsidiary banks between 2001 and December 2008.

4.4 The Company has agreed that it will pay to the Seller on Completion a proportion of the charges levied or to be levied by member(s) of the Seller’s group on Direct Line Life in respect of management and/or administrative services provided by such member(s) of the Seller’s group to Direct Line Life in the period from 1 September 2013 to Completion to the extent that such charges have not been settled by the Company prior to Completion.

5. COVENANTS

5.1 The Acquisition Agreement contains a number of customary covenants in respect of the Seller’s conduct of the business of Direct Line Life prior to Completion. In particular, the Seller has covenanted to procure that during the period from the date of the Acquisition Agreement to Completion, the business of Direct Line Life will be carried on in the ordinary and proper course consistent with the manner it was carried on in the 12 month period prior to the date of the Acquisition Agreement and certain specified actions will not be taken by either the Seller or Direct Line Life without the consent of the Company.

5.2 The Seller has also agreed that, for a period of 24 months from the date of Completion, it and each member of its group shall refrain from:

- (a) disclosing or using confidential information or trade secrets in relation to the business or affairs of Direct Line Life for marketing purposes, except for information that is in the public domain; and

- (b) conducting or organising any marketing campaign or other co-ordinated marketing effort intended to induce, solicit or encourage policyholders to surrender, cancel or terminate their policies or to suspend or cease the payment of premiums, save that the Seller shall not be restricted from operating its existing business in the ordinary and proper course.

6. TERMINATION

6.1 The Acquisition Agreement may only be terminated as follows:

- (a) automatically if the Conditions have not been satisfied by the Long-Stop Date;
- (b) by the Company if:
 - (i) there is any material breach by the Seller of certain obligations under the Acquisition Agreement that has or would be likely to give rise to a material adverse effect on the Embedded Value (being an effect having or likely to have an adverse impact of more than £2,000,000) other than any adverse effect resulting from or attributable to:
 - (A) changes in the UK or global economy;
 - (B) any act of civil unrest, war or terrorism;
 - (C) a natural or manmade disaster or other acts of God;
 - (D) any action taken at the request or with the consent of the Company;
 - (E) changes in law, interpretation of law or regulation generally affecting the sectors in which Direct Line Life conducts its business;
 - (F) the negotiation, execution, announcement, performance of, or actions taken pursuant to the Acquisition Agreement and any agreement entered into pursuant to the terms of the Acquisition Agreement; or
 - (G) any of the matters fairly disclosed by the Seller to the Company in the data room or the disclosure letter.

6.2 In the event that the Directors withdraw or adversely qualify their recommendation of the Resolution to Shareholders and the Resolution is not passed by the Shareholders, the Company must pay £200,000 in compensation to the Seller unless the reason for the failure, withdrawal or qualification is directly related to Direct Line Life or to the business of Direct Line Life.

7. LIMITATIONS ON LIABILITY

- 7.1 The Acquisition Agreement contains customary limits on the Seller's liability. The Seller will only be liable in respect of claims under the warranties for claims which individually exceed £10,000 (each a "**Qualifying Claim**") and only where the Qualifying Claims, in aggregate, exceed £200,000.
- 7.2 Save in the case of fraud and fraudulent concealment, the aggregate liability of the Seller in respect of claims under the warranties, the tax deed and specific indemnities will not exceed £15,000,000.
- 7.3 The Seller will not be liable for:
 - (a) any claim relating to breaches of the warranties (other than in relation to tax matters), unless the Seller has received written notice from the Company setting out the details of the breach on or before the second anniversary of Completion; and
 - (b) any claim relating to breaches of the tax warranties or the tax deed, unless the Seller has received written notice from the Company setting out the details of the breach on or before the seventh anniversary of Completion.

8. TRANSITIONAL SERVICES

- 8.1 Following Completion, certain subsidiaries of the Seller provide the following services to Direct Line Life:
 - (a) administrative services required to enable Direct Line Life to carry on its business in the ordinary course (the "**Administrative Services**"), using employees of the Seller's group who are currently performing similar services ("**Employees**"); and

- (b) certain transitional services which are intended to assist Direct Line Life in transferring responsibility for providing the Administrative Services to HCL, which provides similar services to the Group pursuant to an existing contract,

together (the “**Services**”). The Seller’s subsidiaries will be paid monthly fees based on actual costs incurred in consideration of providing the Services. The Services, and costs, will terminate upon completion of the transfer of the Administrative Services to HCL, which is expected to occur on or about 30 November 2014 (or such other date as may be agreed). Direct Line Life, HCL and the Sellers’ subsidiaries have agreed an outline timetable and schedule of responsibilities for this purpose. At the end of the term of the TSA, the parties acknowledge this will likely give rise to a relevant transfer for the purposes of the Transfer of Undertakings (Protection of Employment) Regulations 2006, and the Seller’s subsidiaries shall assist with the required transfer process and/or redundancy process. Direct Line Life has agreed to indemnify the Seller’s subsidiaries in respect of certain liabilities arising if Employees are dismissed on the grounds of redundancy in connection with the transfer of the Administrative Services at the end of the term.

PART VI – ADDITIONAL INFORMATION

1. Responsibility

The Company and the Directors, whose names appear on page 3 of this document, accept responsibility for the information contained in this document. To the best of the knowledge and belief of the Company and the Directors (who have taken all reasonable care to ensure that such is the case) the information contained in this document is in accordance with the facts and does not omit anything likely to affect the import of such information.

2. Company address

The registered office and the principal place of business in the UK of the Company is at Harbour House, Portway, Preston, Lancashire PR2 2PR (telephone number 01772 840 000 or, if dialling from outside the UK, + 44 1772 840 000).

3. Interests of Directors and major Shareholders

- 3.1 As at 17 October 2013 (being the latest practicable date prior to the posting of this document), the aggregate interests of each of the Directors in the share capital of the Company which have been notified by each Director to the Company pursuant to DTRs 3.1.2R and 3.1.3R or the interests of persons connected with them which would, if the connected person were a Director, be required to be disclosed under DTRs 3.1.2R and 3.1.3R and the existence of which is known to, or could with reasonable diligence be ascertained by, that Director were as follows. The Company's issued share capital consists of 115,047,662 Ordinary Shares, of which 194,183 are held in treasury, thus total voting rights in the Company are 114,853,479:

	Number of Ordinary Shares	% of issued voting share capital
Directors		
Peter Mason	19,768	0.02
Graham Kettleborough	68,100	0.06
Frank Hughes	5,832	0.01
David Rimmington	2,127	0.00
David Brand	–	–
Mike Evans	–	–
Veronica France	–	–
Peter Wright	70,000	0.06

- 3.2 The Board has established frameworks for a sharesave plan and approved unapproved discretionary share option plans which may, at the discretion of the Company's remuneration committee, be utilised for granting options to executive Directors and other employees. As at 17 October 2013 (being the latest practicable date prior to the posting of this document), share options have been granted to Directors under a sharesave plan offering made to all UK employees in October 2011, following approval of the scheme by shareholders at the 2011 Annual General Meeting.
- 3.3 Save as disclosed in paragraph 3.1 above, the Directors do not have any interest in the share capital of the Company.
- 3.4 Related party transactions of the Company between 1 January 2013 and 17 October 2013 (being the latest practicable date prior to the publication of this document) comprise (a) Directors' compensation; (b) the provision of centralised administration functions to subsidiaries of the Company; and (c) transactions with companies within the Chesnara plc group which were controlled or significantly influenced by Directors, each as further detailed below.

- (a) The following amounts were paid in compensation to the Directors, who are the key management personnel of the Company during the period from 1 January 2010:

	From 1 January 2013 to 17 October 2013	Year ended 31 December		
		2012	2011	2010
	£000	£000	£000	£000
Short-term employee benefits	711	1,028	700	628
Post-employment benefits	100	109	96	91
Long-term employment benefits	–	39	–	347
Total	811	1,176	796	1,066

- (b) The following amounts were payable to Directors in respect of bonuses and incentives during the period from 1 January 2010:

	From 1 January 2013 to 17 October 2013	31 December		
		2012	2011	2010
	£000	£000	£000	£000
Annual bonus scheme	–	339	84	143
Long-term incentive plan	330	330	292	345
Discretionary bonus	55	155	155	210
Total	385	824	531	698

- (c) Subsidiaries of the Company were charged the following amounts for central services provided during the period from 1 January 2010:

	From 1 January 2013 to 17 October 2013	Year ended 31 December		
		2012	2011	2010
	£000	£000	£000	£000
Transactions with subsidiaries	2,595	2,834	2,775	2,158

- 3.5 So far as the Company is aware, as at 17 October 2013 (being the latest practicable date prior to the publication of this document), the following persons (other than Directors) had notifiable interests in three per cent or more of the entire issued voting share capital of the Company pursuant to DTR 5:

	Number of Ordinary Shares	% of issued voting share capital
Amerprise Financial, Inc. (Threadneedle Asset Management)	14,898,826	12.97
Artemis Investment Management LLP	12,845,608	11.18
Standard Life Investments Limited	4,172,345	3.63
Legal and General Group	4,130,698	3.60

4. Directors service agreements and letters of appointment

The Company has entered into service contracts with each of Graham Kettleborough and Frank Hughes, dated 1 March 2004 which took effect from the demerger of the Company from Countrywide Assured group (now CA) in May 2004 and with David Rimmington on 17 May 2013. Prior to this date, David Rimmington held the position of Associate Finance Director and formed part of the Senior Management Team until his appointment as Finance Director on 17 May 2013. In addition to salary, each executive Director is entitled to bonus at the discretion of the remuneration committee. Other benefits include a company car, private health insurance and the right to participate in the Company's stakeholder pension scheme and its share option schemes (although no awards have yet been made under the latter). The employment is capable of termination, in each case, on 12 months' notice by either party, or a Director may be summarily dismissed for, amongst other things, neglect of duty, non-observance of their service agreement provisions, prejudicial conduct, a criminal conviction

(except for minor road traffic offences) or becoming bankrupt. During the course of his employment and afterwards, the Director agrees to keep information relating to the Group confidential. The Directors have also agreed to post-employment non-solicitation clauses of six months duration. The Directors benefit from qualifying third party indemnity provisions.

The Company has entered into letters of appointment with each of the non-executive Directors. The non-executive Directors comprise Peter Mason (Chairman and Chairman of the Nomination Committee, member of Audit & Risk Committee and Remuneration Committee), Veronica France (member of Nomination and Audit & Risk Committees and Chair of Remuneration Committee), David Brand (member of Nomination and Audit & Risk Committees), Peter Wright (member of Nomination Committee and Chair of the Audit & Risk Committee) and Mike Evans (Senior Independent Director and member of Audit & Risk, Nomination and Remuneration Committees). The non-executive Directors are not eligible for bonuses, pensions or participation in the Company share option schemes. Each letter of appointment is for a term of three years.

As disclosed in the Company's accounts for the year ended 31 December 2012, any compensation on termination of service contracts will be decided on a case by case basis having regard to the particular circumstances. There are no contractual entitlements to benefits on termination of appointments.

The identity of the Directors of the Company will not change on completion of the Acquisition.

5. Material contracts

5.1 The following contracts (not being contracts entered into in the ordinary course of business) have been entered into by members of the Group (i) in the two years immediately preceding the date of this document and are, or may be, material to the Group or (ii) contain provisions under which any member of the Group has any obligation or entitlement which is material to the Group as at the date of this document:

- (a) the Acquisition Agreement and the TSA, the principal terms of which are set out in Part V of this document;
- (b) the Facility Agreement entered into on 7 October 2013 between Chesnara and The Royal Bank of Scotland plc as mandated lead arranger, original lender and as facility agent in relation to a £73,800,000 credit facility made up of two separate facilities as follows:
 - (i) facility A which will be repayable in yearly instalments with the first instalment due on the date which is 12 months after the earlier of 31 December 2013 and Completion and the final instalment will be due on the date which is the earlier of 60 months from completion of the Acquisition or 31 December 2013. Facility A will be made available in two tranches comprising (i) £30,000,000 available to refinance the existing term loan facility with The Royal Bank of Scotland plc; and (ii) an amount up to £31,000,000 to be available to finance the consideration payable to the Seller under the Acquisition Agreement and the costs of the Acquisition; and
 - (ii) facility B for an amount up to £12,800,000 which will be repayable on the date which is the earlier of 18 months from completion of the Acquisition or 30 June 2015 to be available to finance the consideration payable to the Seller under the Acquisition Agreement and the costs of the Acquisition.

The Facility Agreement is entered into for the purposes of refinancing the existing £30,000,000 term loan facility entered into between Chesnara and The Royal Bank of Scotland plc and for the purposes of funding the Acquisition (including the costs of the Acquisition). Repayment of the Facility is mandatory in certain circumstances, including upon an acceleration following an event of default, a change of control in Chesnara or upon The Royal Bank of Scotland plc notifying Chesnara that it has become unlawful in any applicable jurisdiction for it to perform any of its obligations under the Facility or to fund or maintain its share of the loan. The representations, warranties, undertakings and events in the Facility Agreement are customary for a transaction of this nature.

- (c) an agreement between Chesnara and JPMorgan Asset Management Marketing Limited dated 26 November 2010 pursuant to which Chesnara agreed to acquire S&P for consideration of £63.5 million payable in cash on completion of the acquisition together with interest on such purchase price for the period from (and excluding) the date of the S&P acquisition agreement up

to (and including) the date of completion at the rate of the London Interbank Offer Rate at the date of completion.

5.2 The following contracts (not being contracts entered into in the ordinary course of business) have been entered into by Direct Line Life (a) in the two years immediately preceding the date of this document and are, or may be, material to Direct Line Life or (b) contain provisions under which Direct Line Life has any obligation or entitlement which is material to Direct Line Life as at the date of this document:

- (a) a settlement deed entered into between Direct Line Insurance Services Limited, UK Insurance Limited (“UKIL”), Direct Line Insurance Group plc, Direct Line Life, Direct Line Group Limited, Tesco Personal Finance plc, Tesco plc and Tesco Personal Finance Group Limited on 26 September 2012 pursuant to which the parties agree to settle any claims and disputes arising at or prior to the date of the settlement deed pursuant to agreements between the parties for the distribution of general insurance policies and the underwriting of life insurance policies. The deed also provides for the repayment of a loan made by Tesco Personal Finance plc to Direct Line Life. The loan has now been repaid. Tesco Personal Finance plc consents, in the settlement deed, to the use of trade marks by UKIL, Direct Line Life and its affiliates to effect the run-off and to comply with regulatory responsibilities;
- (b) a services agreement between Direct Line Life and UKIL dated 12 November 2004 by which UKIL agrees to administer all claims payments arising from life insurance products provided by Direct Line Life. On Completion, the services agreement will terminate and be replaced with a life insurance services agreement on arm’s length terms between the Company and UKIL. The life insurance services agreement will continue in force, subject to earlier termination by either party, until all relevant insurance policies have expired or terminated and all claims relating thereto have been settled; and
- (c) an insurance intermediation agreement dated 26 September 2012 pursuant to which Direct Line Life has agreed to underwrite, administer and manage certain payment protection insurance policies distributed by The Royal Bank of Scotland plc and National Westminster Bank plc (the “Banks”) in respect of legacy business only. The parties to the agreement agree to enter into trade mark licences to enable use by the other parties of their respective trade marks. Direct Line Life has no right to terminate the agreement on notice. The Banks are entitled to terminate upon a change of control of Direct Line Life, in which case Direct Line Life is obliged to administer the relevant insurance policies until expiry. A letter of waiver has been obtained from the Banks confirming that they waive their right to terminate the agreement and the payment protection insurance schemes on the change of control of Direct Line Life pursuant to the Acquisition.

6. Working capital of the Enlarged Group

The Company is of the opinion that the Enlarged Group has sufficient working capital for its present requirements, that is, for at least the next 12 months from the date of this document.

7. Litigation

- 7.1 There has been no governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Company is aware), during the 12 months prior to the date of this document which may have or have had in the recent past significant effects on the Company’s or any member of the Group’s financial position or profitability.
- 7.2 There has been no governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Company is aware), during the 12 months prior to the date of this document which may have or have had in the recent past significant effects on Direct Line Life’s financial position or profitability.

8. Significant change

- 8.1 Other than the payment of dividends totalling £7.2 million, there has been no significant change in the financial or trading position of the Group since 30 June 2013, being the date of the last financial statements of the Company.
- 8.2 Other than the payment of dividends totalling £15 million, there has been no significant change in the financial or trading position of Direct Line Life since 31 December 2012 being the date to which the latest audited financial information shown in Part III of this document has been prepared.

9. Consent

- 9.1 Canaccord Genuity Limited has given and not withdrawn its written consent to the issue of this document with the inclusion in it of references to its name in the form and context in which it appears.
- 9.2 Deloitte LLP (a member of the Institute of Chartered Accountants in England and Wales), has given and has not withdrawn its written consent to the inclusion in this document of its reports included in Part III and Part IV of this document in the form and context in which it appears.
- 9.3 The Royal Bank of Scotland plc has given and not withdrawn its written consent to the issue of this document with the inclusion in it of references to its name in the form and context on which it appears.

10. Documents available for inspection and available information

Copies of the following documents will be available for inspection at the offices of Ashurst LLP, Broadwalk House, 5 Appold Street, London EC2A 2HA and at the registered office of the Company during normal business hours on any weekday (Saturdays, Sundays and public holidays excepted) until the conclusion of the General Meeting:

- (a) the memorandum and articles of association of the Company;
- (b) the report by Deloitte LLP on the historical financial information on Direct Line Life set out at Part III of this document;
- (c) the report by Deloitte LLP on the pro forma financial information set out at Part IV of this document;
- (d) the published audited consolidated accounts of the Group for the two financial years ended 31 December 2011 and 31 December 2012;
- (e) the Acquisition Agreement; and
- (f) this document.

PART VII – DEFINITIONS

The following definitions apply throughout this document and the accompanying Form of Proxy, unless the context otherwise requires:

“Acquisition”	the proposed acquisition by the Company of the entire issued share capital of Direct Line Life pursuant to the Acquisition Agreement;
“Acquisition Agreement”	the conditional acquisition agreement between the Company and the Seller dated 7 October 2013 relating to the Acquisition, the principal terms of which are set out in Part V of this document;
“Articles”	the articles of association of the Company as amended from time to time;
“CA”	Countrywide Assured plc;
“CALH”	Countrywide Assured Life Holdings Limited and its subsidiary companies;
“Canaccord”	Canaccord Genuity Limited;
“Chesnara” or “the Company”	Chesnara plc;
“Completion”	completion of the Acquisition;
“Directors or Board”	the directors of the Company as at the date of this document whose names are set out on page 3 of this document;
“Direct Line Life”	Direct Line Life Insurance Company Limited, a company incorporated under the laws of England and Wales with company number 02199286;
“DTRs”	the FCAs Disclosure Rules and Transparency Rules;
“Enlarged Group”	the Group as enlarged by the acquisition of Direct Line Life;
“Facility”	a new loan facility for £73,800,000 million with Royal Bank of Scotland plc, further details of which are set out in paragraph 5 of Part VI of this document;
“Facility Agreement”	the agreement between, <i>inter alia</i> , the Company and The Royal Bank of Scotland plc dated 7 October 2013 relating to the Facility;
“FI”	Finansinspektionen, being the Swedish Financial Supervisory Authority;
“Financial Conduct Authority or FCA”	the Financial Conduct Authority of the UK in its capacity as the competent authority for the purposes of Part VI of FSMA and in the exercise of its functions in respect of admission to the Official List otherwise than in accordance with Part VI of FSMA 2000;
“Form of Proxy”	the form of proxy relating to the General Meeting being sent to Shareholders with this document;
“FSMA 2000”	the Financial Services and Markets Act 2000 of England and Wales, as amended;
“General Meeting”	the general meeting of the Company convened for 7 November 2013 (or any adjournment of it), notice of which is set out at the end of this document;
“Group”	the Company and its existing subsidiary undertakings;

“Guardian”	Guardian Assurance plc;
“HCL”	HCL Insurance BPO Services Limited;
“IFRS”	International Financial Reporting Standards;
“Listing Rules”	the listing rules made by the FCA under Part VI of FSMA 2000 (as amended from time to time);
“London Stock Exchange”	London Stock Exchange plc;
“Movestic”	Movestic Livförsäkring AB;
“Official List”	the Official List of the Financial Conduct Authority;
“Ordinary Shares”	ordinary shares of five pence each in the capital of the Company;
“PRA”	the Prudential Regulation Authority;
“Prospectus Rules”	the rules made by the FCA under Part VII of FSMA in relation to offers of transferable securities to the public and admission of transferable securities to trading on a regulated market (as amended from time to time);
“Resolution”	the resolution set out in the notice of General Meeting set out in this document;
“S&P”	Save & Prosper Insurance Limited and Save & Prosper Pensions Limited;
“Seller”	Direct Line Insurance Group plc;
“Shareholder(s)”	holder(s) of Ordinary Shares;
“Swedish Business”	Movestic and its subsidiaries and associated companies;
“Swiss Re”	Swiss Reinsurance Company Limited;
“TSA”	the Transitional Services Agreement to be entered into between certain subsidiaries and Direct Line Life following Completion for the provision of the transitional services as set out in paragraph 8 of Part V;
“UK or United Kingdom”	the United Kingdom of Great Britain and Northern Ireland; and
“UK Business”	CA, CALH and, following the Acquisition, Direct Line Life.

Chesnara plc

NOTICE OF GENERAL MEETING

NOTICE is hereby given that a General Meeting of Chesnara plc (the “**Company**”) will be held at 11.00 a.m. on 7 November 2013 at the offices of Canaccord Genuity Limited, 41 Lothbury, London, EC2R 7AE for the purpose of considering and, if thought fit, passing the following resolution which it is intended to propose as an ordinary resolution:

ORDINARY RESOLUTION

THAT the proposed acquisition by the Company of the entire issued share capital of Direct Line Life Insurance Company Limited (the “**Acquisition**”) be and is hereby approved on the terms and conditions contained in the acquisition agreement dated 7 October 2013 between the Company and Direct Line Insurance Group plc and set out in the circular to the Company’s shareholders dated 21 October 2013 of which the Notice forms part and that each and any of the directors of the Company and the secretary of the Company be authorised to conclude and implement the Acquisition with such non-material amendments thereto as the directors of the Company (or any duly constituted committee thereof) may consider appropriate.

By order of the board

Mary Fishwick
Secretary

21 October 2013

Registered Office: Harbour House, Portway Ashton on Ribble, Preston, Lancashire PR2 2PR

Registered in England and Wales No: 04947166

Notes:

1. Only holders of Ordinary Shares are entitled to attend and vote at the General Meeting. A member is entitled to appoint another person as his proxy to exercise all or any of his rights to attend, to speak and to vote at the General Meeting. A member may appoint more than one proxy in relation to the meeting, provided that each proxy is appointed to exercise the rights attached to a different share or shares held by him. A proxy need not be a member of the Company.
2. A Form of Proxy is enclosed with this notice and instructions for completion are shown on the form. Forms of Proxy need to be deposited with the Company’s registrars, Capita Asset Services at PXS, 34 Beckenham Road, Beckenham, Kent BR3 4TU, so as to arrive by no later than 11.00 a.m. on 5 November 2013. Completion of a Form of Proxy, or other instrument appointing a proxy or any CREST Proxy Instruction, does not preclude members attending and voting in person at the General Meeting, should they so wish.
3. Shareholders may submit their proxy online via the registrars website at www.capitashareportal.com. Enter Chesnara into the search box and click on the company’s name to be taken to the login page. From there, shareholders can log into their account or register for the share portal.
4. Alternatively, if you are a member of CREST, you may register the appointment of a proxy by using the CREST electronic proxy appointment service. Further details are contained below.
5. CREST members who wish to appoint a proxy or proxies through the CREST electronic proxy appointment service may do so for the General Meeting and any adjournment(s) thereof by using the procedures, and to the address, described in the CREST Manual (available via www.euroclear.com/CREST) subject to the provisions of the Company’s articles of association. CREST personal members or other CREST sponsored members, and those CREST members who have appointed a voting service provider(s), should refer to their CREST sponsor or voting service provider(s), who will be able to take the appropriate action on their behalf.
6. In order for a proxy appointment or instruction made using the CREST service to be valid, the appropriate CREST message (a “**CREST Proxy Instruction**”) must be properly authenticated in accordance with Euroclear UK and Ireland Limited’s (“**Euroclear**”) specifications and must contain the information required for such instructions, as described in the CREST Manual. The message, regardless of whether it constitutes the appointment of a proxy or an amendment to the instruction given to a previously appointed proxy, must, in order to be valid, be transmitted so as to be received by the issuers agent (ID RA10) 11.00 a.m. on 5 November 2013. For this purpose, the time of receipt will be taken to be the time (as determined by the time stamp applied to the message by the CREST Applications Host) from which the issuers agent is able to retrieve the message by enquiry to CREST in the manner prescribed by CREST. After this time any change of instructions to proxies appointed through CREST should be communicated to the appointee through other means.
7. CREST members and, where applicable, their CREST sponsors or voting service provider(s) should note that Euroclear does not make available special procedures in CREST for any particular messages. Normal system timings and limitations will therefore apply in relation to the input of CREST Proxy Instructions. It is the responsibility of the CREST member concerned to take (or, if the CREST member is a CREST personal member or sponsored member or has appointed a voting service provider(s), to procure that his CREST sponsor or voting service provider(s) take(s)) such action as shall be necessary to ensure

that a message is transmitted by means of the CREST system by any particular time. In this connection, CREST members and, where applicable, their CREST sponsors or voting service provider(s) are referred, in particular, to those sections of the CREST Manual concerning practical limitations of the CREST system and timings.

8. The Company may treat as invalid a CREST Proxy Instruction in the circumstances set out in Regulation 35(5)(a) of the Uncertificated Securities Regulations 2001.
9. Pursuant to regulation 41 of the Uncertificated Securities Regulations 2001, the Company specifies that in order to have the right to attend and vote at the General Meeting (and also for the purpose of determining how many votes a person entitled to attend and vote may cast), a person must be entered on the register of members of the Company at 6.00 p.m. on 5 November 2013, or, in the event of any adjournment, at 6.00 p.m. on the date which is two days before the day of the adjourned meeting. Changes to entries on the register of members after this time shall be disregarded in determining the rights of any person to attend or vote at the meeting.
10. Any corporation which is a member can appoint one or more corporate representatives who may exercise on its behalf all of its powers as a member provided they do not do so in relation to the same shares.
11. Any person to whom this notice is sent who is a person nominated under section 146 of the Companies Act 2006 to enjoy information rights (a “**Nominated Person**”) may have a right, under an agreement between him/her and the member by whom he/she was nominated, to be appointed (or to have someone else appointed) as a proxy for the General Meeting. If a Nominated Person has no such proxy appointment right or does not wish to exercise it, he/she may have a right, under such an agreement, to give instructions to the member as to the exercise of voting rights.

The statement of the above rights of the members in relation to the appointment of proxies does not apply to Nominated Persons. Those rights can only be exercised by members of the Company.
12. Any member attending the General Meeting has the right to ask questions. The Company must cause to be answered any such question relating to the business being dealt with at the meeting but no such answer need be given if (a) to do so would interfere unduly with the preparation for the meeting or involve the disclosure of confidential information, (b) the answer has already been given on a website in the form of an answer to a question, or (c) it is undesirable in the interests of the company or the good order of the meeting that the question be answered.
13. A copy of this notice, and other information required by section 311A of the Companies Act 2006, can be found at www.chesnara.co.uk.
14. You may not use any electronic address (within the meaning of section 333(4) of the Companies Act 2006) provided in this Notice of Meeting (or in any related documents including this Circular to shareholders and any proxy form) to communicate with the Company for any purposes other than those expressly stated.
15. As at 17 October 2013 (being the last practicable day prior to the publication of this notice), the Company’s issued share capital consists of 115,047,662 ordinary shares of which 194,183 are held in treasury. Therefore the total voting rights in the Company as at 17 October 2013 are 114,853,479.

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