Company Registration No: 00042133

# THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

## DIRECTORS' REPORT AND FINANCIAL STATEMENTS

## 31 DECEMBER 2005

Group Secretariat
The Royal Bank of Scotland Group plc
3 Princess Way
Redhill
Surrey
RH1 1NP

**THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED**

**CONTENTS** **PAGES**

## THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

### OFFICERS AND PROFESSIONAL ADVISORS

| | |
|---|---|
| **DIRECTORS:** | I H Chippendale<br>A E Court<br>C R Crawford<br>I Falconer<br>M A Fisher<br>M A Hesketh<br>R D Houghton<br>N C McLuskie |
| **SECRETARY:** | P A Hutchings |
| **REGISTERED OFFICE:** | Crown House<br>145 City Road<br>London<br>EC1V 1LP |
| **AUDITORS:** | Deloitte & Touche LLP<br>London |

**Registered in England and Wales**

## THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

### DIRECTORS' REPORT

The directors present their report and the audited financial statements for the year ended 31 December 2005.

The directors note with sadness the death of Mr P J Atkinson, Joint Company Secretary, on 21 January 2006.

### ACTIVITIES AND BUSINESS REVIEW

The Company's principal activity during the year was the provision of general insurance.

*The retained profit for the period was £32.6 million (2004: £7.5 million) and this was transferred to reserves. The directors* do not recommend the payment of a dividend in respect of the year ended 31 December 2005 (2004: £nil).

The financial and risk management objectives of the Company and the information on the Company's exposure to insurance, market, credit and liquidity risk are contained in note 3 to the financial statements.

The directors do not anticipate any material change in either the type or level of activities of the Company.

### DIRECTORS AND SECRETARY

The present directors and secretary are listed on page 1.

From 1 January 2005 to date the following changes have taken place:

| | Appointed | Resigned |
|---|---|---|
| **Directors** | | |
| R D Houghton | 18 January 2005 | |
| J B O'Roarke | | 30 June 2005 |
| C H D Earle | | 19 August 2005 |
| B Higgins | | 5 January 2006 |
| M A Hesketh | 23 January 2006 | |
| ***Secretary*** | | |
| P A Hutchings | 20 May 2005 | |

### DIRECTORS' RESPONSIBILITIES

The directors are required by the Companies Act 1985 to prepare accounts for each financial year and have elected to prepare them in accordance with International Financial Reporting Standards. They are responsible for preparing accounts that present fairly the financial position, financial performance, and cash flows of the Company. In preparing those accounts, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- *make judgements and estimates that are reasonable and prudent;*
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the accounts; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the Annual report and accounts complies with the Companies Act 1985. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

### DIRECTORS' INDEMNITIES

In terms of Section 309c of The Companies Act 1985 (as amended), Mr I H Chippendale, Miss A E Court, Mr C R Crawford, Mr I Falconer, Mr M A Fisher, Mr M A Hesketh and Mr R D Houghton have been granted Qualifying Third Party Indemnity Provisions by The Royal Bank of Scotland Group plc.

## THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

### DIRECTORS' REPORT

### DIRECTORS' INTERESTS

No director had an interest in the shares of the Company.

The following director was beneficially interested in the ordinary shares of The Royal Bank of Scotland Group plc:

| | As at 1 January 2005 | As at 31 December 2005 |
|---|---|---|
| C R Crawford | 1,632 | 4,890 |

Options to subscribe for ordinary shares of 25p each in The Royal Bank of Scotland Group plc granted to and exercised during the period by the following director of the Company and connected persons are:

| | As at 1 January 2005 | Granted during the period | | Exercised during the period | | As at 31 December 2005 |
|---|---|---|---|---|---|---|
| | | Options | Price (p) | Options | Price (p) | |
| C R Crawford | 11,359 | 760 | 1304 | - | - | 23,224 |
| | | 11,105 | 1729 | | | |

No director had an interest in any of the preference shares of The Royal Bank of Scotland Group plc during the year to 31 December 2005.

The interests of Mr I H Chippendale, Miss A E Court, Mr I Falconer, Mr M A Fisher, Mr B Higgins, Mr R D Houghton and Mr N C McLuskie in the share capital of The Royal Bank of Scotland Group plc are disclosed in the financial statements of RBS Insurance Group Limited.

Other than as disclosed, none of the directors in office at 31 December 2005 held any interest in the share or loan capital of the Company or any other group company.

### POLICY AND PRACTICE ON PAYMENT OF CREDITORS

The Company follows the policy and practice on payment of creditors determined by The Royal Bank of Scotland Group plc, as outlined below.

In the year ending 31 December 2006, the Group will adhere to the following payment policy in respect of all suppliers. The Group is committed to maintaining a sound commercial relationship with its suppliers. Consequently, it is the Group's policy to negotiate and agree terms and conditions with its suppliers, which includes the giving of an undertaking to pay suppliers within 30 days of receipt of a correctly prepared invoice submitted in accordance with the terms of the contract or such other payment period as may be agreed.

### ELECTIVE RESOLUTIONS

The Company has elected to dispense with the requirement to hold annual general meetings, lay accounts before a general meeting and re-appointment of auditors annually.

### AUDITORS

Deloitte & Touche LLP have expressed their willingness to continue in office as auditors.

Approved by the Board of Directors and signed on behalf of the Board.

Director

31 March 2006

## INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

We have audited the financial statements of The National Insurance and Guarantee Corporation Limited for the year ended 31 December 2005 which comprise the income statement, the balance sheet, the statement of changes in equity, the cash flow statement, the accounting policies and the related notes to the accounts 2 to 33. These financial statements have been prepared under the accounting policies set out therein.

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

**Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable United Kingdom law and those International Financial Reporting Standards (IFRSs) as adopted for use in the European Union are set out in the statement of directors' responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant United Kingdom legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view in accordance with the relevant framework and are properly prepared in accordance with the Companies Act 1985 and IAS Regulation. We also report to you if, in our opinion, the directors' report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and transactions with the Company and other members of the group is not disclosed.

We read other information contained in the directors' report and the other information contained in the annual report, and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

**Basis of audit opinion**

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

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

**Opinion**

In our opinion:

1. the financial statements give a true and fair view, in accordance with those IFRSs as adopted for use in the European Union, of the state of the Company's affairs as at 31 December 2005 and of its profit for the year then ended; and

2. the financial statements have been properly prepared in accordance with the Companies Act 1985.

**Separate opinion in relation to IFRS**

As explained in Note 1.1, the Company, in addition to complying with its legal obligation to comply with IFRSs as adopted for use in the European Union, has also complied with the IFRSs as issued by the International Accounting Standards Board. Accordingly, in our opinion the financial statements give a true and fair view, in accordance with IFRSs, of the state of the Company's affairs as at 31 December 2005 and of its profit for the year then ended.

Deloitte & Touche LLP

**Deloitte & Touche LLP**
Chartered Accountants and Registered Auditors
London

31 March 2006

## THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

### INCOME STATEMENT
### FOR THE YEAR ENDED 31 DECEMBER 2005

| | Notes | 2005 £ Million | 2004 £ Million |
|---|---|---|---|
| Insurance premium revenue | 4 | 863.9 | 889.2 |
| Insurance premium ceded to reinsurers | 4 | (219.3) | (218.9) |
| **Net insurance premium revenue** | | **644.6** | **670.3** |
| Fee income | 5 | 7.1 | - |
| Investment income | 6 | 63.6 | 80.7 |
| Net realised gains/(losses) on financial assets | 7 | 0.4 | (11.3) |
| Other operating income | 8 | 27.5 | 47.1 |
| **Net income** | | **743.2** | **786.8** |
| Insurance claims and loss adjustment expenses | 9 | (607.0) | (592.5) |
| Insurance claims and loss adjustment expenses recovered from reinsurers | 9 | 140.5 | 122.7 |
| **Net insurance claims** | | **(466.5)** | **(469.8)** |
| Expenses for the acquisition of insurance contracts | 10 | (137.5) | (206.0) |
| Expenses for marketing and administration | 10 | (91.1) | (99.2) |
| **Expenses** | | **(228.6)** | **(305.2)** |
| **Results of operating activities** | | **48.1** | **11.8** |
| Finance costs | 11 | (0.2) | - |
| **Profit before tax** | | **47.9** | **11.8** |
| Tax charge | 12 | (15.3) | (4.3) |
| **Profit for the year** | 13 | **32.6** | **7.5** |

The profit for the year was entirely attributable to equity shareholders of the Company.

The notes on pages 9 to 55 form part of these financial statements.

## THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

**BALANCE SHEET**
**AS AT 31 DECEMBER 2005**

| | Notes | 2005 £ Million | 2004 £ Million |
|---|---|---|---|
| **ASSETS** | | | |
| Plant and equipment | 14 | 0.6 | 0.7 |
| Investment property | 15 | - | 0.3 |
| Investments in associates and subsidiaries | 16 | 27.5 | 27.5 |
| Financial assets | | | |
| Available-for-sale debt securities | 17 | 565.8 | 571.2 |
| Loans and receivables | 17 | 909.7 | 585.3 |
| Current tax assets | | - | 14.8 |
| Deferred tax assets | 19 | - | 2.1 |
| Insurance contracts | | | |
| Reinsurance assets | 20, 25 | 315.0 | 270.9 |
| Deferred acquisition costs | 21 | 72.9 | 59.8 |
| Cash and cash equivalents | 22 | 219.8 | 486.0 |
| **Total assets** | | **2,111.3** | **2,018.6** |
| **EQUITY** | | | |
| Share capital | 23 | 255.0 | 255.0 |
| Other reserves | 24 | 36.0 | - |
| Retained earnings | 24 | 21.4 | 5.2 |
| **Total equity** | | **312.4** | **260.2** |
| **LIABILITIES** | | | |
| Insurance contracts | 25 | 1,562.7 | 1,516.6 |
| Financial liabilities | | | |
| Borrowings | 26 | 23.6 | 11.8 |
| Trade and other payables including insurance payables | 27 | 165.7 | 217.3 |
| Current tax liabilities | | 23.6 | - |
| Deferred tax liabilities | 19 | 8.0 | - |
| Provisions for other liabilities and charges | 28 | 15.3 | 12.7 |
| **Total liabilities** | | **1,798.9** | **1,758.4** |
| **Total equity and liabilities** | | **2,111.3** | **2,018.6** |

The financial statements were approved by the board of directors and authorised for issue on 31 March 2006. They were signed on its behalf by:

Director

The notes on pages 9 to 55 form part of these financial statements.

## THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

### STATEMENT OF CHANGES IN EQUITY
### FOR THE YEAR ENDED 31 DECEMBER 2005

| | Notes | Share capital £ Million | Other reserves £ Million | Retained earnings £ Million | Total £ Million |
|---|---|---|---|---|---|
| **Balance as at 1 January 2004** | | **255.0** | **-** | **(2.3)** | **252.7** |
| Profit for the year | | - | - | 7.5 | 7.5 |
| **Balance as at 31 December 2004** | | **255.0** | **-** | **5.2** | **260.2** |
| Implementation of IAS 32, IAS 39 and IFRS 4 | 33 (3) | - | 26.8 | (9.4) | 17.4 |
| **Balance as at 1 January 2005** | | **255.0** | **26.8** | **(4.2)** | **277.6** |
| Net fair value gain on available-for-sale investments | 24 | - | 2.5 | - | 2.5 |
| Movement in claims equalisation reserves | 24 | - | 7.0 | (7.0) | - |
| Net income recognised directly in equity | | - | 9.5 | (7.0) | 2.5 |
| Transfer to income statement on sale of available-for-sale | 24 | - | (0.3) | - | (0.3) |
| Profit for the year | | - | - | 32.6 | 32.6 |
| Total recognised income and expense for the year | | - | 9.2 | 25.6 | 34.8 |
| **Balance as at 31 December 2005** | | **255.0** | **36.0** | **21.4** | **312.4** |

Total recognised income and expense for the year was entirely attributable to equity shareholders of the Company.

The notes on pages 9 to 55 form part of these financial statements.

## THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

### CASH FLOW STATEMENT
### FOR THE YEAR ENDED 31 DECEMBER 2005

| | Notes | 2005 £ Million | 2004 £ Million |
|---|---|---|---|
| Profit for the year | | 32.6 | 7.5 |
| Adjustments for: | | | |
| Fee income | | (7.1) | - |
| Investment revenues | | (63.6) | (80.7) |
| Other operating income | | (27.5) | (47.1) |
| Finance costs | | 0.2 | - |
| Income tax expense | | 15.3 | 4.3 |
| Depreciation of property, plant and equipment | | 0.1 | 0.6 |
| Impairment of investment in subsidiaries | | - | 4.8 |
| Profit on sale of available-for-sale debt securities | | (0.4) | (11.3) |
| Interest received | | 67.6 | 71.1 |
| Income received from other investments | | 27.6 | 47.0 |
| Proceeds on disposal/maturity of available-for-sale debt securities | | 89.7 | 411.3 |
| Proceeds on disposal of investment property | | 0.3 | - |
| Net decrease in investment balances held with credit institutions | | (269.9) | (345.0) |
| Purchases of debt securities | | (80.6) | (261.0) |
| **Operating cash flows before movements in working capital** | | **(215.7)** | **(198.5)** |
| Net decrease in insurance net assets | | 50.6 | 174.6 |
| Net increase in reinsurance assets | | (47.2) | (84.7) |
| Net decrease in loans and receivables | | 4.0 | 3.8 |
| Net increase in other assets | | (10.0) | (0.3) |
| Net increase in related party balances | | (51.5) | (0.1) |
| Net decrease in other operating liabilities | | (15.8) | (11.1) |
| **Cash used by operations** | | **(285.6)** | **(116.3)** |
| Income taxes paid | | 24.7 | (0.1) |
| Interest paid | | (0.2) | - |
| **Net cash used by operating activities** | | **(261.1)** | **(116.4)** |
| **Cash flows from investing activities** | | | |
| Dividends received from subsidiaries | | (5.0) | 10.0 |
| Purchases of property, plant and equipment | | - | (0.1) |
| **Net cash (used by)/generated from investing activities** | | **(5.0)** | **9.9** |
| **Cash flow from financing activities** | | | |
| Loan advances to related parties | | (11.9) | 70.0 |
| Proceeds from borrowings | | 0.2 | (2.3) |
| **Net cash (used by)/generated from financing activities** | | **(11.7)** | **67.7** |
| **Net decrease in cash and bank overdrafts** | | **(277.8)** | **(38.8)** |
| Cash and cash equivalents at the beginning of the year | 22 | 478.7 | 517.5 |
| **Cash and bank overdrafts at the end of the year** | 22 | **200.9** | **478.7** |

The Company classifies the cash flows for the purchase and disposal of financial assets in its operating cash flows as the purchases are funded from the cash flows associated with the origination of insurance contracts, net of the cash flows from payment of insurance claims.

The notes on pages 9 to 55 form part of these financial statements.

**NOTES TO THE FINANCIAL STATEMENTS**
**FOR THE YEAR ENDED 31 DECEMBER 2005**

## 1. ACCOUNTING POLICIES

### 1.1 Adoption of International Financial Reporting Standards

The financial statements have, for the first time, been prepared in accordance with International Financial Reporting Standards (IFRS) adopted for use in the European Union and therefore comply with Article 4 of the EU IAS regulation. The financial statements also comply with those parts of the Companies Act 1985 applicable to companies reporting under IFRS. The date of transition to IFRS for the Company and the date of its opening IFRS balance sheet was 1 January 2004. On initial adoption of IFRS, the Company applied the following exemptions from the requirements of IFRS and from their retrospective application as permitted by IFRS 1 'First-time Adoption of International Financial Reporting Standards' (IFRS 1):

***Implementation of IAS 32, IAS 39 and IFRS 4*** – as permitted by IFRS 1, the Company has not restated its 2004 comparative information to comply with IAS 32, IAS 39 and IFRS 4. The date of transition in respect of these standards is 1 January 2005.

In preparing the Company's 2004 income statement and balance sheet, UK GAAP principles then current have been applied to insurance contracts and financial instruments. The main differences between UK GAAP and IFRS on financial instruments are summarised in note 33.

### 1.2 Basis of preparation

The financial statements have been prepared on the historical cost basis except that the following assets and liabilities are stated at their fair value: available-for-sale financial assets and investment property.

***Changes in accounting policies*** – The impact of IAS 32, IAS 39 and IFRS 4 have been treated as a change in accounting policy on 1 January 2005. This change in policy has been applied prospectively as noted under 1.1 above.

### 1.3 Insurance premium revenue

Insurance premiums comprise the total premiums receivable for the whole period of cover provided by contracts incepted during the financial year, adjusted by an unearned premium provision, which represents the proportion of the premiums that relate to periods of insurance after the balance sheet date. Unearned premiums are calculated over the period of exposure under the policy, on a daily basis, 24ths basis or allowing for the estimated incidence of exposure under policies which are longer than twelve months.

Premiums collected by intermediaries, but not yet received, are assessed based on estimates from underwriting or past experience, and are included in insurance premiums. Insurance premiums exclude insurance premium tax and are shown gross of any commission payable to intermediaries.

### 1.4 Insurance claims and loss adjustment expenses

Insurance claims are recognised in the accounting period in which the loss occurs. Provision is made for the full cost of settling outstanding claims at the balance sheet date including claims incurred but not yet reported at that date, net of salvage and subrogation recoveries. Costs for both direct and indirect claims handling costs are also included.

The estimation of insurance claims and loss adjustment expenses has been explained in note 2.1.

### 1.5 Liability adequacy provision

Provision is made for unexpired risks arising where the expected value of claims and expenses attributable to the unexpired periods of policies in force at the balance sheet date exceeds the unearned premium provision in relation to such policies after the deduction of any acquisition costs deferred. The expected value is determined by reference to recent experience and allowing for changes to the premium rates. The provision for unexpired risks is calculated separately by reference to classes of business that are managed together after taking account of relevant investment returns.

## 1. ACCOUNTING POLICIES (Continued)

### 1.6 Special Risks business - reserves

The Special Risks business was put into run-off during 2003. Future levels of premiums, their earnings profile and claims are linked but subject to particular uncertainty. This business has consequently been reserved on an ultimate result basis. Premium and associated acquisition costs are deemed to be fully earned and a single reserve for claims, net of future premium movements but gross of reinsurance has been established.
Movements on the Special Risks technical reserves are largely recoverable from a previous ultimate holding company.

Due to the nature of Special Risks' insurance contracts, claims reserves are reported on an underwriting year basis.

### 1.7 Claims equalisation

To comply with IFRS 4 a claims equalisation reserve is no longer classified as a liability. Since the date of transition for IFRS 4 is 1 January 2005, a claims equalisation reserve is included within insurance contract liabilities in the 2004 comparative figures. This reserve is established in accordance with chapter 7.5 of the Integrated Prudential Sourcebook and is in addition to the reserve required to meet the anticipated ultimate cost of settlement of outstanding claims at the balance sheet date.

In 2005 a statutory claims equalisation reserve has been included as a non distributable reserve within Other Reserves in Equity. This reserve continues to be calculated in accordance with chapter 7.5 of the Integrated Prudential Sourcebook.

### 1.8 Reinsurance

The Company cedes reinsurance in the normal course of business, with retention limits varying by line of business. Outwards reinsurance premiums are 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.

Where the Company is not certain about the collectability of a reinsurance asset or where the reinsurer's credit rating has been downgraded significantly, the Company reduces the carrying value of the asset accordingly and the impairment loss is recognised in the income statement.

### 1.9 Deferred acquisition costs

Acquisition costs relating to new and renewing insurance policies are matched with the earning of the premiums to which they relate. A proportion of acquisition costs incurred during the year is therefore deferred to the subsequent accounting period to match the extent to which premiums written during the year are unearned at the balance sheet date.

The principal acquisition costs so deferred are commissions paid to brokers, third party administration fees, direct advertising expenditure and costs associated with the underwriting staff.

## 1. ACCOUNTING POLICIES (Continued)

### 1.10 Revenue recognition (non insurance)

Interest income on financial assets that are classified as loans and receivables or available-for-sale and interest expense on financial liabilities is determined using the effective interest rate method. In the case of loans and receivables this is estimated using the Rule of 78 method and for available-for-sale assets estimates are based on the straight line method, both of which management has determined are a close approximation to the effective interest rate.

Fees in respect of services are recognised as the right to consideration accrues through the provision of the service to the customer. The arrangements are generally contractual and the cost of providing the service is incurred as the service is rendered. The price is usually fixed and always determinable.

### 1.11 Provisions

***Regulatory levies*** – the Company accrues for all insurance industry levies, which are based on past underwriting levels at the best estimate given the available information at the balance sheet date. Such amounts are not included within insurance liabilities but are included under provisions in the balance sheet. They are charged to the income statement as an expense.

### 1.12 Plant and equipment

Items of plant and equipment are stated at historical cost less accumulated depreciation (see below) and impairment losses. Where an item of plant and equipment comprises major components having different useful lives, they are accounted for separately.

Depreciation is charged to the income statement on a straight-line basis so as to write off the depreciable amount of plant and equipment (including assets owned and let on operating leases (except investment property – see note 1.12)) over their estimated useful lives. The depreciable amount is the cost of an asset less its residual value. Land is not depreciated. Estimated useful lives are as follows:

- Vehicles - 5 years
- Computer equipment - up to 5 years
- Other equipment, including property adaptation costs - 4 to 15 years

### 1.13 Investment property

Investment property comprises freehold and long leasehold properties that are held to earn rentals or for capital appreciation or both. It is not depreciated and is stated at fair value based on valuations by independent registered valuers. Fair value is based on current prices in an active market for similar properties in the same location and condition. Any gain or loss arising from a change in fair value is recognised in the income statement. Rental income from investment property is recognised on a straight-line basis over the term of the lease. Lease incentives granted are recognised as an integral part of the total rental income.

### 1.14 Leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases.

Rentals payable under operating leases are recognised in the income statement on a straight line basis over the term of the lease.

Incentives received as an inducement to enter into an operating lease are spread on a straight line basis over the lease term.

## 1. ACCOUNTING POLICIES (Continued)

### 1.15 Investment in associates and subsidiaries

*Investments in associates and subsidiary companies are stated at cost less any impairment in the value of individual* investments, based on an annual assessment. Any impairment is charged to the income statement.

### 1.16 Financial assets

*Financial assets are classified into available-for-sale financial assets or loans and receivables.*

***Available-for-sale*** – available-for-sale financial assets are initially recognised at fair value plus directly related transaction costs. They are subsequently measured at fair value. Exchange differences resulting from retranslating the amortised cost of currency monetary available-for-sale financial assets are recognised in the income statement.

Changes in the fair value of available-for-sale financial assets are reported in a separate component of shareholders' equity. Interest calculated using the straight line method (see note 1.9) is recognised in the income statement.

Regular way purchases of financial assets classified as loans and receivables are recognised on settlement date; all other regular way purchases are recognised on trade date.

Fair value for a net open position in a financial asset that is quoted in an active market is the current bid price times the number of units of the instrument held. Fair values for financial assets not quoted in an active market are determined using appropriate valuation techniques.

***Loans and receivables*** – financial assets with fixed or determinable repayments that are not quoted in an active market are classified as loans and receivables. These include deposits with credit institutions which are long term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risks of change in value.

Insurance receivables comprise outstanding insurance premiums where the policyholders have elected to pay in instalments or amounts due from brokers or third parties, where they have collected the money from the policyholder.

### 1.17 Impairment of financial assets

The Company assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets classified as available-for-sale or loans and receivables is impaired. A financial asset or portfolio of financial assets is impaired and an impairment loss incurred if there is objective evidence that an event or events since initial recognition of the asset have adversely affected the amount or timing of future cash flows from the asset.

***Financial assets carried at fair value*** – when a decline in the fair value of a financial asset classified as available-for-sale has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative *loss is removed from equity and recognised in the income statement. The loss is measured as the difference between* the amortised cost of the financial asset and its current fair value. Impairment losses on available-for-sale equity instruments are not reversed through the income statement, but those on available-for-sale debt instruments are reversed, if there is an increase in fair value that is objectively related to an event subsequent to the recognition of the impairment.

***Loans and receivables*** – a system based hold and chase process is applied should a customer fail to pay an instalment. The relevant credit control department is notified automatically of any failed collections. The customer is taken off cover until the issue is resolved. After the third payment is missed the policy is cancelled. Premiums are then adjusted for cancelled policies.

## 1. ACCOUNTING POLICIES (Continued)

***Loans and receivables*** – when a customer instalment payment fails the relevant credit control department is notified automatically. Provisions are made on outstanding customer payments against all balances in excess of 90 days overdue.

For debts due from intermediaries and brokers the bad debt provision is calculated based upon prior loss experience. For all balances outstanding in excess of 6 months, a provision of 50% is made, with a full provision against all debts over one year old.

### 1.18 Foreign currencies

The Company's financial statements are presented in sterling which is the functional and presentation currency of the Company.

Transactions in foreign currencies are translated into sterling at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into sterling at the rates of exchange ruling at the balance sheet date. Foreign exchange differences arising on translation are recognised in the income statement. Non-monetary items denominated in foreign currencies that are stated at fair value are translated into sterling at foreign exchange rates ruling at the dates the values were determined.

### 1.19 Taxation

Provision is made for taxation at current enacted rates on taxable profits, arising in income or in equity, taking into account relief for overseas taxation where appropriate.

Deferred taxation is accounted for in full for all temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes.

Deferred tax assets are only recognised to the extent that it is probable that they will be recovered.

### 1.20 Transactions with related parties

IFRS requires all entities to disclose related party transactions. The Company's policy is to have regard to materiality from both the shareholder's and the related party's perspective.

### 1.21 Cash and cash equivalents

Cash and cash equivalents comprises cash on hand and demand deposits with banks together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of change in value.

Under IAS 7 the Company is producing a cash flow statement using the indirect method. This shows an explanation of the movement in cash and cash equivalents as defined above.

### 1.22 Borrowings

Borrowings comprises bank overdrafts and inter company loans. Interest on inter company loans is recognised in the income statement as finance costs.

The Company 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. An instrument is classified as equity if it evidences a residual interest in the assets of the Company after the deduction of liabilities.

## 1. ACCOUNTING POLICIES (Continued)

### 1.23 Accounting Developments

The International Accounting Standards Board (IASB) has issued IFRS 7 'Financial Instruments: Disclosures' in August 2005. The standard replaces IAS 30 'Disclosures in the Financial Statements of Banks and Similar Financial Institutions' and the disclosure provisions in IAS 32 'Financial Instruments: Disclosure and Presentation'. IFRS 7 requires disclosure of the significance of financial instruments for an entity's financial position and performance and of quantitative information about exposure to risks arising from financial instruments. The Standard is effective for annual periods beginning on or after 1 January 2007.

At the same time the IASB issued an amendment 'Capital Disclosures' to IAS 1 'Presentation of Financial Statements'. It requires disclosures about an entity's capital and the way it is managed. This amendment is also effective for annual periods beginning on or after 1 January 2007.

The IASB has also issued three amendments to IAS 39 'Financial Instruments: Recognition and Measurement'. The first, 'Cash Flow Hedge Accounting of Forecast Intragroup Transactions' published in April 2005, amends IAS 39 to permit the foreign currency risk of a highly probable forecast intragroup transaction to qualify as a hedged item in the consolidated financial statements. The amendment is effective for annual periods beginning on or after 1 January 2006.

The second, 'Fair Value Option', published in June 2005, places conditions on the option in IAS 39 to designate on initial recognition a financial asset or financial liability as at fair value through profit or loss. The amendment is effective for annual periods beginning on or after 1 January 2006.

The third, 'Financial Guarantee Contracts', published in August 2005, amends IAS 39 and IFRS 4 'Insurance Contracts'. The amendments define a financial guarantee contract. They require such contracts to be recorded initially at fair value and subsequently at higher of the provision determined in accordance with IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' and the amount initially recognised less amortisation. The amendments are effective for annual periods beginning on or after 1 January 2006.

In December 2005, the IASB issued amendments to IAS 21 'The Effects of Changes in Foreign Exchange Rates' to clarify that a monetary item can form part of the net investment in overseas operations regardless of the currency in which it is denominated and that the net investment in a foreign operation can include a loan from a fellow subsidiary. The amendments are effective immediately but have not been endorsed by the EU.

The Company is reviewing the above standards and amendments to determine their effect if any on its financial reporting, but does not intend to adopt any of the standards early.

## 2. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The reported results of the Company are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. The Company's principal accounting policies are set out on pages 9 to 14. UK company law and IFRS require the directors, in preparing the Company's financial statements, 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 'Accounting Policies, Changes in Accounting Estimates and Errors' 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 the Company'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 the Company would affect its reported results.

### 2.1 Outstanding claims provisions and related reinsurance recoveries

Provisions are determined by management based on experience of claims settled and on statistical models which require certain assumptions to be made regarding the incidence, timing and amount of claims and any specific factors such as adverse weather conditions. In order to calculate the total provision required, the historical development of claims is analysed using statistical methodology to extrapolate, within acceptable probability parameters, the value of outstanding claims (gross and net) at the balance sheet date. Also included in the estimation of outstanding claims are factors such as the potential for judicial or legislative inflation. In addition an allowance is made for reinsurance assets deemed not recoverable.

For more recent claim periods the provisions will make use of techniques that incorporate expected loss ratios. As periods mature, the reserves are increasingly driven by methods based on actual claims experience. The approaches adopted take into account the nature, type and significance of the business and the type of data available, with large claims generally being assessed separately. The data used for statistical modelling purposes is internally generated.

The calculation is particularly sensitive to the estimation of the ultimate cost of claims for the particular classes of business at gross and net levels, the estimation of future claims handling costs and the rate of investment return assumed in the calculation.

Management use the external actuaries' work to undertake their internal benchmark assessment of the level of gross and net outstanding claims provision required and adopt a measurement basis of reserves which results in a provision in excess of the external actuaries' best estimate.

Actual claims experience may differ from the historical pattern on which the estimate is based and the cost of settling individual claims may exceed that assumed. As a result management adopt a cautious view and set the reserves at a margin above the best estimate. It is this amount that is recorded as claims reserves.

Outstanding claims provisions net of related reinsurance recoveries at 31 December 2005 amounted to £848.8 million (2004: £871.1 million).

### 2.2 Impairment provisions – financial assets

***Available-for-sale*** – the Company determines that available-for-sale financial assets are impaired when there has been a significant or prolonged decline in the fair value below its cost. This determination of what is significant or prolonged requires judgement. In making this judgement, the Company evaluates among other factors, the normal volatility of share price, the financial health of the investee, industry and sector performance, changes in technology and operational and financing cash flow. Impairment may be appropriate when there is evidence of deterioration in these factors.

Impairment provisions on loans and receivables at 31 December 2005 amounted to £Nil (2004: £Nil).

**2. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS (Continued)**

Had all the declines in fair values below cost been considered significant or prolonged, the Company would suffer a £8,988 loss in its 2005 financial statements, being the transfer of the total equity reserve for unrealised losses to the income statement.

***Loans and receivables including insurance receivables*** – on a monthly basis a list of late payments by brokers or intermediaries is produced and all missed payments are chased individually by letter or phone for significant debtors. Additionally any brokers that have exceeded their credit limits – set as a percentage of their annual gross written premiums – are also chased to bring their accounts back into line. Brokers who persistently fail to comply with their terms are put on "stop new business" and subject to a three-month probationary period and ultimately into run-off. As a last resort their book of business will be sold on in the market place.

**2.3 Impairment provisions - investments in associates and subsidiaries**

The Company considers that an investment in an associate or subsidiary company is impaired when the recoverable value of the associate or subsidiary company is less than the carrying amount. Recoverable value is determined as the higher of the net realisable value or the discounted cash flow of future profits after tax. Determining the discounted cash flow of future profits requires judgement in forecasting the level of future profits.

Impairment provisions on investments in associates and subsidiaries at 31 December 2005 amounted to £4.8 million (2004: £4.8 million).

**2.4 Fair value**

Financial assets classified as available-for-sale are recognised in the financial statements at fair value. In the balance sheet, financial assets carried at fair value are included within Debt securities and Equity shares. Unrealised gains and losses on available-for-sale financial assets are recognised directly in equity unless an impairment loss is recognised.

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.

The fair value of available-for-sale financial assets at 31 December 2005 amounted to £565.8 million (2004: £571.2 million).

**2.5 Provisions**

The main regulatory levies, which are included under Provisions, are the Financial Services Compensation Scheme (FSCS) and the Motor Insurance Bureau (MIB) levies.

The levy accruals are based on a percentage of gross premium written. The Company will receive levy invoices from the Regulatory bodies based on the Company's market share of the industry, which is not known with certainty at the time of approval of these financial statements and, therefore some judgement is required.

In 2005 the FSCS levy was accrued at an agreed percentage of forecast gross written premium.

The MIB levy was calculated by apportioning the 'total levy' for the UK motor insurance industry (as communicated by the MIB) by the Company's estimated share of the UK motor insurance market.

Total regulatory levy provisions at 31 December 2005 amounted to £15.3 million (2004: £12.7 million).

## 3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK

The Company issues contracts that accept insurance risk in return for a premium. It also has financial risk exposures. This section summarises these risks and the way the Company manages these.

The Company is a member of the Insurance Division of The Royal Bank of Scotland Group plc (RBSG) and benefits from services provided by specialist teams and risk management procedures and controls which are applied across the Division.

### 3.1 Insurance risk

Insurance risk is the risk of fluctuations in the timing, frequency and severity of insured events, relative to the expectations of the Company at the time of underwriting. This risk is managed according to the following separate components:

- Underwriting and pricing risk
- Claims management risk
- Reinsurance risk
- Reserving risk

#### 3.1.1 Underwriting and pricing risk

Underwriting and pricing risk is the risk that inappropriate business will be written or inappropriate prices charged.

The classes and sectors of business written, underwriting criteria, and relevant limits, define underwriting risk appetite.

***Personal lines***

The Company manages this risk through a wide range of processes and forums, some of which include:

- Underwriting guidelines which exist for all business transacted restricting the types and classes of business that may be accepted
- Exception reports and other underwriting monitoring tools
- Comprehensive audit programmes
- Pricing policies which are set by pricing committees by product line and by brand
- Central control, within underwriting, of policy wordings and any subsequent changes
- Insurance risk framework that involves, among other things, regular minuted meetings where all aspects of insurance risk are discussed, and additional meetings where detailed claims data are examined and discussed
- 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 Company Executive

***Commercial lines***

Commercial risks are written within a pre-defined strategy fully documented in underwriting guides and issued to all authorised underwriters. The Company's strategy is towards low to medium risk trades within the small to medium enterprise (SME) market. Higher risk trades are excluded by way of a decline list clearly documented within the underwriting guides.

Property risk exposures are generally written on a full sum insured basis to a maximum of £30 million. Regional underwriters are required to refer any risk with a maximum exposure in excess of £10 million to head office underwriting for authorisation. This sum is reduced for higher risk trade categories. Reinsurance (as described elsewhere in these financial statements) is purchased on this basis and on occasion, facultative reinsurance is obtained on individual 'higher risk' trades to further protect the Company's exposure.

All underwriters have a personal authority based on job role, competency and business need. All underwriters *undertake a competency based assessment once a year. Audits are conducted every month to check that business is* written within strategy and authorised at the correct level. These manual audits are backed up by processing system referrals.

## 3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)

***Special risks***

This division of the business was discontinued and closed to new business in 2003. The special risks portfolio is now in run-off. The lines of business underwritten in the Special Risks business were motor warranty, vehicle assistance, extended warranty, miscellaneous and pecuniary loss, legal expenses, miscellaneous property, miscellaneous accident, bonds & guarantees and travel. No policies have renewal rights attached. The longest policy terms are for miscellaneous property (land) insurance (25 years), bonds (20 years) and legal expense insurance (20 years).

***Frequency and severity of specific risks***

The following paragraphs explain the frequency and severity of specific risks under the key classes that the Company is exposed to:

a) Motor insurance contracts

The causes of motor claims are theft of, or from, the vehicle, personal accident, accidental damage to the vehicle, third-party property damage and third-party personal injury. To meet statutory requirements, policies of insurance provide unlimited exposure for policyholders' liability at law for third party bodily injury and reinsurance is purchased for the unlimited element over a suitable deductible.

Claims experience is quite variable, due to a wide number of factors, such as the age of driver and type of vehicle. Contracts are issued typically on an annual basis, which means that our liability usually extends for a 12-month period, after which we are entitled to decline to renew or we can impose renewal terms by amending the premium or excess or both.

b) Residential property insurance contracts

The major claim perils for residential property insurance are theft, flood, escape of water, fire, storm, subsidence, liability and various types of accidental damage.

All contracts are written typically on an annual basis which means our commitment is usually for a 12-month period, after which we can decline to renew or can impose special renewal terms through increased premium or excesses, or both.

c) Commercial motor insurance contracts

Commercial motor insurance contracts can include individual commercial vehicles, fleets of vehicles for businesses or motor trade risks.

The causes of commercial motor claims are theft of, or from, the vehicle, personal accident, accidental damage to the vehicle, third party property damage and third party personal injury.

Claims experience is quite variable, due to a wide number of factors, the principal ones are age of driver, type of vehicle and use. Contracts are issued on an annual basis, which means that our liability extends to a 12-month period, after which we are entitled to decline to renew or we can impose renewal terms by amending the premium or excess or both.

d) Commercial other insurance contracts

Commercial claims come mainly from property loss or damage, business interruption and loss arising from the negligence of the Insured (liability insurance).

Property loss/damage claims come from causes such as fire, theft, storm, flood and other defined perils. Business interruption losses come from the loss of income, revenue and/or profit as a result of the cause of the property damage claim. These covers are generally written on a sum insured basis based on the values at risk.

**3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)**

Liability insurance can be broken down between employers liability and public/products liability. The first is to indemnify employees for injury caused as a result of the insured's negligence. Public/products liability is to indemnify a third party for injury and/or damage as a result of an act of the Insured's negligence. Employers liability has a standard limit of indemnity of £10 million plus authorised costs, but can be increased to £25 million for larger policyholders on request.

Public/products liability generally has a limit of up to £5 million, but can be increased to £10 million on request.

Insurance contracts are typically issued on an annual basis which means that our liability is limited to a 12-month period, after which we can decline to renew the policy or can impose renewal terms such as increasing the premium or applying a policy excess. However, as liability insurance is written on an occurrence basis, these covers are still subject to claims that manifest over a substantial period of time, but where loss was in existence during the life of the policy (for example long-tail disease claims such as asbestosis).

e) Special risks contracts

Loss reserve movements in the discontinued special risks portfolio are largely covered by an indemnity from the Company's former parent company Winterthur Swiss Insurance.

The portfolio comprises non-standard risk schemes and there are large variations in policy coverages across the range of schemes. The wide variety of risks covered means that there is very little standardisation of terms between schemes. Administrators are required to provide updates on the activity on individual schemes through regularly submitted bordereaux. These provide details of claims for the period as well as exposure details such as the mix by policy term. Scheme performance is reviewed regularly by internal and external actuaries and reserves are adjusted accordingly. This involves best estimates based on the development of earning patterns by scheme and ultimate loss ratios based on available exposure information. This requires analysis of the incidence of exposure in the underlying policies throughout the policy term.

f) Creditor insurance contracts

Creditor insurance contracts are designed to cover payments on secured or unsecured lending, whether for individuals or in certain circumstances for sole traders and nominated individuals in small commercial companies.

The causes of creditor insurance claims are loss of income through accident, sickness or unemployment or, in some circumstances, loss of life.

The largest influence on claims experience is the economic environment. Contracts are issued either on a monthly renewable basis (regular premium) and can be amended or cancelled by either party at any point during the contract, or for the full term of the loan (single premium). In the latter case, the customer has the option to cancel the contract at any point but generally the company is obligated for the full term of up to a maximum of 5 years.

***Sources of uncertainty***

The following paragraphs explain the source of uncertainty in respect of the specific key classes of business:

a) Motor insurance contracts (both private and commercial)

There are various sources of uncertainty which will impact the Company's experience under Motor insurance, including, operational risk, reserving risk, premiums rates not matching claims inflation rates, the social, economic and legislative enviroment, in particular court judgments and legislation (e.g. periodical payments under the Courts Act, a review of the Ogden tables used by courts when setting personal injury claim values) and reinsurance failure risks. However, the Company has documented risk policies, coupled with governance frameworks to oversee and control those risks and hence minimise the losses.

**3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)**

b) Property insurance contracts (both residential and commercial)

The major source of uncertainty in the performance of the Company's property account is the volatility of the weather. Weather in the UK can affect the following causes or claims: flood, storm, escape of water following freezing (burst pipes) and subsidence. Our flood and subsidence strategies are being maintained in order to control these exposures.

Over a longer period the strength of the economy is also a factor. During tougher times as more businesses close down and unemployment increases, arson, theft and similar types of claims tend to increase.

There are many other sources of uncertainty which include operational, reserving and reinsurance issues. However, the Company has documented risk policies, coupled with governance frameworks to oversee and control those risks and hence minimise the losses.

c) Commercial other insurance contracts

There are a number of uncertainties which will impact the Company's general liability account, such as changes in the social, economic and legislative environment and in particular court judgments and legislation (e.g. periodical payments under the Courts Act, a review of the Ogden tables used by courts when setting personal injury claim values), significant events (e.g. terrorist attacks), and any emerging new heads of damage, types of claim that are not envisaged when the policy is written.

There are many other sources of uncertainty which include operational, reserving and reinsurance issues. However, the Company has documented risk policies, coupled with governance frameworks to oversee and control those risks and hence minimise the losses.

d) Special risks contracts

The wide variety of risks covered means that there are a significant number of uncertainties which affect the underwriting performance of the special risks portfolio arising from the economic, social and legislative environment. Reserving risk is monitored through regular review by internal and external actuaries. The Company's exposure is mitigated through the indemnity from the Company's former parent.

**3.1.2 Claims management risk**

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

Claims are managed utilising a range of IT system driven controls coupled with manual processes to enable claims to be handled in a timely and accurate manner.

Detailed policies and procedures exist to ensure that all claims are handled appropriately, with each member of staff having a specified handling authority. The processes include controls to avoid claims staff handling or paying claims outside of their authorities, as well as controls to avoid 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.

Loss adjustors are used in certain circumstances to handle claims to conclusion. This involves liaison with the policyholder, third parties, suppliers and management.

A process is in place to deal with severe weather / other catastrophic events, known as SWEP (Severe Weather Event Plan). SWEP is the collective name given to an incident which significantly impacts the volume and cost of claims reported to the claims management of the Company. The plan covers triggers, stages of incident, operational impact, communication, and management information monitoring of the impact.

## 3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)

### 3.1.3 Reinsurance risk

Reinsurance is used:

- To protect the insurance results against the impact of major catastrophic events, e.g. flood, storm
- 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 transfer risk that is not within the Company's current risk appetite

The following types of reinsurance are used where appropriate:

- Excess of loss 'per individual risk' reinsurance to protect against significantly large individual losses. The upper limit of this protection is to be sufficient for the largest individual risks accepted. The maximum amount of retention on these contracts is £2 million
- Excess of loss catastrophe 'event' reinsurance to protect against major events, for example, windstorms or floods. Various windstorm and flood simulation models are used to model a range of scenarios and calculate the Company's potential exposure to catastrophic events by class of business. Cover will then be purchased with an upper limit equivalent to a windstorm return period of at least one in 150 years. The 'per event' retention will be based upon the amount that the Company is prepared to sustain from such a loss with due regard to the reinsurance cost and will be ratified each year by the board. If subsequent re-modelling indicates increased exposure outside our risk appetite, additional reinsurance cover will be purchased. The 'per event' retention is within the estimated cost of an event that has been modelled to occur with a 1 in 7 year return period
- Quota share reinsurance to protect against unforeseen adverse trends, where the reinsurer takes an agreed percentage of premiums and claims
- Other forms of reinsurance may be utilised according to need, subject to approval by senior management or the board as appropriate

The acceptance criteria of reinsurers is based on internal assessments and information from security ratings agencies. All reinsurers contracted with are subject to the Credit Risk Approval process as described in the Royal Bank of Scotland Insurance Credit Risk Policy manual. Acceptable reinsurers are rated at A- or better unless specifically authorised by the Royal Bank of Scotland Insurance Board. Reinsurers may not be rated where the reinsurer is a member of the Royal Bank of Scotland Group. Where the reinsurer is rated below A-, a guarantee will be obtained in the form of a letter of credit, where considered necessary.

The rating profile of the top ten external reinsurers of the Company which accounts for 70.52% of the total non Royal Bank of Scotland Group ceded reinsurance premium is as follows:

| Rating from Standard & Poors | Number of Reinsurers |
|---|---|
| AAA | 0 |
| AA | 2 |
| AA- | 2 |
| A+ | 4 |
| A | 1 |
| A- | 0 |
| Not rated | 1 |

The quantification of reinsurer credit risk exposure is calculated taking into account various factors such as the current liability of the reinsurer, including outstanding claims and unexpired risk. In addition, reinsurers are monitored and reviewed by the group Credit Risk Committee. A provision is made against reinsurance debtors considered bad or doubtful.

## 3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)

### 3.1.4 Reserving risk

Reserving risk relates to both premiums and claims. It is the risk that reserves are assessed incorrectly such that insufficient funds have been retained to pay or handle claims as the amounts fall due, both in relation to those claims which have already occurred (in relation to the claims reserves, including claims handling expense reserves) or will occur in future periods of insurance (in relation to the premium reserves).

***Categories of technical reserves***

The main categories of technical reserves (both gross and net of reinsurance) held by the Company are:

a) Premium reserves

- Unearned premium reserves is an amount set aside in the accounts that represents the amount of premium applicable to the unexpired portion of the policy net of reinsurance
- Deferred acquisition costs is when the company defers the sales costs that are associated with acquiring a new customer over the term of the insurance contract
- Liability adequacy provisions are required to cover claims costs and related expenses which will emerge from unexpired risks. If it is greater than the unearned premium reserve (i.e. recent premiums are thought to be inadequate) an additional reserve for unexpired risk should be held

b) Claims reserves

- Claims reserves, including amounts in relation to claims which have occurred but not been reported is the estimate of the amount required to pay ultimate net losses over and above the claims costs paid to date
- *Claims handling expense reserve is the amount put aside to cover the estimated expenses that can be directly* attributed to the settlement of claims which are not included within the claims cost

***Reserving policy***

Reserves are assessed in accordance with our internal reserving policy, namely:

a) Premium reserves

In respect of premium reserves, it is the Company's policy to ensure that the unearned premium reserves, net of reinsurance and deferred acquisition costs are adequate to meet the expected cost of claims and associated expenses in relation to the exposure after the balance sheet date.

To the extent that the unearned premium reserves net of reinsurance and deferred acquisition expenses are inadequate a liability adequacy provision will be held which will initially write down any deferred acquisition asset held. Once the deferred acquisition asset has been exhausted, an additional liability adequacy provision will be established.

To estimate if any such additional provision is required, the Company estimates the cost of the unexpired risks for each class, which is based on our estimate of the claims experience, based on the performance in recent periods, seasonally adjusted and allowing for any premium rating changes, together with allowance for the continuing expense of administering the business and investment income. Further, the requirement for such a reserve would be assessed by considering the premium reserves for classes of business which are managed together as one.

b) Claims reserves

It is the Company's policy to hold undiscounted claims reserves (including reserves to cover claims which have occurred but not been reported (IBNR reserves)) for all classes at a sufficient level to meet all liabilities as they fall due.

**3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)**

In particular, the Company's policy is to hold claims reserves for the major classes of business (namely motor, domestic property and commercial) in excess of the actuarial best estimate. For this purpose 'actuarial best estimate' is defined as the mean of the range of potential outcomes.

The Company undertakes an actuarial review of the outstanding claims reserves using past claims data and current market knowledge to project statistically the likely ultimate claims arising from business already written on the basis of the information available utilising generally accepted actuarial methods. The reserves set up by the Company for each class of business are then reviewed against a range of projected values taking account of the statistical uncertainty in the claims process.

Details of the aggregate claims development are included in note 25.

***Key sources of reserving risk***

The key sources of reserving risk are as follows:

- Uncertainty in the number of claims incurred but not reported by the balance sheet date
- Uncertainty in the ultimate settlement amounts for claims that have already been reported by the balance sheet date
- Uncertainty in the ultimate settlement amounts for claims that have been incurred but not reported by the balance sheet date

The main causes of the uncertainty are as follows:

- Inaccurate identification of changes in claims development patterns as a result of changes in claims handling practices and/or claimant reporting behaviour
- The incidence and severity of large claims
- The inflation of claim settlement amounts exceeds that anticipated in the reserving process
- The risk of new heads of damage and/or new types of claims that are unforeseen or unanticipated at the time of underwriting and reserving
- Legislative and common law changes which have a retrospective impact, (i.e. which impact claims that have already occurred but are not settled by the balance sheet date), including changes in the interpretation of policy wordings. Such changes include a potential reduction in the Ogden discount rate used to assess the quantum of lump sum awards for personal injury claims. The estimate of the retrospective impact on bodily injury claims costs of a further 1% reduction in the Ogden discount rate would be £2.8 million reduction in the profit after tax and net assets (on a net of excess of loss and quota share reinsurance basis)

If the gross claims reserves carried in the balance sheet moved by 1% the impact on the income statement would be a change in profit after tax and net assets of £7.42 million.

***Risk identification and control***

Reserving risk is controlled through a range of processes, the most significant ones being:

- Regular periodic reviews of the claims reserves for the main classes of business by the internal actuarial team
- The use of external actuaries to periodically review the adequacy of the reserves for the major classes
- Oversight of the reserving process by the Royal Bank of Scotland Insurance Audit Committee

## 3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)

The following table summarises premiums earned and the claims incurred together with the corresponding loss ratios for each major class of business on a gross and net of reinsurance basis.

| | | 2005 | | | 2004 | | |
|---|---|---|---|---|---|---|---|
| | | Earned premiums £m | Claims Incurred £m | Loss Ratio % | Earned premiums £m | Claims Incurred £m | Loss Ratio % |
| Residential property | Gross | 64.3 | 50.3 | 78 | 63.7 | 43.0 | 67 |
| | Net | 48.6 | 42.9 | 88 | 48.7 | 35.9 | 74 |
| Motor | Gross | 342.7 | 277.1 | 81 | 246.6 | 195.1 | 74 |
| | Net | 253.7 | 210.0 | 83 | 199.6 | 145.7 | 73 |
| Commercial property | Gross | 211.7 | 83.5 | 39 | 190.9 | 81.4 | 43 |
| | Net | 154.7 | 62.2 | 40 | 142.5 | 62.4 | 44 |
| Commercial motor | Gross | 102.1 | 45.8 | 45 | 93.5 | 53.8 | 70 |
| | Net | 83.5 | 31.0 | 37 | 59.7 | 42.5 | 71 |
| Discontinued (Special Risks) | Gross | (7.3) | 42.8 | -587 | 151.6 | 111.7 | 74 |
| | Net | (9.4) | 33.5 | -357 | 138.7 | 103.8 | 75 |
| Other | Gross | 150.4 | 107.5 | 71 | 142.9 | 107.5 | 75 |
| | Net | 113.4 | 86.9 | 77 | 81.1 | 79.5 | 98 |
| **Total** | **Gross** | 863.9 | 607.0 | 70 | 889.2 | 592.5 | 67 |
| | **Net** | 644.5 | 466.5 | 72 | 670.3 | 469.8 | 70 |

### 3.2 Financial risk

The Company is member of the Insurance Division of the Royal Bank of Scotland Group. As such, the Company benefits from services provided by specialist teams and risk management procedures and controls which are applied consistently across the Division.

The Company is exposed to financial risk through its financial assets and financial liabilities (borrowings). The Company's financial risk is concentrated within its investment portfolio. This portfolio is managed in accordance with the RBS Insurance Investment Policy and Investment Guidelines. These are drawn up in compliance with the objectives and risk appetite parameters set by The Royal Bank of Scotland Group plc and are approved by the RBS Insurance Group Limited Board. The Investment Policy is operated by the Investment Management Committee, which is made up of Senior Executives of both the Insurance Division and the Company, and the Funds Management Committee.

***The Investment Management Committee (IMC)***

The IMC determines high level policy and controls, covering such areas as safety, liquidity and performance. It meets half-yearly to evaluate risk exposure, the current strategy and to consider investment recommendations submitted to it. Any strategy changes are included in a revised Terms of Reference for the Funds Management Committee and the Company's Investment Policy and Guidelines are updated to reflect the changes.

## 3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)

***The Funds Management Committee (FMC)***

The FMC's Terms of Reference includes:

- To ensure that the day-to day investment management is carried out effectively in accordance with the Investment Policy and Investment Guidelines
- To develop and maintain an investment strategy that is appropriate to the circumstances of the Company and satisfies all regulators
- To review the appointment and dismissal of investment advisers and the suitability of investment and dealing recommendations having regard to the nature of the investment and the circumstances of the Company
- Report non compliance to the Company and the Royal Bank of Scotland Insurance Group Limited Board

The FMC meets on a monthly basis to review summary portfolios and to review any new investment proposals. If there are any portfolio positions outside the investment strategy the fund manager is instructed to rectify the position.

The Investment Policy sets out its objectives as:

- 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 need for operations
- To maximise the portfolio's total return within the constraints of the other objectives and the limits defined by the Investment Guidelines

To achieve these objectives the portfolio is required to be split between Operating Funds and Long-Term Funds. Operating Funds are those needed for current business operations and to support identified liabilities, together with an adequate safety margin, and must always be at least 35% of the total portfolio. The remainder of the portfolio is classified as long term. Derivatives may only be used for the purposes of reducing investment risks and efficient portfolio management. The Investment Guideline set out asset allocation rules and controls for each component part of the portfolio as follows:

***Operating Funds***

a) Asset Allocation - The Operating Funds segment of the investment portfolio shall only be invested in high quality liquid fixed and floating rate interest securities and in cash (bank deposits). Qualifying investments include:

- Bank Deposits
- Certificates of Deposit (CDs) and Commercial Paper (CP)
- Floating Rate Notes (FRNs)
- Government securities with maturities up to five years (including index linked)
- Listed Debt Securities with maturity up to five years

Investments should be managed to ensure a reasonably even spread of maturities over the forthcoming three-month period. In addition, the maturity profile must take account of any potential market price reduction due to interest rate or credit risk.

- Investments must be denominated in Sterling
- Investments in subordinated debt issued by Institutions authorised by the FSA may be made up to the specific limits agreed with Royal Bank of Scotland Group Risk
- All debt securities must have a pre-determined fixed coupon or an unrestricted variable coupon positively linked to a recognised market rate. They must also have a definitive maturity date
- The use of Futures and Forward Rate Agreements ("FRAs") are permitted strictly for the purpose of locking in yields or as an expedient method of investing in or hedging, subject to normal limits. It is expressly forbidden to use Futures or Options for gearing purposes
- Stock lending of securities is permitted within the limits agreed with Royal Bank of Scotland Group Risk

THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

**NOTES TO THE FINANCIAL STATEMENTS**
**FOR THE YEAR ENDED 31 DECEMBER 2005**

**3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)**

b) Controls - Bank Deposits up to one year may be approved by one member of the IMC. Other transactions must be approved by at least two members of the IMC. Any investment not specifically named in the limits agreed with Royal Bank of Scotland Group Risk must be approved by at least three members of the IMC.

***Long Term Funds***

a) Asset Allocation - To achieve its investment objective, the Long-Term Funds segment of the investment portfolio may be invested in the following asset classes, in addition to those mentioned in the Operating Funds.

- Equities
- Property
- Fixed Interest Debt Securities (five to fifteen years)
- Floating Rate Debt Securities (up to forty years)

Opportunistic investments in individual equity stocks will also be allowed up to a maximum of £50m and will be held as an Individual Equity Fund. This type of investment purchased for this portfolio would typically be those which are of undoubted credit quality and offer a good dividend yield. It is likely that such stocks would be liquid and traded on one of the major world stock exchanges.

b) Controls

- Investments will normally be denominated in Sterling. Suitable opportunities to invest in other currencies are permitted up to 10% (by reference to market value) of total invested funds
- Apart from currency investments, no other currency transactions are permitted except those which are specifically designed to hedge the risk associated with an underlying currency investment
- Bank Deposits up to one year may be approved by one member of the IMC, where there is a specific credit limit in place
- All debt securities must have a pre-determined fixed coupon or an unrestricted variable coupon positively linked to a recognised market rate. They must also have a definitive maturity date
- The use of Futures and Forward Rate Agreements ("FRAs") are permitted strictly for the purpose of locking in yields or as an expedient method of investing in or hedging, subject to normal limits. It is expressly forbidden to use Futures or Options for gearing purposes
- Stock lending of securities is permitted within the limits agreed with Royal Bank of Scotland Group Risk
- All equity purchases, with the exception of the Individual Equity Fund, must be purchased through one of the Investment Managers retained to run the equity funds. Any additional investments in any of the funds, other than reinvestment, must be approved by the IMC
- The Royal Bank of Scotland Insurance Board must approve any property purchased for the sole purpose of investment. Other than owner occupied premises, property investments shall be restricted to single tenant occupied office buildings with a 'blue-chip' covenant
- Fixed interest investments with a maturity up to fifteen years may be purchased if approved by at least two members of the IMC and must be within the limits as agreed with Royal Bank of Scotland Group Risk. Any investment where no specific prior limit has been approved by Royal Bank of Scotland Group Risk must be approved by at least three members of the IMC
- Floating rate investments with a maturity up to forty years may be purchased if approved by at least two members of the IMC, and must be within the limits as agreed with Royal Bank of Scotland Group Risk. Any investment where no specific prior limit has been approved by Royal Bank of Scotland Group Risk must be approved by at least three members of the IMC
- As mentioned above any purchase for the Individual Equity Fund must not exceed the portfolio limit of £50m and must be approved by the IMC plus either the Chairman of Royal Bank of Scotland Insurance or the Chairman of Royal Bank of Scotland Group. Due regard will be had to the regulator's admissibility limits and the total exposure aggregated with other debt or equity exposures to that name. Where the investment is to be made in a foreign currency, it is likely that the cost price would be hedged in the underlying currency

In general, the long-term fund will be invested in a manner such that at least 90% (by market value) of the investments are admissible assets for regulatory purposes.

The most important components of financial risk are market risk, credit risk and liquidity risk.

## 3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)

### 3.2.1 Market risk (comprising interest rate 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, equity prices and property valuations.

The Company is exposed to market risk because of positions held in its investment portfolio. Exposure to market risk is managed in accordance with the guidelines set out in the Royal Bank of Scotland Insurance Investment Policy as detailed above.
The following tables indicate financial assets that are exposed to interest rate risk together with the corresponding range of applicable interest rates:

**At 31 December 2005**

Maturity date or contractual repricing date

| | Within one year | After one but not more than two years | After two but not more than three years | After three but not more than four years | After four but not more than five years | More than five years | Total |
|---|---|---|---|---|---|---|---|
| | £ Million | £ Million | £ Million | £ Million | £ Million | £ Million | £ Million |
| **Exposed to fair value interest rate risk** | | | | | | | |
| Debt securities - fixed interest risk | 89.0 | 31.8 | 76.9 | 62.4 | 9.4 | 122.5 | **392.0** |
| **Exposed to cash flow interest rate risk** | | | | | | | |
| Debt securities - floating interest risk | 173.8 | - | - | - | - | - | **173.8** |
| Loans and receivables | 804.6 | - | - | - | - | - | **804.6** |
| **Total fair value** | **1,067.4** | **31.8** | **76.9** | **62.4** | **9.4** | **122.5** | **1,370.4** |

Interest rate range

| | Within one year | After one but not more than two years | After two but not more than three years | After three but not more than four years | After four but not more than five years | More than five years |
|---|---|---|---|---|---|---|
| | % Interest rate range | % Interest rate range | % Interest rate range | % Interest rate range | % Interest rate range | % Interest rate range |
| Debt securities - fixed interest risk | 4.07-4.47 | 4.27-4.57 | 4.17-4.66 | 4.19-4.68 | 4.51-4.63 | 4.11-4.88 |
| Debt securities - floating interest risk | 4.52-5.29 | n/a | n/a | n/a | n/a | n/a |
| Loans and receivables | 0.00-8.00 | n/a | n/a | n/a | n/a | n/a |

## 3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)

**At 31 December 2004**

Maturity date or contractual repricing date

| | Within one year | After one but not more than two years | After two but not more than three years | After three but not more than four years | After four but not more than five years | More than five years | Total |
|---|---|---|---|---|---|---|---|
| | £ Million | £ Million | £ Million | £ Million | £ Million | £ Million | £ Million |
| **Exposed to fair value interest rate risk** | | | | | | | |
| Debt securities - fixed interest risk | 27.2 | 90.2 | 86.1 | 75.6 | 61.2 | 70.8 | **411.1** |
| **Exposed to cash flow interest rate risk** | | | | | | | |
| Debt securities - floating interest risk | 160.1 | - | - | - | - | - | **160.1** |
| Loans and receivables | 757.0 | - | - | - | - | - | **757.0** |
| **Total fair value** | **944.3** | **90.2** | **86.1** | **75.6** | **61.2** | **70.8** | **1,328.2** |

Interest rate range

| | Within one year | After one but not more than two years | After two but not more than three years | After three but not more than four years | After four but not more than five years | More than five years |
|---|---|---|---|---|---|---|
| | % Interest rate range | % Interest rate range | % Interest rate range | % Interest rate range | % Interest rate range | % Interest rate range |
| Debt securities - fixed interest risk | 4.57-9.36 | 4.77-4.35 | 4.45-4.95 | 4.47-5.13 | 4.48-5.08 | 4.5-5.34 |
| Debt securities - floating interest risk | 4.86-5.61 | n/a | n/a | n/a | n/a | n/a |
| Loans and receivables | 0.00-8.00 | n/a | n/a | n/a | n/a | n/a |

The floating interest rate securities are stated at the contractual repricing date which is generally earlier than the maturity dates of these debt securities. All floating interest rate securities are subject to repricing within 12 months.

Investments in floating rate securities which are subject to an early repayment option have a market value of £80.7 million (2004: £75.4 million). This option lies with the issuer and the Investments would be redeemed at par. The Company would reinvest any amounts received as a settlement from application of the early repayment options into similar investments that accord with the Company's Investment Strategy.

### 3.2.2 Credit Risk

Credit risk arises from the potential that losses are incurred from the failure of a counterparty to meet its credit obligations. The main sources of credit risk for the Company 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 that have been incurred but not yet settled
- Partnership Premiums – where the partner collects premiums from the policyholder and subsequently remits the premium to the underwriter
- Premium Finance – a facility provided to policyholders whereby the annual premium due is spread over the policy period. The spreading of payments is achieved by providing the customer with a loan to pay the up front annual premium
- Broker Finance – a facility provided to brokers in relation their general business activities, mainly in connection with premium financing
- Brokers – credit facilities provided to brokers, where premiums collected by the broker do not have to be paid over to the insurer until an agreed future date

## 3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (Continued)

Royal Bank of Scotland Group Risk Management sets standards for maintaining and developing credit risk management throughout The Royal Bank of Scotland Group plc. This is achieved via a combination of governance structures, credit risk policies, control processes and infrastructure collectively known as the Group's Credit Risk Management Framework ("CRMF").

Royal Bank of Scotland Insurance has established its own CRMF consistent with The Royal Bank of Scotland Group CRMF. The Royal Bank of Scotland Insurance CRMF sets out the prior approval process for credit exposures and provides for appropriate analysis and reporting of these exposures at both the Company and Royal Bank of Scotland Group level. Where appropriate, larger credit exposures are aggregated with other credit exposures, elsewhere in the Group for credit approval and monitoring purposes.

The following table analyses the credit exposure of the Company by type of asset. The table includes reinsurance exposure, after provision. Refer to 3.1.3 for details of reinsurance credit risk management.

| **At 31 December 2005** | AAA £ Million | AA £ Million | A £ Million | BBB £ Million | Not rated £ Million | Total £ Million |
|---|---|---|---|---|---|---|
| Debt securities (note 17) | 392.3 | 72.4 | 60.4 | - | 40.7 | **565.8** |
| Deposits with credit institutions (note 17 & 22) | 55.0 | 749.6 | - | - | - | **804.6** |
| Insurance contracts - reinsurance asset (note 25) | 8.4 | 6.5 | 44.2 | 0.4 | 154.6 | **214.1** |
| Cash at bank and in hand (note 22) | - | 30.1 | - | - | - | **30.1** |
| Other loans and receivables (note 18) | - | - | - | - | 294.8 | **294.8** |
| **Total assets bearing credit risk** | **455.7** | **858.6** | **104.6** | **0.4** | **490.1** | **1,909.4** |

| **At 31 December 2004** | AAA £ Million | AA £ Million | A £ Million | BBB £ Million | Not rated £ Million | Total £ Million |
|---|---|---|---|---|---|---|
| Debt securities (note 17) | 370.2 | 39.8 | 143.6 | - | 17.6 | **571.2** |
| Deposits with credit institutions (note 17 & 22) | - | 757.0 | - | - | - | **757.0** |
| Insurance contracts - reinsurance asset (note 25) | 8.9 | 6.2 | 48.6 | 0.2 | 108.2 | **172.1** |
| Cash at bank and in hand (note 22) | - | 74.0 | - | - | - | **74.0** |
| Other loans and receivables (note 18) | - | - | - | - | 240.3 | **240.3** |
| **Total assets bearing credit risk** | **379.1** | **877.0** | **192.2** | **0.2** | **366.1** | **1,814.6** |

Receivables due from policyholders largely comprises individuals, brokers and intermediaries which generally will not have a credit rating.

### 3.2.3 Liquidity risk

Liquidity risk is the potential that obligations cannot be met as they fall due as a consequence of having a timing mismatch.

The management of liquidity risk within the Royal Bank of Scotland Insurance Division is undertaken within the limits and other policy parameters set out in the Investment Guidelines. The asset class and maturity parameters contained within this policy are summarised above. Compliance is monitored both in respect of the internal policy and the regulatory requirements of the FSA.

THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

**NOTES TO THE FINANCIAL STATEMENTS**
**FOR THE YEAR ENDED 31 DECEMBER 2005**

## 4. NET INSURANCE PREMIUM REVENUE

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| Premium income from insurance contracts issued: | | |
| Premium receivables | 909.1 | 952.7 |
| Change in unearned premium provision | (45.2) | (63.5) |
| | 863.9 | 889.2 |
| Premium revenue ceded to reinsurers on insurance contracts issued: | | |
| Premium payables | (221.3) | (238.5) |
| Change in unearned premium provision | 2.0 | 19.6 |
| | (219.3) | (218.9) |
| Net insurance premium revenue | **644.6** | **670.3** |

## 5. FEE INCOME

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| Profit participation from related parties (note 32) | **7.1** | **-** |

## 6. INVESTMENT INCOME

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| Available-for-sale financial assets: | | |
| Interest income from debt securities | 32.0 | 41.9 |
| Interest income: | | |
| from policyholders | 3.3 | 3.4 |
| from loans to related parties (note 32) | 1.2 | 1.9 |
| from deposits with credit institutions | 37.3 | 24.0 |
| Net unrealised gains/(losses) on financial assets: | | |
| Debt securities | - | (0.4) |
| Dividend (refund)/income from subsidiaries (note 32) | (5.0) | 10.0 |
| Net amortisation of (discount)/premium on purchase of financial assets | (5.3) | - |
| Income from other investments | 0.1 | (0.1) |
| | **63.6** | **80.7** |

As noted in 1.1, the Company has not restated its comparative information to comply with IAS 32 and 39. Consequently unrealised gains and losses from financial assets designated as available-for-sale are included within investment income for 2004.

The Dividend refund of £5.0 million in 2005 is in respect of reversal of an over accrual of dividend income in 2004.

## 7. NET REALISED GAINS/(LOSSES) ON FINANCIAL ASSETS

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| Net realised gains/(losses) on financial assets - available-for-sale: | | |
| *Debt securities* | ***0.4*** | **(11.3)** |

## 8. OTHER OPERATING INCOME

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| Other income | **27.5** | **47.1** |

An amount of £26.6 million (2004: £44.8 million) relates to the receipt of funds from the Company's former parent company, Winterthur Swiss Insurance (Winterthur), as part of an indemnity on loss movements within the Special Risks Division.

## 9. INSURANCE CLAIMS AND LOSS ADJUSTMENT EXPENSES

| | 2005 | | |
|---|---|---|---|
| | Gross<br>£ Million | Reinsurance<br>£ Million | Net<br>£ Million |
| Current accident year claims paid | 244.0 | (47.2) | 196.8 |
| Prior accident years' claims paid | 343.4 | (51.3) | 292.1 |
| Movement in current accident year claims provision | 453.6 | (110.1) | 343.5 |
| Movement in prior accident years' claims provision | (434.0) | 68.1 | (365.9) |
| | **607.0** | **(140.5)** | **466.5** |

| | 2004 | | |
|---|---|---|---|
| | Gross<br>£ Million | Reinsurance<br>£ Million | Net<br>£ Million |
| Current accident year claims paid | 180.4 | (33.9) | 146.5 |
| Prior accident years' claims paid | 288.5 | (27.7) | 260.8 |
| Movement in current accident year claims provision | 380.9 | (88.6) | 292.3 |
| Movement in prior accident years' claims provision | (263.9) | 27.5 | (236.4) |
| Movement in claims equalisation reserve | 6.6 | - | 6.6 |
| | ***592.5*** | ***(122.7)*** | ***469.8*** |

Loss adjustment expenses for the year have been included in the accident year claims paid figures above. As noted in 1.1, the Company has not restated its 2004 income statement and balance sheet to comply with IFRS 4. Consequently movements in the claims equalisation reserve are included in the income statement for 2004.

## 10. EXPENSES

| *a) Expenses for the acquisition of insurance contracts* | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Cost incurred for the acquisition of insurance contracts expensed in the year | 164.0 | 233.0 |
| Expense contributions under quota share contracts | (26.5) | (27.0) |
| | **137.5** | **206.0** |

| *b) Expenses for marketing and administration* | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Marketing and administration expenses | 108.6 | 110.2 |
| Depreciation (note 14) | 0.1 | 0.6 |
| Expense contributions under quota share contracts | (17.6) | (11.6) |
| | **91.1** | **99.2** |

Expenses for marketing and administration include integration costs of £18.3 million (2004: £19.5 million) arising from the integration of the Churchill Group of companies.

## 11. FINANCE COSTS

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Interest expense: | | |
| Borrowings from related parties (note 32) | **0.2** | **-** |

## 12. TAX CHARGE

| | 2005 *£ Million* | 2004 *£ Million* |
|---|---|---|
| Current taxation: | | |
| Tax charge/(credit) for the period | 11.4 | (53.5) |
| *Under provision in respect of prior periods* | 1.2 | 58.7 |
| | 12.6 | 5.2 |
| Deferred taxation (note 19): | | |
| *Charge for the period* | 2.7 | 57.4 |
| Under/(over) provision in respect of prior periods | - | (58.3) |
| | 2.7 | (0.9) |
| | **15.3** | **4.3** |

The actual tax charge differs from the expected tax charge computed by applying the standard rate of UK corporation tax of 30% as follows:

| | 2005 *£ Million* | 2004 *£ Million* |
|---|---|---|
| Expected tax charge | 14.4 | 1.4 |
| Effects of: | | |
| Non-deductible items | - | 5.4 |
| *Non-taxable items* | (0.3) | (3.0) |
| Discounting of reserves | - | 0.2 |
| Adjustments in respect of prior periods | 1.2 | 0.3 |
| ***Tax charge*** | **15.3** | **4.3** |

The aggregate current and deferred tax relating to items that are charged or (credited) to equity is £1.0 million (2004: Nil).

## 13. PROFIT FOR THE YEAR

| Profit for the year is stated after charging: | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Depreciation of plant and equipment | 0.1 | 0.6 |
| Impairment of investment in subsidiary undertakings | - | 4.8 |
| Total | 0.1 | 5.4 |
| | | |
| Operating lease rentals (note 30) | 3.8 | 4.8 |

**Auditors' remuneration**

Fees for audit and non-audit services, included within marketing and administration expenses, are borne and recharged by a related party. The amounts recharged in respect of audit services amount to £0.3 million (2004: £0.2 million). There were no non-audit services incurred in the current or previous year.

| **Directors' emoluments** | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Fees as directors | - | - |
| Other emoluments | 1.1 | 1.3 |
| Company pension contributions | 0.1 | 0.2 |
| Compensation for loss of office | - | 0.6 |
| | **1.2** | **2.1** |
| | | |
| Highest paid directors' emoluments (excluding pension contributions) | 0.2 | 0.3 |
| Highest paid directors' pension contributions | 0.0 | 0.0 |

No directors who served during this or the previous financial year were remunerated by the Company. The amounts disclosed above are those relating to their services as directors for the Company based on an estimated time allocation basis. Emoluments in relation to services performed by the directors for other group companies are not disclosed in the Company's financial statements.

Included in the above are emoluments, excluding pension contributions, paid to the highest director amounting to £208,408 (2004: £290,002).

A contribution of £37,686 (2004: £41,635) to a money purchase scheme was made on behalf of the highest paid director. 4 other directors (2004: 6 directors) had retirement benefits accruing under money purchase pension schemes in respect of qualifying service and 1 directors (2004: 1 directors) had benefits accruing under defined pension schemes.

During the year 3 directors have exercised share options (2004: 3 directors). Details of these share options are disclosed within the directors' report.

## 14. PLANT AND EQUIPMENT

| | Vehicles £ Million | Other equipment £ Million | Total £ Million |
|---|---|---|---|
| **Cost** | | | |
| At 1 January 2004 | 0.3 | 9.0 | **9.3** |
| Additions | 0.1 | - | **0.1** |
| **At 1 January 2005** | 0.4 | 9.0 | **9.4** |
| **At 31 December 2005** | 0.4 | 9.0 | **9.4** |
| **Depreciation** | | | |
| At 1 January 2004 | 0.2 | 7.9 | **8.1** |
| Depreciation charge for the year | 0.1 | 0.5 | **0.6** |
| **At 1 January 2005** | 0.3 | 8.4 | **8.7** |
| Depreciation charge for the year | - | 0.1 | **0.1** |
| **At 31 December 2005** | 0.3 | 8.5 | **8.8** |
| **Net book amount** | | | |
| At 31 December 2005 | **0.1** | **0.5** | **0.6** |
| At 31 December 2004 | **0.1** | **0.6** | **0.7** |

## 15. INVESTMENT PROPERTIES

| | 2005 *£ Million* | 2004 *£ Million* |
|---|---|---|
| At 1 January | 0.3 | 0.3 |
| Disposals | (0.3) | - |
| **At 31 December** | **-** | **0.3** |

Investment property comprised freehold property occupied by entities outside The Royal Bank of Scotland Group plc on an operating lease. Operating lease rentals included in the income statement for the year were £0.00 million (2004: £0.1 million).

**NOTES TO THE FINANCIAL STATEMENTS**
**FOR THE YEAR ENDED 31 DECEMBER 2005**

## 16. INVESTMENTS IN ASSOCIATES AND SUBSIDIARIES

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| At 1 January | 27.5 | 32.3 |
| Impairment taken through income statement | - | (4.8) |
| **At 31 December** | **27.5** | **27.5** |

**Details of the Company's subsidiaries as at 31 December 2005 are as follows:**

| Name of subsidiary | Place of incorpor-ation and operation | Proportion of ownership interest | Proportion of voting power held | Principal activity |
|---|---|---|---|---|
| NIG Hallmark Limited | UK | 100% | 100% | Holding company |
| *Finsure Premium Finance Limited* | *UK* | *100%* | *100%* | *Premium finance company* |
| Set2print Limited | UK | 100% | 100% | Printing company |
| Ali Risk Management Limited | UK | | | Risk management consultancy |
| "A" shares | | 100% | 75% | |
| "B" shares | | 0% | 0% | |
| Deferred shares | | 100% | 100% | |

## 17. FINANCIAL ASSETS

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| **Available-for-sale investments** | | |
| Debt Securities: | | |
| Listed - fixed interest rate | 392.0 | 411.1 |
| Listed - floating interest rate | 173.8 | 160.1 |
| | **565.8** | **571.2** |
| **Loans and receivables** | | |
| Deposits with credit institutions with maturities in excess of three months - third parties | 614.9 | 345.0 |
| Other loans and receivables, including insurance receivables (note 18) | 294.8 | 240.3 |
| | **909.7** | **585.3** |

## 18. OTHER LOANS AND RECEIVABLES INCLUDING INSURANCE RECEIVABLES

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| *Receivables arising from insurance and reinsurance contracts:* | | |
| Due from policyholders | 53.5 | 57.4 |
| Less provision for impairment of receivables from policyholders | (0.2) | (0.2) |
| Due from agents, brokers and intermediaries | 122.2 | 112.8 |
| Less provision for impairment of receivables from agents, brokers and intermediaries | (6.3) | (6.2) |
| Due from reinsurers: | | |
| Third party reinsurers | 18.3 | - |
| Other loans and receivables: | | |
| Accrued interest and rent | 10.6 | 9.9 |
| Receivables from related parties (note 32) | 37.8 | 29.6 |
| *Loans to related parties (note* 32) | 41.1 | 29.2 |
| Other prepayments and accrued income | 8.9 | 0.4 |
| Other debtors | 8.9 | 7.4 |
| **Total loans and receivables including insurance receivables** | **294.8** | **240.3** |
| Current | 294.8 | 240.3 |
| | **294.8** | **240.3** |

## 19. DEFERRED TAXATION

The following are the tax assets and liabilities recognised by the Company, and the movements thereon, during the current and prior reporting periods.

| | Accelerated capital allowances £ Million | Provisions £ Million | Equalisation Reserve £ Million | Total £ Million |
|---|---|---|---|---|
| **At 1 January 2004** | 1.2 | - | - | **1.2** |
| Credit/(charge) to income statement (note 12) | (0.2) | 1.1 | - | **0.9** |
| **At 1 January 2005** | **1.0** | **1.1** | - | **2.1** |
| Implementation of IAS 32, IAS 39 and IFRS 4 (note 33) | - | - | (7.4) | **(7.4)** |
| **At 1 January 2005 restated** | **1.0** | **1.1** | **(7.4)** | **(5.3)** |
| Credit/(charge) to income statement (note 12) | (0.3) | (0.3) | (2.1) | **(2.7)** |
| **At 31 December 2005** | **0.7** | **0.8** | **(9.5)** | **(8.0)** |

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Deferred tax assets | - | 2.1 |
| Deferred tax liabilities | (8.0) | - |
| | **(8.0)** | **2.1** |

## 20. REINSURANCE ASSETS

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Reinsurers' share of insurance liabilities | | |
| - third party reinsurers | 79.3 | 92.3 |
| - related parties (note 32) | 237.5 | 180.5 |
| Impairment provision | (1.8) | (1.8) |
| Total assets arising from reinsurance contracts | **315.0** | **270.9** |
| *Current* | 315.0 | 270.9 |
| | **315.0** | **270.9** |

## 21. *DEFERRED ACQUISITION COSTS*

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| At 1 January | 59.8 | 53.2 |
| Net credit to income statement | 13.1 | 6.6 |
| **At 31 December** | **72.9** | **59.8** |

## 22. CASH AND CASH EQUIVALENTS

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Cash at bank and in hand | | |
| - third parties | 23.4 | 62.7 |
| - related parties (note 32) | 6.7 | 11.3 |
| Short term deposits with credit institutions | | |
| - third parties | 112.3 | 153.8 |
| - related parties (note 32) | 77.4 | 258.2 |
| | **219.8** | **486.0** |

The effective interest rate on short term deposits with credit institutions was 4.53% (2004: 4.63%) and has an average maturity of 6 days.

For the purposes of the cash flow statement, cash and bank overdrafts are as follows:

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Cash and cash equivalents | 219.8 | 486.0 |
| Bank overdrafts (note 26) | (18.9) | (7.3) |
| | **200.9** | **478.7** |

## 23. SHARE CAPITAL

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| *Authorised:* | | |
| **Equity shares** | | |
| 255,000,000 ordinary shares of £1 each | **255.0** | **255.0** |
| Issued and fully paid: | | |
| **Equity shares** | | |
| 255,000,000 ordinary shares of £1 each | | |
| At 1 January and 31 December | **255.0** | **255.0** |

## 24. *OTHER RESERVES AND RETAINED EARNINGS*

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Reserve for revaluation of available-for-sale investments | 4.2 | - |
| Claims equalisation reserve | 31.8 | - |
| **Other reserves at 31 December** | **36.0** | **-** |
| **Retained earnings at 31 December** | **21.4** | **5.2** |

In 2005, and in order to comply with chapter 7.5 of the Integrated Prudential Sourcebook, a statutory claims equalisation reserve has been included as a non distributable reserve within other reserves in equity.

Movements in the revaluation reserve for available-for-sale investments were as follows:

| | Debt securities £ Million |
|---|---|
| **At 1 January 2005** | - |
| *Implementation of IAS 32 and IAS 39 on 1 January 2005* | 2.0 |
| **At 1 January 2005 (Restated)** | 2.0 |
| Revaluation during the period - gross | 3.6 |
| Revaluation during the period - taxation | (1.1) |
| Net gains transferred to net profit on disposal and impairment - gross (note 7) | (0.4) |
| Net gains transferred to net profit on disposal and impairment - tax (note 12) | 0.1 |
| **At 31 December 2005** | **4.2** |

Movements in the claims equalisation reserve were as follows:

| | £ Million |
|---|---|
| **At 1 January 2005** | - |
| Transfer from retained earnings on implementation of IFRS 4 on 1 January 2005 | 24.8 |
| **At 1 January 2005 (Restated)** | 24.8 |
| Transfer from retained earnings for movement in year | 7.0 |
| **At 31 December 2005** | **31.8** |

THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2005

## 25. *INSURANCE CONTRACTS AND REINSURANCE ASSETS*

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| **Gross** | | |
| Claims reported | 577.2 | 508.5 |
| Claims incurred but not reported | 485.7 | 534.7 |
| Loss adjustment expenses | 39.8 | 33.8 |
| Unearned premiums | 460.0 | 414.8 |
| *Claims equalisation reserve* | - | 24.8 |
| **Total insurance liabilities, gross** | **1,562.7** | **1,516.6** |
| | | |
| **Recoverable from reinsurers** | | |
| Claims reported | (128.6) | (110.3) |
| Claims incurred but not reported | (85.5) | (61.8) |
| Unearned premiums | (100.9) | (98.8) |
| **Total reinsurers' share of insurance liabilities** | **(315.0)** | **(270.9)** |

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| **Net** | | |
| Claims reported | 448.6 | 398.2 |
| *Claims incurred but not reported* | 400.2 | 472.9 |
| Loss adjustment expenses | 39.8 | 33.8 |
| Unearned premiums | 359.1 | 316.0 |
| Claims equalisation reserve | - | 24.8 |
| **Total insurance liabilities, net** | **1,247.7** | **1,245.7** |
| | | |
| Current | 1,247.7 | 1,245.7 |
| | **1,247.7** | **1,245.7** |

THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2005

## 25. INSURANCE CONTRACTS AND REINSURANCE ASSETS (Continued)

Insurance claims - gross

| **Accident year** | 2001 £ Million | 2002 £ Million | 2003 £ Million | 2004 £ Million | 2005 £ Million | Total £ Million |
|---|---|---|---|---|---|---|
| Estimate of ultimate claims costs: | | | | | | |
| At end of accident year | 294.8 | 348.3 | 520.4 | 541.1 | 677.4 | **2,382.0** |
| One year later | (7.3) | 0.1 | (66.1) | (72.5) | - | **(145.8)** |
| Two years later | 8.7 | (7.5) | (28.3) | - | - | **(27.1)** |
| Three years later | (8.1) | (13.8) | - | - | - | **(21.9)** |
| Four years later | (8.1) | - | - | - | - | **(8.1)** |
| Current estimate of cumulative claims | 280.0 | 327.1 | 426.0 | 468.6 | 677.4 | **2,179.1** |
| *Cumulative payments to date* | *(245.5)* | *(262.9)* | *(278.8)* | *(268.6)* | *(223.8)* | **(1,279.6)** |
| Liability recognised in balance sheet | 34.5 | 64.2 | 147.2 | 200.0 | 453.6 | **899.5** |
| Liability in respect of prior years | | | | | | 25.7 |
| **Total liability included in the balance sheet** | | | | | | **925.2** |

Insurance claims - net of reinsurance

| **Accident year** | 2001 £ Million | 2002 £ Million | 2003 £ Million | 2004 £ Million | 2005 £ Million | Total £ Million |
|---|---|---|---|---|---|---|
| Estimate of ultimate claims costs: | | | | | | |
| *At end of accident year* | *286.6* | *340.5* | *421.0* | *418.6* | *520.1* | **1,986.8** |
| One year later | (9.2) | (1.7) | (55.8) | (59.6) | - | **(126.3)** |
| Two years later | 7.6 | (8.5) | (20.6) | - | - | **(21.5)** |
| Three years later | (6.2) | (13.8) | - | - | - | **(20.0)** |
| Four years later | (6.5) | - | - | - | - | **(6.5)** |
| Current estimate of cumulative claims | 272.3 | 316.5 | 344.6 | 359.0 | 520.1 | **1,812.5** |
| Cumulative payments to date | (244.0) | (261.0) | (224.3) | 209.2 | (176.4) | **(696.5)** |
| Liability recognised in balance sheet | 28.3 | 55.5 | 120.3 | 568.2 | 343.7 | **1,116.0** |
| Liability in respect of prior years | | | | | | 12.8 |
| **Total liability included in the balance sheet** | | | | | | **1,128.8** |

Insurance claims - gross

| **Underwriting year** | 2001 £ Million | 2002 £ Million | 2003 £ Million | 2004 £ Million | 2005 £ Million | Total £ Million |
|---|---|---|---|---|---|---|
| Estimate of ultimate claims costs: | | | | | | |
| At end of underwriting year | 88.2 | 102.1 | 64.9 | 12.4 | 9.2 | **276.8** |
| One year later | 50.0 | 66.9 | 53.0 | 0.4 | - | **170.3** |
| Two years later | 21.8 | 13.7 | (8.6) | - | - | **26.9** |
| Three years later | 29.5 | 35.6 | - | - | - | **65.1** |
| Four years later | (5.7) | - | - | - | - | **(5.7)** |
| Current estimate of cumulative claims | 183.8 | 218.3 | 109.3 | 12.8 | 9.2 | **533.4** |
| Cumulative payments to date | (144.0) | (166.5) | (81.3) | (10.4) | (9.2) | **(411.4)** |
| Liability recognised in balance sheet | 39.8 | 51.8 | 28.0 | 2.4 | - | **122.0** |
| Liability in respect of prior years | | | | | | 15.7 |
| **Total liability included in the balance sheet** | | | | | | **137.7** |

## 25. INSURANCE CONTRACTS AND REINSURANCE ASSETS (Continued)

Insurance claims - net of reinsurance

| **Underwriting year** | 2001<br>£ Million | 2002<br>£ Million | 2003<br>£ Million | 2004<br>£ Million | 2005<br>£ Million | Total<br>£ Million |
|---|---|---|---|---|---|---|
| Estimate of ultimate claims costs: | | | | | | |
| At end of underwriting year | 69.5 | 70.3 | 50.5 | 12.4 | 9.2 | **211.9** |
| One year later | 34.8 | 71.6 | 49.4 | 0.4 | - | **156.2** |
| Two years later | 26.3 | 9.4 | (9.4) | - | - | **26.3** |
| Three years later | 29.2 | 35.3 | - | - | - | **64.5** |
| Four years later | (8.8) | - | - | - | - | **(8.8)** |
| Current estimate of cumulative claims | 151.0 | 186.6 | 90.5 | 12.8 | 9.2 | **450.1** |
| Cumulative payments to date | (110.8) | (134.9) | (62.6) | (10.4) | (9.2) | **(327.9)** |
| Liability recognised in balance sheet | 40.2 | 51.7 | 27.9 | 2.4 | - | **122.2** |
| Liability in respect of prior years | | | | | | 16.0 |
| **Total liability included in the balance sheet** | | | | | | **138.2** |

***Movements in insurance liabilities and reinsurance assets***

(i) Claims and loss adjustment expenses

| | Gross<br>£ Million | Reinsurance<br>£ Million | Net<br>£ Million |
|---|---|---|---|
| *Notified claims* | 462.3 | (71.2) | 391.1 |
| Incurred but not reported | 489.7 | (39.9) | 449.8 |
| **At 1 January 2004** | **952.0** | **(111.1)** | **840.9** |
| | | | |
| Cash paid for claims settled in the year | (469.0) | 61.7 | (407.3) |
| Increase in liabilities | | | |
| - arising from current year claims | 569.4 | (122.5) | 446.9 |
| - arising from prior year claims | 24.6 | (0.2) | 24.4 |
| **At 31 December 2004** | **1,077.0** | **(172.1)** | **904.9** |
| | | | |
| Notified claims | 542.3 | (110.3) | 432.0 |
| Incurred but not reported | 534.7 | (61.8) | 472.9 |
| **At 1 January 2005** | **1,077.0** | **(172.1)** | **904.9** |
| | | | |
| Cash paid for claims settled in the year | (587.3) | 98.5 | (488.8) |
| Increase in liabilities | | | |
| - arising from current year claims | 703.6 | (157.3) | 546.3 |
| - arising from prior year claims | (90.6) | 16.8 | (73.8) |
| **At 31 December 2005** | **1,102.7** | **(214.1)** | **888.6** |
| | | | |
| Notified claims | 617.0 | (128.6) | 488.4 |
| Incurred but not reported | 485.7 | (85.5) | 400.2 |
| **At 31 December 2005** | **1,102.7** | **(214.1)** | **888.6** |

## 25. INSURANCE CONTRACTS AND REINSURANCE ASSETS (Continued)

(ii) Provisions for unearned premiums and unexpired short term insurance risks

| | Gross £ Million | Reinsurance £ Million | Net £ Million |
|---|---|---|---|
| **Unearned premium provision** | | | |
| At 1 January 2004 | 351.2 | (79.2) | 272.0 |
| Net increase/(decrease) in the year | 63.6 | (19.6) | 44.0 |
| **At 31 December 2004** | **414.8** | **(98.8)** | **316.0** |
| Net increase/(decrease) in the year | 45.2 | (2.1) | 43.1 |
| **At 31 December 2005** | **460.0** | **(100.9)** | **359.1** |

## 26. BORROWINGS

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| *Loans from related parties (note 32)* | 4.7 | 4.5 |
| Bank overdrafts from related parties (note 32) | 18.9 | 7.3 |
| | **23.6** | **11.8** |

The borrowings are repayable as follows:

| | | |
|---|---|---|
| On demand or within one year | **23.6** | **11.8** |

The average interest rates paid were as follows:

| | 2005 | 2004 |
|---|---|---|
| Bank overdrafts | 5.69% | 5.58% |

Details of loans and bank overdrafts with related parties can be found in note 32.

The carrying value of the short term borrowings approximates to their fair value.

## 27. TRADE AND OTHER PAYABLES INCLUDING INSURANCE PAYABLES

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Due to agents, brokers and intermediaries | | |
| third party | 14.9 | 13.0 |
| related parties (note 32) | 0.8 | 0.3 |
| Due to reinsurers: | | |
| third party reinsurers | - | 1.7 |
| related parties (note 32) | 108.3 | 98.6 |
| Due to related parties (note 32) | 28.0 | 71.3 |
| Trade creditors and accruals | (0.2) | 16.3 |
| Other creditors | 5.3 | 4.6 |
| Other taxes | 8.6 | 11.5 |
| | **165.7** | **217.3** |

## 28. PROVISIONS FOR OTHER LIABILITIES AND CHARGES

| | Regulatory levies £ Million |
|---|---|
| **At 1 January 2004** | **14.4** |
| Charged to the income statement: | |
| - additional provisions | 12.7 |
| - unused amounts reversed | (3.6) |
| Used during year | (10.8) |
| **At 31 December 2004** | **12.7** |
| Charged to the income statement: | |
| - additional provisions | 15.8 |
| - unused amounts reversed | (2.6) |
| Used during year | (10.6) |
| **At 31 December 2005** | **15.3** |

## 29. CONTINGENT LIABILITIES

There are no contingent liabilities that require disclosure in these financial statements.

## 30. COMMITMENTS

**Operating lease commitments**

The company leases certain of its office properties under non-cancellable operating lease agreements. The leases have varying terms, escalation clauses and renewal rights.

The Company also leases vehicles and other assets under cancellable operating lease agreements.

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Minimum lease payments under operating leases recognised as an expense in the year | 4.0 | 4.8 |

At the balance sheet date, the Company had outstanding commitments under non-cancellable operating leases, which fall due as follows:

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Within one year | - | 0.2 |
| In the second to fifth years inclusive | 0.1 | 0.2 |
| After five years | 3.7 | 4.4 |
| | 3.8 | 4.8 |

## 31. IMMEDIATE PARENT COMPANIES

The Company's immediate parent company is RBS Insurance Group Limited.

The Company's ultimate holding company, ultimate controlling party, and the parent of the largest and smallest group into which the Company is consolidated is The Royal Bank of Scotland Group plc, which is incorporated in Great Britain and registered in Scotland. Financial statements for The Royal Bank of Scotland Group plc can be obtained from The Royal Bank of Scotland Group plc, Gogarburn, PO Box 1000, Edinburgh EH12 1HQ.

THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2005

## 32. RELATED PARTY TRANSACTIONS

The following transactions were carried out with related parties.

### i. Sales of insurance contracts and other services

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| *Sales of services:* | | |
| All Risk Management Limited | - | 0.2 |
| Churchill Insurance Company Limited | 9.8 | 0.5 |
| Finsure Premium Finance Limited | 1.7 | 0.3 |
| NIG Hallmark Limited | 5.0 | - |
| RBS plc | 0.4 | - |
| Set2print Limited | 0.1 | - |
| | 17.0 | 1.0 |
| Interest received: | | |
| Finsure Premium Finance Limited | 1.2 | 1.9 |
| | 1.2 | 1.9 |

Interest income received from deposits held with related parties were at rates ranging from 4.54% to 4.78%.

### ii. Purchases of products and services

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Purchases of services: | | |
| Churchill Insurance Company Limited | 0.1 | 2.1 |
| Churchill Management Limited | - | 65.3 |
| C.S.G. Claims Services Limited | - | 1.7 |
| Devitt Insurance Services Limited | 3.7 | 1.9 |
| Direct Line Accident Management Limited | 0.1 | - |
| RBS Insurance Services Limited | 143.5 | - |
| RBS Business Insurance Service Limited | 0.5 | - |
| Set2print Limited | 1.0 | 1.2 |
| UK Assistance Accident Repair Centres Limited | 9.6 | 7.8 |
| | 158.5 | 80.0 |
| Interest paid: | | |
| NIG Hallmark Limited | 0.3 | - |
| | 0.3 | - |

## 32. RELATED PARTY TRANSACTIONS (Continued)

All employees were employed by RBS Insurance Services Limited, a fellow subsidiary company. Total employee costs, including directors' remuneration, recharged to the Company by RBS Insurance Services Limited during the year were £44.1 million (2004: £26.3 million). Prior year amounts were recharged to the Company by Churchill Management Limited.

*Employee costs recharged by RBS Insurance Services Limited includes the full costs of key managers and other staff* in respect of share-based payments. The attribution among members of the RBS Group has regard to the needs of the group as a whole. It would be inappropriate to deem that any employees had received share-based payments as a result of their employment with this Company.

### iii. Acquisition of reinsurance contracts

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| In relation to Headrow Reinsurance Limited | | |
| Purchases of reinsurance: | | |
| Written premium | 185.1 | 150.2 |
| *Change in unearned premium provision* | (16.1) | (11.0) |
| | 169.0 | 139.2 |
| Amounts recoverable in respect of: | | |
| Claims paid | 70.2 | 50.2 |
| Movement in claims provision | 40.9 | 44.0 |
| Expenses | 44.1 | 35.9 |
| Profit share receivable | 7.1 | - |
| | 162.3 | 130.1 |

### iv. Compensation of key management

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

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| Company pension contributions | 0.2 | 0.2 |
| | 1.6 | 2.3 |



31/03/200623:25

## 32. RELATED PARTY TRANSACTIONS (Continued)

### v. Year-end balances arising from sales/purchases of products/services

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Bank deposits held with related parties (note 22): | | |
| National Westminster plc | 6.6 | 9.0 |
| The Royal Bank of Scotland plc | 45.3 | 139.2 |
| | 51.9 | 148.2 |

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Bank overdrafts held with related parties (note 22): | | |
| *National Westminster plc* | 11.2 | 2.8 |
| The Royal Bank of Scotland plc | 7.7 | - |
| | 18.9 | 2.8 |

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Term deposits held with related parties (notes 17 and 22): | | |
| The Royal Bank of Scotland plc | - | 29.1 |
| | - | 29.1 |
| Movements in term deposits held with related parties were as follows: | | |
| At 1 January | 29.1 | - |
| New deposits placed in the period | 282.7 | 203.7 |
| Received on maturity in the period | (312.3) | (175.3) |
| Interest received | 0.5 | 0.7 |
| At 31 December | (0.0) | 29.1 |

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Receivables from related parties (note 18) | | |
| All Risk Management Limited | 0.1 | 0.8 |
| Churchill Insurance Company Limited | 10.8 | - |
| Direct Line Insurance Limited | 0.6 | - |
| Finsure Premium Finance Limited | 26.3 | 25.4 |
| Hallmark Insurance Company Limited | - | 2.1 |
| NIG Hallmark Limited | - | 0.9 |
| Set2print Limited | - | 0.5 |
| | 37.7 | 29.6 |
| Movements in receivables from related parties were as follows: | | |
| At 1 January | 29.6 | (32.4) |
| Transactions in the period | 11.0 | 90.5 |
| Settled in the period in cash | (2.9) | (28.5) |
| At 31 December | 37.7 | 29.6 |

**NOTES TO THE FINANCIAL STATEMENTS**
**FOR THE YEAR ENDED 31 DECEMBER 2005**

## 32. RELATED PARTY TRANSACTIONS (Continued)

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| Payables to related parties (note 27): | | |
| Churchill Insurance Company Limited | - | 0.9 |
| Churchill Management Limited | - | 69.3 |
| CSG Claims Services Limited | - | 1.1 |
| Devitt Insurance Services Limited | 0.8 | 0.3 |
| Headrow Reinsurance Limited | 108.3 | 98.6 |
| NIG Hallmark Limited | 4.2 | - |
| RBS Business Insurance Services Limited | 0.5 | - |
| RBS Insurance Services Limited | 23.3 | - |
| | 137.1 | 170.2 |

| | | |
|---|---|---|
| Movements in payables to related parties were as follows: | | |
| At 1 January | 170.2 | 137.9 |
| Transactions in the period | 211.8 | 83.1 |
| Settled in the period in cash | (244.9) | (50.8) |
| | - | - |
| At 31 December | 137.1 | 170.2 |

### vi. Loans to related parties

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| Loans to related parties (note 18): | | |
| Finsure Premium Finance Limited | 41.0 | 29.2 |
| | 41.0 | 29.2 |

Movements in loans to related parties were as follows:

| | 2005<br>£ Million | 2004<br>£ Million |
|---|---|---|
| Loans to directors and key management of the company: | | |
| At 31 December | - | - |
| | | |
| Loans to related parties (note 18): | | |
| At 1 January | 29.2 | 7.6 |
| Loans advanced during year | 19.3 | 44.6 |
| Loan repayments received | (6.3) | (21.1) |
| Interest charged | (1.2) | (1.9) |
| At 31 December | 41.0 | 29.2 |

## 32. RELATED PARTY TRANSACTIONS (Continued)

### vii. Loans from related parties

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Loans from related parties (note 26): | | |
| NIG Hallmark Limited | 4.7 | 4.5 |
| | 4.7 | 4.5 |

Movements in loans from related parties were as follows:

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Loans from related parties (note 26): | | |
| At 1 January | 4.5 | 4.5 |
| Interest received | 0.2 | - |
| At 31 December | 4.7 | 4.5 |

### viii. Reinsurance assets (note 20)

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| In relation to Headrow Reinsurance Limited | | |
| Amounts in respect of technical provisions: | | |
| Claims reported and incurred but not reported | 142.4 | 101.5 |
| Unearned premium | 95.1 | 79.0 |
| | 237.5 | 180.5 |

Movements in reinsurance assets were as follows:

| | 2005 £ Million | 2004 £ Million |
|---|---|---|
| Reinsurance assets (note 20): | | |
| At 1 January | 180.5 | 125.5 |
| Movement in claims provision | 40.9 | 44.0 |
| Change in unearned premium provision | 16.1 | 11.0 |
| At 31 December | 237.5 | 180.5 |

## 33. TRANSITION TO IFRS

This is the first year that the company has presented its financial statements under IFRS. The following disclosures are required in the year of transition. The Company's previous financial statements under UK GAAP were for the year ended 31 December 2004 and the date of transition to IFRS was therefore 1 January 2004. As stated at note 1.1, the Company has not restated its comparative statements to comply with IAS 32, 39 and IFRS 4. The date of transition for these statements is 1 January 2005.

**(1) Significant differences between the Company's UK GAAP and IFRS accounting policies**

| | UK GAAP | IFRS |
|---|---|---|
| a. | **Cash and cash equivalents**<br>Cash comprises cash and balances with banks repayable on demand. | Cash and cash equivalents comprise cash on hand and demand deposits with banks together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to insignificant risk of changes in value.<br><br>On implementation of IFRS short term deposits with credit institutions with original maturities of three months or less have been reclassified from loans and receivables to cash and cash equivalents. Cash and cash equivalents have increased by £464.4 million and £412.0 million at 1 January 2004 and 31 December 2004 respectively with a corresponding decrease in loans and receivables. |
| b. | **Income tax**<br>Deferred tax is not accounted for in relation to: revaluations of plant and equipment where there is no commitment to dispose of the asset; taxable gains or losses on sales of plant and equipment that are rolled over into the tax cost of replacement plant and equipment. | Deferred tax is provided on plant and equipment revaluations and on taxable gains and losses on sales of plant and equipment rolled over into the tax cost of replacement plant and equipment. |

**Implementation of IAS 32, IAS 39 and IFRS 4**

| | UK GAAP | IFRS |
|---|---|---|
| c. | **Financial instruments: financial assets**<br>Unrealised investment gains and losses arising from movements in the market value of debt securities and equity shares are taken to the income statement. | Under IAS 39, the Company has classified its financial assets as available-for-sale and loans and receivables. Available-for-sale assets are measured at fair value. Changes in the fair value of available-for-sale financial assets are reported in a separate component of shareholders' equity.<br><br>Any premium/discount on the purchase of debt securities is now amortised using the straight line basis.<br><br>On the implementation of IAS 39 on 1 January 2005 net unrealised gains and losses on available-for-sale debt securities amounting to £2.0 million were transferred from retained earnings to other reserves. The transfer comprised gross unrealised gains and losses on available-for-sale debt securities of £2.8 million offset by a related tax provision of £0.8 million. |

**33. TRANSITION TO IFRS (Continued)**

**d. Financial instruments: accrued interest**

Accrued income on the Company's investments in debt securities and equity shares is included within trade and other payables.

Accrued income on the Company's available-for-sale financial assets is included as part of the fair value of those assets at the balance sheet date.

The effect of implementing IAS 39 at 1 January 2005 is to increase the carrying amount of available-for-sale debt securities by £5.9 million with a corresponding decrease in loans and receivables.

**e. Insurance contracts: claims equalisation reserves**

Equalisation reserves are established in accordance with Chapter 7.5 of the Integrated Prudential Sourcebook and are in addition to the provision required to meet the anticipated ultimate cost of settlement of outstanding claims at the balance sheet date.

As no actual liability exists at the balance sheet date, no provision is made in the income statement in relation to movements in claims equalisation reserves.

An amount equal to the claims equalisation reserve is transferred from retained earnings to other reserves within shareholders' funds. Deferred tax has not been included in this transfer.

The impact of implementing IFRS 4 at 1 January 2005 is to reduce insurance contracts by £24.8 million with a corresponding increase in other reserves. The associated deferred tax asset has also been extinguished resulting in the elimination of the deferred tax asset of £2.1 million and the creation of a deferred tax liability of £5.4 million, retained earnings have reduced by £7.5 million. The net impact is to increase shareholders' funds by £17.4 million.

## 33. TRANSITION TO IFRS (Continued)

### (2) Analysis of IFRS adjustments, excluding IAS32, IAS 39 and IFRS 4

**Opening balance sheet at 1 January 2004**

| | Notes | UK GAAP £ Million | Effect of transition to IFRSs £ Million | IAS £ Million |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Plant and equipment | | 1.2 | - | 1.2 |
| Investment property | | 0.3 | - | 0.3 |
| Investments in associates and subsidiaries | | 32.3 | - | 32.3 |
| Financial assets | | | | |
| Available-for-sale debt securities | | 710.6 | - | 710.6 |
| Loans and receivables | a | 746.5 | (464.4) | 282.1 |
| Current tax assets | | 19.9 | - | 19.9 |
| Deferred tax asets | | 1.2 | - | 1.2 |
| Insurance contracts | | | | |
| Reinsurance assets | | 220.3 | - | 220.3 |
| Deferred acquisition costs | | 53.2 | - | 53.2 |
| Cash and cash equivalents | a | 53.1 | 464.4 | 517.5 |
| **Total assets** | | **1,838.6** | **-** | **1,838.6** |
| **EQUITY** | | | | |
| Share capital | | 255.0 | - | 255.0 |
| Retained earnings | | (2.3) | - | (2.3) |
| **Total equity** | | **252.7** | **-** | **252.7** |
| **LIABILITIES** | | | | |
| Insurance contracts | | 1,321.3 | - | 1,321.3 |
| Financial liabilities | | | | |
| Borrowings | | 6.8 | - | 6.8 |
| Trade and other payables including insurance payables | | 243.4 | - | 243.4 |
| Provisions for other liabilities and charges | | 14.4 | - | 14.4 |
| **Total liabilities** | | **1,585.9** | **-** | **1,585.9** |
| **Total equity and liabilities** | | **1,838.6** | **-** | **1,838.6** |

**Reconciliation of shareholders' funds as at 1 January 2004**

There are no reconciling items between shareholders' funds stated under UK GAAP and IFRS.

## 33. TRANSITION TO IFRS (Continued)

**Balance sheet at 31 December 2004**

| | Notes | UK GAAP £ Million | Effect of transition to IFRSs £ Million | IAS £ Million |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Plant and equipment | | 0.7 | - | 0.7 |
| Investment property | | 0.3 | - | 0.3 |
| Intangible assets including intangible insurance assets | | - | - | - |
| Investments in associates and subsidiaries | | 27.5 | - | 27.5 |
| Financial assets | | | | |
| Available-for-sale equity shares | | - | - | - |
| Available-for-sale debt securities | | 571.2 | - | 571.2 |
| Loans and receivables | a | 997.3 | (412.0) | 585.3 |
| Current tax assets | | 14.8 | - | 14.8 |
| Deferred tax assets | | 2.1 | - | 2.1 |
| Insurance contracts | | | | |
| Reinsurance assets | | 271.0 | (0.1) | 270.9 |
| Deferred acquisition costs | | 59.8 | - | 59.8 |
| Cash and cash equivalents | a | 74.0 | 412.0 | 486.0 |
| **Total assets** | | **2,018.7** | **(0.1)** | **2,018.6** |
| **EQUITY** | | | | |
| Share capital | | 255.0 | - | 255.0 |
| Other reserves | | - | - | - |
| Retained earnings | | 5.2 | - | 5.2 |
| **Total equity** | | **260.2** | **-** | **260.2** |
| **LIABILITIES** | | | | |
| Insurance contracts | | 1,516.7 | (0.1) | 1,516.6 |
| Financial liabilities | | | | |
| Borrowings | | 11.8 | - | 11.8 |
| Trade and other payables including insurance payables | | 217.3 | - | 217.3 |
| Provisions for other liabilities and charges | | 12.7 | - | 12.7 |
| **Total liabilities** | | **1,758.5** | **(0.1)** | **1,758.4** |
| **Total equity and liabilities** | | **2,018.7** | **(0.1)** | **2,018.6** |

## 33. TRANSITION TO IFRS (Continued)

**Income statement for the year ended 31 December 2004**

| | Notes | UK GAAP £ Million | Effect of transition to IFRSs £ Million | IAS £ Million |
|---|---|---|---|---|
| Insurance premium revenue | | 889.2 | - | 889.2 |
| Insurance premium ceded to reinsurers | | (218.9) | - | (218.9) |
| **Net insurance premium revenue** | | **670.3** | **-** | **670.3** |
| Investment income | | 80.7 | - | 80.7 |
| Net realised gains and losses on financial assets | | (11.3) | - | (11.3) |
| Other operating income | | 47.1 | - | 47.1 |
| **Net income** | | **786.8** | **-** | **786.8** |
| Insurance claims and loss adjustment expenses | | (592.5) | - | (592.5) |
| Insurance claims and loss adjustment expenses recovered from reinsurers | | 122.7 | - | 122.7 |
| **Net insurance claims** | | **(469.8)** | **-** | **(469.8)** |
| Expenses for the acquisition of insurance contracts | | (206.0) | - | (206.0) |
| Expenses for marketing and administration | | (99.2) | - | (99.2) |
| **Expenses** | | **(305.2)** | **-** | **(305.2)** |
| **Profit before tax** | | **11.8** | **-** | **11.8** |
| Income tax expenses | | (4.3) | - | (4.3) |
| **Profit for the year** | | **7.5** | **-** | **7.5** |

THE NATIONAL INSURANCE AND GUARANTEE CORPORATION LIMITED

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2005

## 33. TRANSITION TO IFRS (Continued)

### (3) Analysis of IAS 32, IAS 39 and IFRS 4 adjustments

**Balance sheet at 1 January 2005**

| | Notes | At 1 January 2005 £ Million | Effect of IAS 32, 39 and IFRS 4 £ Million | At 1 January 2005 £ Million |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Plant and equipment | | 0.7 | - | 0.7 |
| Investment property | | 0.3 | - | 0.3 |
| Investments in associates and subsidiaries | | 27.5 | - | 27.5 |
| Financial assets | | | | |
| Available-for-sale debt securities | d | 571.2 | 5.9 | 577.1 |
| Loans and receivables | d | 585.3 | (5.9) | 579.4 |
| Current tax assets | e | 14.8 | - | 14.8 |
| Deferred tax assets | | 2.1 | (2.1) | - |
| Insurance contracts | | | | |
| Reinsurance assets | | 270.9 | 0.1 | 271.0 |
| Deferred acquisition costs | | 59.8 | - | 59.8 |
| Cash and cash equivalents | | 486.0 | - | 486.0 |
| **Total assets** | | **2,018.6** | **(2.0)** | **2,016.6** |
| **EQUITY** | | | | |
| Share capital | | 255.0 | - | 255.0 |
| Other reserves | c, e | - | 26.8 | 26.8 |
| Retained earnings | c, e | 5.2 | (9.4) | (4.2) |
| **Total equity** | | **260.2** | **17.4** | **277.6** |
| **LIABILITIES** | | | | |
| Insurance contracts | e | 1,516.6 | (24.8) | 1,491.8 |
| Financial liabilities | | | | |
| Borrowings | | 11.8 | - | 11.8 |
| Trade and other payables including insurance payables | | 217.3 | - | 217.3 |
| Deferred income tax | e | - | 5.4 | 5.4 |
| Provisions for other liabilities and charges | | 12.7 | - | 12.7 |
| **Total liabilities** | | **1,758.4** | **(19.4)** | **1,739.0** |
| **Total equity and liabilities** | | **2,018.6** | **(2.0)** | **2,016.6** |

| ***Reconciliation of shareholders' funds*** | £ Million |
|---|---|
| **Shareholders' funds under UK GAAP and IFRS at 31 December 2004** | 260.2 |
| Standards applicable from 1 January 2005: | |
| Claims equalisation reserves | 24.9 |
| Tax effect on cumulative IFRS adjustments | (7.5) |
| ***Shareholders' funds under IFRS at 1 January 2005*** | 277.6 |