Company Registration No: 2199286

DIRECT LINE LIFE INSURANCE COMPANY 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

DIRECT LINE LIFE INSURANCE COMPANY LIMITED

CONTENTS

DIRECT LINE LIFE INSURANCE COMPANY LIMITED

OFFICERS AND PROFESSIONAL ADVISERS

DIRECTORS:	I H Chippendale A E Court R D Houghton D A MacKechnie C Moat
SECRETARY:	P A Hutchings
HEAD OF ACTUARIAL FUNCTION:	D T Addison
REGISTERED OFFICE:	3 Edridge Road Croydon Surrey CR9 1AG
AUDITORS:	Deloitte & Touche LLP Glasgow

Registered in England and Wales

DIRECT LINE LIFE INSURANCE COMPANY 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 transacts long term insurance falling within business classes I and IV of Annex 11.1 of chapter 11 in volume 1 of the FSA Interim Prudential Sourcebook: Insurers. The products currently provided are mortgage life cover, fixed term life cover, mortgage life cover with critical illness, and fixed term life cover with critical illness.

The retained profit for the period was £9,503,000 (2004: retained profit £7,893,000) 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 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 2.

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

	Appointed	Resigned
Directors		
R D Houghton	10 February 2005	
C Moat	6 October 2005	
G A F Ross		31 July 2005
Secretary		
P A Hutchings	14 April 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, Ms A E Court, Mr R D Houghton, Mr D A Mackechnie and Mr C Moat have been granted Qualifying Third Party Indemnity Provisions by The Royal Bank of Scotland Group plc.

DIRECT LINE LIFE INSURANCE COMPANY LIMITED

DIRECTORS' REPORT

DIRECTORS' INTERESTS

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

The following directors were 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 Moat	832	211

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 directors of the Company and connected persons are:

	As at 1 January 2005*	Granted during the period		Exercised during the period		As at 31 December
		Options	Price (p)	Options	Price (p)	
C Moat	18,645	13,375	1729	-	-	32,020

* or date of appointment if later

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 and Mr R D Houghton in the share capital of The Royal Bank of Scotland Group plc are disclosed in the financial statements of RBS Insurance Group Limited. The interests of Mr D A MacKechnie in the share capital of The Royal Bank of Scotland Group plc are disclosed in the financial statements of Direct Line Life Holdings 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.

HEAD OF ACTUARIAL FUNCTION

Mr D T Addison is the head of actuarial function and also acts as the reporting actuary.

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.

D A MacKechnie
Managing Director

24 March 2006

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF DIRECT LINE LIFE INSURANCE COMPANY LIMITED

We have audited the individual company's financial statements of Direct Line Life Insurance Company Limited for the year ended 31 December 2005 which comprise the income statement, the balance sheet, the cash flow statement, the statement of changes in equity and the related notes to the accounts 1 to 28. 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 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 is not disclosed.

We read other information contained in the directors' 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 judgements 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:

- 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 its profit for the year then ended; and
- the financial statements have been properly prepared in accordance with the Companies Act 1985.

Deloitte & Touche LLP

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
Glasgow
Date 24 March 2006

DIRECT **LINE LIFE INSURANCE COMPANY LIMITED**

INCOME STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 2005

	Notes	2005 £'000	2004 £'000
Insurance premium revenue	4	122,148	113,924
Insurance premium ceded to reinsurers	4	(13,194)	(9,458)
Net insurance premium revenue		**108,954**	**104,466**
Investment income	5	5,112	4,473
Net income		**114,066**	**108,939**
Insurance benefits	6	25,390	57,156
Insurance benefits recovered from reinsurers	6	(13,306)	(41,636)
Net insurance benefits and claims		**12,084**	**15,520**
Expenses for the acquisition of insurance contracts	7	58,376	50,699
Expenses for marketing and administration	7	30,030	31,415
Expenses		**88,406**	**82,114**
Profit before tax		**13,576**	**11,305**
Income tax expenses	8	4,073	3,412
Profit for the year	9	**9,503**	**7,893**

All of the above amounts relate to continuing operations.

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

The notes on pages 10 to 33 form part of these financial statements

DIRECT LINE LIFE INSURANCE COMPANY LIMITED

BALANCE SHEET
AS AT 31 DECEMBER 2005

	Notes	2005 £'000	2004 £'000
ASSETS			
Property, plant and equipment	10	204	285
Investments	11	31,179	29,620
Insurance contracts:			
Reinsurance assets	12	153,308	147,323
Deferred tax asset	13	85	457
Financial assets:			
Loans and receivables	14	9,510	6,977
Cash and cash equivalents	15	79,943	72,799
Total assets		**274,229**	**257,461**
EQUITY			
Share capital	16	44,000	44,000
Other reserves	17	1,021	-
Retained earnings	17	13,453	3,950
Total equity		**58,474**	**47,950**
LIABILITIES			
Insurance contracts	18	208,776	200,845
Trade and other payables including insurance payables	19	2,931	5,288
Financial liabilities:			
Borrowings	20	1,625	656
Current tax liabilities		2,423	2,722
Total liabilities		**215,755**	**209,511**
Total equity and liabilities		**274,229**	**257,461**

The financial statements were approved by the board of directors and authorised for issue on 24 March 2006. They were signed on its behalf by:

D A Mackechnie
Managing Director

R D Houghton
Director

The notes on pages 10 to 33 form part of these financial statements.

DIRECT LINE LIFE INSURANCE COMPANY LIMITED

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

	Notes	Share capital £'000	Other reserves £'000	Retained earnings £'000	Total £'000
Balance as at 1 January 2004		**44,000**	**-**	**(3,943)**	**40,057**
Profit for the year		-	-	7,893	7,893
Total recognised income and expense for the year		-	-	7,893	7,893
Balance as at 31 December 2004		**44,000**	**-**	**3,950**	**47,950**
Implementation of IAS 32, IAS 39 and IFRS 4	26	-	812	-	812
Balance as at 1 January 2005		**44,000**	**812**	**3,950**	**48,762**
Net fair value gain on available-for-sale investments		-	209	-	209
Net income recognised directly in equity		-	209	-	209
Profit for the year		-	-	9,503	9,503
Total recognised income and expense for the year		-	209	9,503	9,712
Balance as at 31 December 2005		**44,000**	**1,021**	**13,453**	**58,474**

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

The notes on pages 10 to 33 form part of these financial statements

DIRECT LINE LIFE INSURANCE COMPANY LIMITED

CASH FLOW STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 2005

	Notes	2005 £'000	2004 £'000
Profit for the year		9,503	7,893
Adjustments for:			
Investment revenues		(5,112)	(4,473)
Income tax expense		4,073	3,412
Depreciation of property, plant and equipment		82	97
Loss on disposal of property, plant and equipment		-	(12)
Operating cash flows before movements in working capital		**8,546**	**6,917**
Net increase in insurance liabilities		7,931	43,045
Net increase in reinsurance assets		(5,985)	(35,802)
Net increase in loans and receivables		(2,501)	(1,925)
Net increase in other assets		-	4,501
Net (increase)/decrease in related party balances		(2,547)	2,718
Net increase/(decrease) in other operating liabilities		299	(4,634)
Cash generated from operations		**5,743**	**14,820**
Income taxes paid		(4,453)	(1,967)
Interest paid		(8)	-
Other operating activities		24	-
Net cash generated from operating activities		**1,306**	**12,853**
Cash flows from investing activities			
Interest received		5,128	4,238
Management Fee in respect of pension fund		-	15
Proceeds on maturity of available for sale debt securities		10,000	-
Proceeds on disposal of property, plant and equipment		-	12
Purchases of property, plant and equipment		(1)	(22)
Purchases of debt securities		(10,258)	(2,752)
Net cash generated from investing activities		**4,869**	**1,491**
Net increase in cash and cash equivalents		6,175	14,344
Cash and cash equivalents at the beginning of the year	15	72,143	57,799
Cash and cash equivalents at the end of the year	15	**78,318**	**72,143**

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 cash flows from payment of insurance claims.

The notes on pages 10 to 33 form part of these financial statements.

DIRECT LINE LIFE INSURANCE COMPANY LIMITED

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. 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 allowed 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.

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.

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 Life assurance

The Company's long-term assurance contracts include whole-life and term assurance contracts that are expected to remain in force for an extended period of time. These contracts insure events associated with human life (for example death or the occurrence of a critical illness).

a) Insurance premium revenue

Premiums are recognised as revenue when they become payable by the contract holder. Premiums are shown before the deduction of commission.

b) Insurance benefits

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

c) Insurance contracts

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

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

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

d) Reinsurance

The Company has reinsurance treaties that transfer significant insurance risk. Reinsurance cash flows are recognised when they become payable.

The Company cedes reinsurance in the normal course of business, with retention levels varying by book of business. Outwards reinsurance premiums are accounted for when they become payable. Outward reinsurance recoveries are accounted for in the same accounting period as the direct claims to which they relate.

1. **ACCOUNTING POLICIES (continued)**

The benefits to which the Company is entitled under its reinsurance contracts held are recognised as reinsurance assets. These assets consist of short-term balances due from reinsurers (classified within loans and receivables) as well as longer term receivables that are dependant on the expected benefits arising under the related reinsured contracts. 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 reinsurers 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.

e) Deferred acquisition costs

Acquisition expenses comprise direct costs and costs associated with obtaining and processing new business. Costs are amortised over a period no longer than that in which they are expected to be recoverable out of margins in revenues from the related policies.

1.4 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 available-for-sale assets estimates are based on the straight line method, which management has determined is a close approximation to the effective interest rate.

1.5 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 over their estimated useful lives. The depreciable amount is the cost of an asset less its residual value. Estimated useful lives are as follows:

Computer equipment:	5 years
Other equipment:	10 years

1.6 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.

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 1.4 above) is recognised in the income statement.

Regular way purchases of financial assets classified as loans and receivables are recognised on settlement date. All other 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 including insurance 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 and reinsurance recoveries.

1. ACCOUNTING POLICIES (continued)

1.7 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 including insurance receivables - A system based hold and chase process is applied should a customer fail to pay a premium. 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.

1.8 Taxation

Provision is made for taxation at current enacted rates on taxable profits, arising in income or 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.

1.9 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.

1.10 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.

1.11 Borrowings

Borrowings comprises bank overdrafts and inter company loans.

1.12 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.

1. ACCOUNTING POLICIES (continued)

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 effectively 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 above 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 10 to 13. 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 Life Insurance: Liabilities under long-term insurance contracts

Liabilities under long term insurance contracts are dependant on estimates made by the Company. Estimates are made regarding the expected number of deaths or critical illness claims for each of the years for which the Company is exposed to the risk. These estimates are based on standard industry and national mortality and morbidity tables which reflect recent historical mortality and morbidity experience. Adjustments to these tables are then made to reflect the Company's own recent experience.

The estimated number of deaths or critical illness claims determine the value of the benefit payments. The main source of uncertainty being the effect of epidemics and wide ranging lifestyle changes such as eating, smoking and exercise habits on future mortality and morbidity. Such factors could result in future mortality being significantly worse than in the past for age groups in which the Company has significant exposure.

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

Liabilities under long-term insurance contracts net of reinsurance at 31 December 2005 amounted to £54,759,000 (2004: £52,670,000).

2.2 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 £31,179,000 (2004: £29,620,000).

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 them.

The Company is a member of the Insurance Division of The Royal Bank of Scotland 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, pricing and reserving risk
- Claims management risk
- Reinsurance risk

3.1.1 Underwriting, pricing and reserving risk

Underwriting and pricing risk is the risk that inappropriate business will be written or inappropriate prices charged. The classes of business written, underwriting criteria and relevant limits define the Company's underwriting risk appetite.

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

Long term insurance contracts

The Company manages these risks 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
- Medical selection is included in the Company's underwriting procedures and premiums vary to reflect the lifestyle, health and family medical history of the applicant
- Comprehensive audit programmes
- Pricing policies which are set by pricing committees by product line
- Central control of policy wordings and any subsequent changes
- Insurance risk framework that involves, among other things, minuted monthly meetings where all aspects of insurance risk are discussed
- Weekly monitoring of key performance indicators by product
- Formal monthly monitoring and reporting to the executive
- Annual budgeting and quarterly re-forecasting
- Reserves are calculated by an independent consulting firm of actuaries

Frequency and severity of specific risks - long term insurance contracts

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

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

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

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

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

Benefits assured per life assured at the end of 2005	Total benefits insured			
	Before reinsurance		After reinsurance	
£'000	£m		£m	
0 - 100	4,837	37.2%	3,864	35.4%
100 - 200	5,962	46.0%	5,112	46.9%
200 -300	1,578	12.2%	1,390	12.8%
300 +	591	4.6%	529	4.9%
Total	12,968		10,895	

Benefits assured per life assured at end of 2004	Total benefits insured			
	Before reinsurance		After reinsurance	
£'000	£m		£m	
0 - 100	4,784	39.8%	3,773	37.9%
100 - 200	5,382	44.8%	4,573	45.8%
200 -300	1,349	11.2%	1,181	11.8%
300 +	502	4.2%	449	4.5%
Total	12,017		9,976	

The concentration in 2005 has not substantially changed from the prior year.

Sources of uncertainty in the estimation of future benefit payments and premium receipts

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

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

3.1.2 Claims management risk

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

Claims are managed utilising a range of controls and manual processes conducted by experienced staff, to ensure that claims are 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 by management.

3.1.3 Reinsurance risk

Reinsurance is used:

- To protect the insurance results against unforeseen volumes of, or adverse trends in, claims thus reducing volatility and improving stability of earnings
- To manage insurance risk by transferring risk that is not within the Company's current risk appetite

3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (continued)

The following types of reinsurance are used where appropriate:

- Quota share reinsurance where the reinsurer takes an agreed percentage of claims arising in return for specified reinsurance premiums which are based on reinsurance rates per £1000 sum assured.

- Excess of loss 'per individual risk' reinsurance to protect against significantly large individual losses.

- Other forms of reinsurance may be utilised according to need, subject to approval by senior management

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 Company's reinsurers which accounts for 100% of the total ceded reinsurance premiums is as follows:

Rating from Standard & Poors	Number of Reinsurers
AA	1
AA-	1
A+	1
A	1

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

3.2 Financial risk

The Company is a 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), reinsurance assets and insurance liabilities. The Company's financial risk is concentrated within its investment portfolio, in particular the risk that the proceeds from its financial assets are not sufficient to fund the obligations arising from its insurance contracts.

The Company's investment portfolio is managed in accordance with the Royal Bank of Scotland 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 and are approved by the Royal Bank of Scotland Insurance Group Limited Board. The Investment Policy is operated by the Investment Management Committee, which is made up of Senior Executives of the Insurance Division, 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 portfolios principal both in economic terms and from an accounting and reporting perspective
- To maintain sufficient liquidity to provide cash needed 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 Guidelines set out asset allocation rules and controls for each component part of the portfolio.

Details of the controls and asset allocation parameters for the Insurance Division of the Royal Bank of Scotland are set out below. The Company's financial assets are managed within these guidelines but particular attention is paid to recommendations from the Actuarial Function Holder regarding the matching of the maturity of assets with the expected maturity of insurance liabilities.

Operating Funds

a) Asset Allocation - The Operating Funds segment of the investment portfolio shall only be invested in high quality liquid fixed

- 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
- 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

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.

3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (continued)

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)

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.

3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (continued)

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

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
	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Exposed to fair value interest rate risk							
Debt securities - fixed interest risk	5,033	-	-	6,258	5,070	14,818	31,179
Exposed to cash flow interest rate risk							
Deposits with credit institutions	79,943	-	-	-	-	-	79,943
Total fair value	**84,976**	**-**	**-**	**6,258**	**5,070**	**14,818**	**111,122**

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	5.00	n/a	n/a	5.50 - 5.75	4.75	4.5 - 6.25
Deposits with credit institutions	4.46-4.57	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
	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Exposed to fair value interest rate risk							
Debt securities - fixed interest risk	10,095	4,987	-	-	5,866	8,672	29,620
Exposed to cash flow interest rate risk							
Deposits with credit institutions	72,799	-	-	-	-	-	72,799
Total fair value	82,894	4,987	-	-	5,866	8,672	102,419

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	6.125-6.375	5.00	n/a	n/a	5.50-5.75	4.50-6.250
Deposits with credit institutions	4.70 - 4.82	n/a	n/a	n/a	n/a	n/a

The Company's investment guidelines are determined with reference to an analysis of the term and nature of the liabilities. Matching assets are then determined that produce a low market risk to the Company. The guidelines are reviewed on a quarterly basis.

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 reinsurers' share of insurance liabilities and amounts due from reinsurers in respect of claims already paid

Royal Bank of Scotland Group Risk Management sets standards for maintaining and developing credit risk management throughout the Royal Bank of Scotland Group. 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").

3. MANAGEMENT OF INSURANCE AND FINANCIAL RISK (continued)

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 £'000	AA+ £'000	AA £'000	AA- £'000	A+ £'000	A £'000	A- £'000
Debt securities	31,179	-	-	-	-	-	-
Insurance contracts: reinsurance asset	-	-	125,189	17,740	7,423	2,956	-
Cash at bank and in hand	4,000	4,000	18,943	23,000	13,000	8,000	9,000
Reinsurance debtors included under loans and receivables	-	-	5,772	1,393	506	232	-
Total assets bearing credit risk	35,179	4,000	149,904	42,133	20,929	11,188	9,000

At 31 December 2004

	AAA £'000	AA+ £'000	AA £'000	AA- £'000	A+ £'000	A £'000	A- £'000
Debt securities	29,620	-	-	-	-	-	-
Insurance contracts: reinsurance asset	-	-	115,410	20,220	8,324	3,369	-
Cash at bank and in hand	4,000	4,000	14,799	21,000	13,000	8,000	8,000
Reinsurance debtors included under loans and receivables	-	-	3,428	1,364	464	227	-
Total assets bearing credit risk	33,620	4,000	133,637	42,584	21,788	11,596	8,000

The Company's investment guidelines recommend that the total assets with any other counterparty should not exceed 20% of the sum of the total investments. It is recommended that all assets are denominated in sterling.

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.

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

4. NET INSURANCE PREMIUM REVENUE

	2005 £'000	2004 £'000
Long-term insurance contracts:		
Premium income from insurance contracts issued	122,148	113,924
Premium revenue ceded to reinsurers on insurance contracts issued	(13,194)	(9,458)
Net insurance premium revenue	**108,954**	**104,466**

5. INVESTMENT INCOME

	2005 £'000	2004 £'000
Available for sale financial assets:		
Interest income from debt securities	1,697	1,632
Interest income:		
From deposits with credit institutions	3,452	2,774
Net unrealised gains on financial assets:		
Other financial assets	-	123
Net amortisation of (discount)/premium on purchase of financial assets	(37)	(56)
	5,112	4,473

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 2005.

6. INSURANCE BENEFITS

	2005		
	Gross £'000	Reinsurance £'000	Net £'000
Long-term insurance contracts with fixed and guaranteed terms:			
- death benefits	18,451	(8,456)	9,995
- increase in liabilities	6,939	(4,850)	2,089
Total cost of policyholder benefits	25,390	(13,306)	12,084

	2004		
	Gross £'000	Reinsurance £'000	Net £'000
Long-term insurance contracts with fixed and guaranteed terms:			
- death benefits	18,960	(6,080)	12,880
- increase in liabilities	38,196	(35,556)	2,640
Total cost of policyholder benefits	57,156	(41,636)	15,520

7. EXPENSES

a) Expenses for the acquisition of insurance contracts

	2005 £'000	2004 £'000
Cost incurred for the acquisition of insurance contracts expensed in the year	58,376	50,699
	58,376	50,699

b) Expenses for marketing and administration

	2005 £'000	2004 £'000
Marketing and administrative expenses	9,483	10,767
Depreciation (note 10)	82	97
Expenses incurred under profit participation (note 24)	20,465	20,551
	30,030	31,415

8. INCOME TAX EXPENSE

	2005 £'000	2004 £'000
Current taxation:		
Tax charge for the period	4,049	4,749
Under / (over) provision in respect of prior periods	-	(1,355)
	4,049	3,394
Deferred taxation (note 13):		
Charge for the period	24	18
	24	18
Tax charge for the period		
Total		
Current taxation	4,049	3,394
Deferred taxation (note 13)	24	18
	4,073	3,412

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 £'000	2004 £'000
Profit before tax	13,576	11,305
Expected tax charge	4,073	3,392
Effects of:		
Adjustments in respect of prior periods	92	20
Other timing differences	(92)	-
Tax charge	4,073	3,412

9. PROFIT FOR THE YEAR

	2005 £'000	2004 £'000
Profit for the year is stated after charging:		
Depreciation of property, plant and equipment	82	97

Auditors' remuneration

Fees for audit and non-audit services, included within marketing and administration expenses, are as follows:

	2005 £'000	2004 £'000
Audit services	130	116
Non-audit services	13	24
	143	140

Directors' emoluments

	2005 £'000	2004 £'000
Other emoluments	216	232
Company pension contributions	66	81
	282	313
Highest paid directors' emoluments (excluding pension contributions)	216	232
Highest paid directors' pension contributions	66	81

9. PROFIT FOR THE YEAR (continued)

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.

During the year no directors have exercised options (2004: nil). Details of share options are disclosed within the directors' report.

10. PROPERTY, PLANT AND EQUIPMENT

	Computer and other equipment £'000	Total £'000
Cost		
At 1 January 2004	1,419	**1,419**
Additions	22	**22**
Disposals	(772)	**(772)**
At 1 January 2005	669	**669**
Additions	1	**1**
At 31 December 2005	670	**670**
Depreciation		
At 1 January 2004	(1,047)	**(1,047)**
Depreciation charge for the year	(97)	**(97)**
Eliminated on disposal	760	**760**
At 1 January 2005	(384)	**(384)**
Depreciation charge for the year	(82)	**(82)**
At 31 December 2005	(466)	**(466)**
Net book amount		
At 31 December 2005	**204**	**204**
At 31 December 2004	**285**	**285**

11. INVESTMENTS

	2005 £'000	2004 £'000
Available for sale investments		
Debt Securities:		
Listed - fixed interest rate	**31,179**	**29,620**

12. REINSURANCE ASSETS

	2005 £'000	2004 £'000
Reinsurers' share of insurance liabilities	149,870	145,020
Reinsurers' share of claims outstanding	3,438	2,303
Total assets arising from reinsurance contracts	**153,308**	**147,323**
Current	3,438	2,303
Non-current	149,870	145,020
	153,308	**147,323**

13. DEFERRED INCOME TAX

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

	Accelerated capital allowances £'000	Other timing differences £'000	Total £'000
At 1 January 2004	**179**	**296**	**475**
(Charge) / credit to income statement (note 8)	(70)	52	(18)
At 1 January 2005	**109**	**348**	**457**
Implementation of IAS 32, IAS 39 and IFRS 4 (note 26)	-	(348)	(348)
At 1 January 2005 restated	**109**	**-**	**109**
(Charge) / credit to income statement (note 8)	(24)	-	(24)
At 31 December 2005	**85**	**-**	**85**

14. LOANS AND RECEIVABLES

	2005 £'000	2004 £'000
Receivables arising from insurance and reinsurance contracts:		
Due from policyholders	360	263
Due from reinsurers	7,903	5,483
Other loans and receivables:		
Accrued interest and rent	943	802
Receivables from related parties (Note 24)	199	308
Other prepayments and accrued income	105	121
Total loans and receivables including insurance receivables	**9,510**	**6,977**
Current	9,510	6,977
Non-current	-	-
	9,510	**6,977**

15. CASH AND CASH EQUIVALENTS

	2005 £'000	2004 £'000
Cash and cash equivalents with related parties (note 24)	1,478	9
Short term deposits with financial institutions		
- third parties	76,000	70,000
- related parties	2,465	2,790
	79,943	**72,799**

The effective interest rate on short term deposits with credit institutions was 4.46% - 4.57% (2004: 4.70% - 4.82%) and has an average maturity of 90 days.

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

	2005 £'000	2004 £'000
Cash and cash equivalents	79,943	72,799
Bank overdrafts (note 20)	(1,625)	(656)
	78,318	**72,143**

DIRECT LINE LIFE INSURANCE COMPANY LIMITED

NOTES TO THE FINANCIAL STATEMENTS
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16. SHARE CAPITAL

	2005 £'000	2004 £'000
Authorised:		
Equity shares		
44 million ordinary shares of £1 each	44,000	44,000
Issued and fully paid:		
Equity shares		
44 million ordinary shares of £1 each		
At 1 January and 31 December	44,000	44,000

17. OTHER RESERVES AND RETAINED EARNINGS

	2005 £'000	2004 £'000
Reserve for revaluation of available-for-sale investments	1,021	-
Other reserves at 31 December	**1,021**	**-**
Retained earnings at 31 December	**13,453**	**3,950**

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

	Debt Securities £'000
At 1 January 2005	-
Implementation of IAS 32 and IAS 39 on 1 January 2005	812
At 1 January 2005 (Restated)	**812**
Revaluation during the period - gross	298
Revaluation during the period - taxation	(89)
At 31 December 2005	**1,021**

18. INSURANCE CONTRACTS AND REINSURANCE ASSETS

	2005 £'000	2004 £'000
Gross		
Long term insurance contracts:		
- with fixed and guaranteed terms	204,629	197,690
- benefits outstanding	4,147	3,155
	208,776	200,845
Recoverable from reinsurers		
Long term insurance contracts		
- with fixed and guaranteed terms	(149,870)	(145,020)
- benefits outstanding	(3,438)	(2,303)
	(153,308)	(147,323)
Net		
Long term insurance contracts		
- with fixed and guaranteed terms	54,759	52,670
- benefits outstanding	709	852
	55,468	**53,522**
Current	11,865	10,847
Non-current	43,603	42,675
	55,468	**53,522**

18.1 Long term life insurance contracts - assumptions, change in assumptions and sensitivity

(a) Assumptions

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

The key assumptions used for the insurance contracts, other than credit insurance business, disclosed in this note are as follows:

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

Investment returns
Valuation discount rate 3.25% net of tax (2004: 3.50%).

Renewal expense level and inflation
The Company's current level of expenses, together with a margin for prudence, is taken as an appropriate expense base and an expense inflation rate of 4% (2004: 4%) is applied.

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

(b) Change in assumptions during the year

The following estimates and assumptions used in determining assets and liabilities for insurance contracts were changed, and had the following effect on profit recognised for the year:

	Effect on profit 2005 £'000
Mortality/Morbidity for insurance contracts	1,170
Valuation interest rate	(280)
	890

(c) Sensitivity analysis

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

Sensitivity factor	Description of sensitivity factor applied
Interest rate & investment return	The impact of a change in market interest rates by +/- 1% (e.g. if a current interest rate is 5% the impact of an immediate change to 4% and 6%). The test allows consistently for similar changes to investment returns and movements in the market backing fixed interest securities.
Expenses	The impact of an increase in maintenance expenses by 10%.
Assurance mortality/morbidity	The impact of an increase in mortality/morbidity rates for assurance contracts by 5%

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

	Variability	Impact on value of investments £'000	Impact on profit £'000	Impact on equity £'000
Interest rates +1%	+1%	1,554	1,492	1,492
Interest rates -1%	-1%	(1,554)	(1,841)	(1,841)
Expenses +10%	+10%	-	(525)	(525)
Assurance mortality +5%	+5%	-	(1,473)	(1,473)

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

	Gross £'000	Reinsurance £'000	Net £'000
At 1 January 2005	**197,690**	**(145,020)**	**52,670**
Provisions in respect of new business	44,055	(21,329)	22,726
Expected change in existing business provisions	(9,935)	404	(9,531)
Variance between actual and expected experience	(11,128)	1,293	(9,835)
Other movements	(16,053)	14,782	(1,271)
At 31 December 2005	**204,629**	**(149,870)**	**54,759**

19. TRADE AND OTHER PAYABLES INCLUDING INSURANCE PAYABLES

	2005 £'000	2004 £'000
Due to reinsurers	68	78
Due to related parties (Note 24)	615	3,271
Trade creditors and accruals	2,207	1,900
Other creditors	41	39
	2,931	**5,288**
Current	2,931	5,288
Non-current	-	-
	2,931	**5,288**

20. BORROWINGS

	2005 £'000	2004 £'000
Bank overdrafts	1,625	656

The borrowings are repayable on demand or within one year.

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

21. CONTINGENT LIABILITIES

There were no contingent liabilities at the balance sheet date.

22. COMMITMENTS

There was no capital expenditure contracted for at the balance sheet date.

23. ULTIMATE PARENT COMPANIES

The Company's immediate parent company is Direct Line Life Holdings 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.

24. RELATED PARTY TRANSACTIONS

The following transactions were carried out with related parties.

i. Sales of insurance contracts and other services

	2005 £'000	2004 £'000
Sales of services		
- UKI Partnerships	32,064	34,676
	32,064	**34,676**

ii. Purchases of products and services

	2005 £'000	2004 £'000
Purchases of services:		
- RBS Insurance Services Limited	2,957	3,339
- UKI Partnerships	20,465	20,551
	23,422	**23,890**

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 £2,801,000 (2004: £2,886,000).

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 only.

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

	2005 £'000	2004 £'000
Bank deposits held with related parties		
- Royal Bank of Scotland plc	840	2,142
- Royal Bank of Scotland International Jersey	1,478	9
	2,318	**2,151**

	2005 £'000	2004 £'000
Receivables from related parties		
- RBS Insurance Services limited	-	177
- Direct Line Unit Trusts Limited	85	37
- UKI Partnerships	114	94
	199	**308**

	2005 £'000	2004 £'000
Payables to related parties		
- RBS Insurance Services limited	615	29
- UKI Partnerships	-	3,242
	615	**3,271**

25. EVENTS AFTER BALANCE SHEET DATE

There are no events after the Balance Sheet date that require reporting.

26. 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	
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.

Implementation of IAS 32, IAS 39 and IFRS 4

UK GAAP	IFRS
b Financial instruments: financial assets	
Unrealised investment gains and losses arising from movements in the market value of debt securities 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. Any premium / discount on the purchase of debt securities is now amortised using the straight line basis.

26. TRANSITION TO IFRS (continued)

(2) Analysis of IFRS adjustments, excluding IAS 32, IAS 39 and IFRS 4

Opening balance sheet at 1 January 2004

	UK GAAP £'000	Effect of transition to IFRS £'000	IFRS £'000
ASSETS			
Investments	85,114	(58,130)	26,984
Assets held to cover linked liabilities	4,448	-	4,448
Insurance contracts			
Reinsurance assets	111,521	-	111,521
Property, plant and equipment	372	-	372
Deferred tax asset	475	-	475
Financial assets			
Loans and receivables including insurance receivables	4,696	-	4,696
Cash and cash equivalents	103	58,130	58,233
Total assets	**206,729**	**-**	**206,729**
EQUITY			
Share capital	44,000	-	44,000
Retained earnings	(3,943)	-	(3,943)
Total equity	40,057	-	40,057
LIABILITIES			
Insurance contracts	157,799	-	157,799
Provision for non linked liabilities	-	-	-
Technical provision for linked liabilities	4,448	-	4,448
Trade and other payables including insurance payables	2,575	-	2,575
Financial liabilities			
Borrowings	562	-	562
Current tax liabilities	1,288	-	1,288
Total liabilities	166,672	-	166,672
Total equity and liabilities	**206,729**	**-**	**206,729**

Income statement for the year ended 31 December 2004

	UK GAAP £'000	Effect of transition to IFRS £'000	IFRS £'000
Insurance premium revenue	113,924	-	113,924
Insurance premium ceded to reinsurers	(9,458)	-	(9,458)
Net insurance premium revenue	**104,466**	**-**	**104,466**
Investment income	4,473	-	4,473
Net income	**108,939**	**-**	**108,939**
Insurance benefits	57,156	-	57,156
Insurance benefits recovered from reinsurers	(41,636)	-	(41,636)
Net insurance benefits and claims	15,520	-	15,520
Expenses for the acquisition of insurance contracts	50,699	-	50,699
Expenses for marketing and administration	31,415	-	31,415
Expenses	82,114	-	82,114
Profit before tax	**11,305**	-	**11,305**
Income tax expenses	3,412	-	3,412
Profit for the year	**7,893**	**-**	**7,893**

26. TRANSITION TO IFRS (continued)

Balance Sheet at 31 December 2004

	Notes	UK GAAP £'000	Effect of transition to IFRS £'000	IFRS £'000
ASSETS				
Investments		102,410	(72,790)	29,620
Insurance contracts				
Reinsurance assets		147,323	-	147,323
Property, plant and equipment		285	-	285
Deferred income tax		457	-	457
Financial assets				
Loans and receivables including insurance receivables		6,977	-	6,977
Cash and cash equivalents		9	72,790	72,799
Total assets		257,461	-	257,461
EQUITY				
Share capital		44,000	-	44,000
Retained earnings		3,950	-	3,950
Total equity		47,950	-	47,950
LIABILITIES				
Insurance contracts		200,845	-	200,845
Trade and other payables including insurance payables		5,288	-	5,288
Financial liabilities				
Borrowings		656	-	656
Current tax liabilities		2,722	-	2,722
Total liabilities		209,511	-	209,511
Total equity and liabilities		257,461	-	257,461

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

Balance Sheet at 1 January 2005

	At 31 December 2004 £'000	Effect of IAS 32, 39 and IFRS 4 £'000	At 1 January 2005 £'000
ASSETS			
Investments	29,620	1,160	30,780
Insurance contracts			
Reinsurance assets	147,323	-	147,323
Property, plant and equipment	285	-	285
Deferred income tax	457	(348)	109
Financial assets			
Loans and receivables including insurance receivables	6,977	-	6,977
Cash and cash equivalents	72,799	-	72,799
Total assets	257,461	812	258,273
EQUITY			
Share capital	44,000	-	44,000
Other reserves	-	812	812
Retained earnings	3,950	-	3,950
Total equity	47,950	812	48,762
LIABILITIES			
Insurance contracts	200,845	-	200,845
Trade and other payables including insurance payables	5,288	-	5,288
Financial liabilities			
Borrowings	656	-	656
Current tax liabilities	2,722	-	2,722
Total liabilities	209,511	-	209,511
Total equity and liabilities	257,461	812	258,273

26. TRANSITION TO IFRS (continued)

Reconciliation of shareholders' funds

	£'000
UK GAAP and IFRS shareholders' funds at 31 December 2004	**47,950**
Standards applicable from 1 January 2005:	
Debt securities classified as available for sale	1,160
Tax effect on cumulative IFRS adjustments	(348)
Shareholders' funds under IFRS at 1 January 2005	**48,762**

27. CAPITAL RESOURCES

Under FRS27 the Company is required to produce a capital position statement, reconciling the capital resources of the life insurance business of the Company to the capital resources available on a regulatory basis. All business of the Company is life business.

	2005 £'000	2004 £'000
Total shareholders' funds as at 31 December	58,474	47,950
Adjustments to regulatory basis	(585)	202
Total available capital resources as at 31 December	57,889	48,152

	2005 £'000	2004 £'000
Shareholders' funds held in long term business fund	35,638	26,995
Shareholders' funds outside long term business fund	22,251	21,157
	57,889	48,152

Movements in the capital resources were as follows:	£'000
Capital resources at 1 January 2005	48,152
Changes in assumptions	890
New business and other factors	8,847
Capital resources at 31 December 2005	**57,889**

28. CAPITAL MANAGEMENT POLICY

The Company is required to meet minimum capital requirements at all times under the Financial Service Authority's Prudential Sourcebook. The capital resources covering the regulatory requirement are not transferable to other areas of the Group. To ensure that the capital requirement is satisfied at all times, the Company holds an additional voluntary buffer above the absolute minimum. Sufficient capital resources are held to ensure that the capital requirements are covered over a specified projection period. Life insurance results are inherently uncertain, due to actual experience being different to modelled assumptions. Such differences affect regulatory capital resources, as do varying levels of new business. Therefore, projections are formally reviewed twice a year. Where there is a shortfall of capital projected, various options are available to provide new capital.