Report & Accounts

for the year ended 31 March 2006

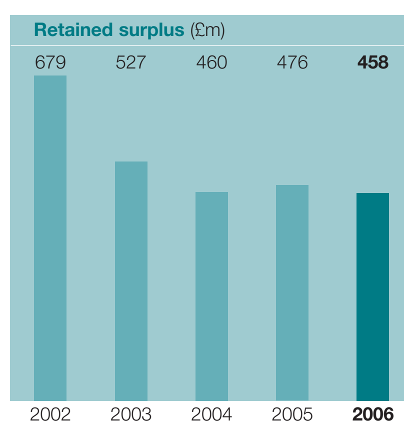
Overview for the year ended 31 March 2006

- £18 million loss for the year reduced retained surplus to £458 million.
- Solvency margin, being retained surplus expressed as a percentage of net claims outstanding, decreased from 12.2 per cent to 12.0 per cent.

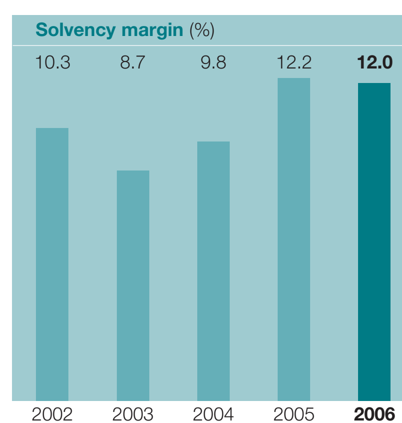
Contents

Chairman's statement	2
Chief Executive Officer's review	4
Claims Director's review	9
Financial review	12
Board of Directors	17
Directors' report	18
Board report on Directors' remuneration	23
Independent Auditors' report	26
Group profit and loss account	28
Group balance sheet	30
Group cash flow statement	32
Notes to the financial statements	33
Company balance sheet	44
Notice to Reinsured Names	Inside back cover

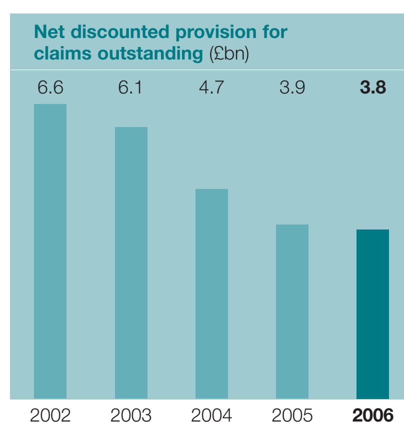
Five year results as at 31 March



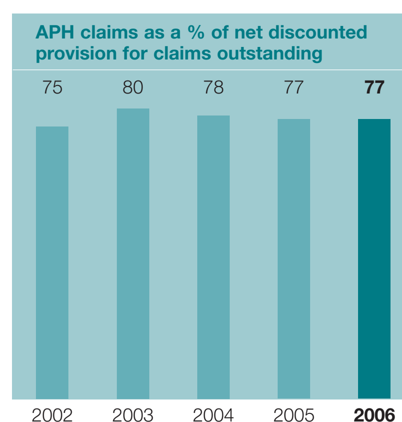
Retained surplus down £18m to £458m



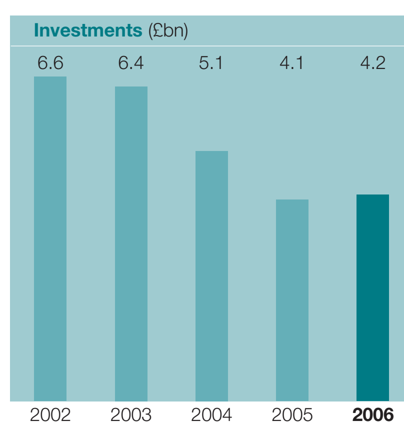
Solvency margin down from 12.2% to 12.0%



Provision for claims down from £3.9bn to £3.8bn



APH claims unchanged at 77% of total claims



Investments up from £4.1bn to £4.2bn

Operating expenses down from £81m to £72m

Chairman's statement

Hugh Stevenson
Chairman

In the financial year ended 31 March 2006 retained surplus after tax decreased by £18 million and our solvency margin fell from 12.2 per cent to 12.0 per cent. Gross discounted asbestos reserves increased by £128 million and for the first time in seven years we have also added to our pollution reserves. These deteriorations more than offset a year of positive performance in each of our key operating areas.

While it is disappointing to report a further increase in our reserves, we cannot escape the fact that our liabilities are still measured in billions of pounds and that the majority of the claims facing us are not expected to be paid for many years and are subject to considerable volatility.

Notwithstanding the modest weakening of our balance sheet, we have again been able to resolve a significant number of claims by reaching settlements on acceptable terms. We have now reached agreement with all 10 of the largest direct asbestos assureds identified in 2001. We have also completed a further 86 commutations in the last year, realising reinsurance asset as well as extinguishing liabilities.

In overall terms the volume of settlements is lower than last year. This is partly as a result of our past success in reducing the size of the liabilities we face. However, it also reflects the fact that we have been less successful than we hoped in commuting reinsurance liabilities.

There have been further developments in Washington as attempts to pass federal asbestos reform have continued. Prospects for the successful passage of a reform Act in the current Congress now appear remote following the defeat of the proposed Act in a procedural motion on the floor of the US Senate in February. Scott Moser discusses events in Washington and the performance of the Group in more detail in his Chief Executive Officer's review on pages 4 to 8.

The investment return for the year exceeded the unwinding of the discount by £88 million, primarily as the result of higher equity markets. We also reported an exchange gain of £25 million arising largely because a portion of our surplus is held in US dollars. Jane Barker reviews the accounts in more detail in her Financial review on pages 12 to 16.

For the eighth consecutive year we have reduced our costs by more than 10 per cent. In the last year we have been successful in selling our freehold property in Farnborough. In a few months time we will vacate another floor of our offices in St Mary Axe. The number of people employed at Equitas is now just over 300 compared with more than 800 in 1999.

In accordance with its commitment to high standards of corporate governance at Equitas, the Board has carried out a formal evaluation of its own performance as well as that of its Committees, each of the Non-Executive Directors and my own role. A number of changes have been or are being implemented as a result of this review but in summary we have concluded that the Board's existing practices and procedures are adequate and appropriate.

Sir Bryan Nicholson retired from the Board in December after serving nine years as a director. Sir Bryan has had an exceptionally distinguished business career and he has made a huge contribution to Equitas as our Senior Independent Director, as Chairman of the Claims and Commutations Committee and as Chairman of the Trustees of the pension scheme. Everyone associated with Equitas stands greatly in his debt. In June of this year, Michael Crall will also step down. When Michael retired as Chief Executive Officer in 2003, I paid warm tribute to his achievements at Equitas. I am pleased to have the opportunity to do so again. Every Reinsured Name owes a great deal to Michael.

The Board recognises that, as the size of the Group reduces, so should the Board. As a result, the Non-Executive Directors who have decided to step down will not be replaced.

In a few months Equitas will be 10 years old. Up to and including the period covered by these accounts, Equitas has settled nearly £17 billion in claims and has realised £7 billion in reinsurance. We have generated investment returns of over £900 million in excess of the unwinding of the discount and we have reduced the annual cost of running the business from £243 million to £72 million. During this time we have considered it necessary to increase our reserves by more than £1.6 billion on a gross discounted basis. Notwithstanding this, while our surplus is £130 million lower, our solvency margin has improved from 5.6 per cent to 12.0 per cent.

Although much has been achieved, much remains to be done. We still face many serious threats and uncertainties and this has led our auditors once again to qualify our accounts. However, we have come a long way and this is solely due to the people who work at Equitas. I have referred before in these statements to the saying that you cannot guarantee success, but you can deserve it. If ever a group of people deserves to succeed it is the team at Equitas and I am sincerely grateful to all of them.

Hugh Stevenson
Chairman
1 June 2006

Chief Executive Officer's review

Last year was one of mixed results. We had important successes and good news: each of our operating divisions made a positive contribution to the balance sheet; exposures for a number of catastrophes moderated; we successfully procured significant reimbursements for some very old claims payments. However, against these positive developments we must set the bad news: the FAIR Act, which would have established a trust to pay US asbestos claims, has stalled in the US Senate and has only slight chances of being enacted in 2006; there were deteriorations in respect of incoming asbestos claims from US insurance companies; we needed to increase pollution reserves for the first time in seven years; a Rhode Island court held lead pigment manufacturers liable on what the Wall Street Journal calls a "bizarre tort theory" of public nuisance. Life in run-off is not for the faint hearted.

Our surplus fell from £476 million to £458 million. Obviously, we prefer that surplus move in the opposite direction. Our solvency margin also decreased slightly, from an all time high of 12.2 per cent last year to 12.0 per cent, but still the second highest margin in our history and well above our opening solvency margin of 5.6 per cent.

The relatively small movements in surplus in the past couple of years must not be allowed to mask the volatility inherent in the book of insurance and reinsurance claims we handle. The liabilities we manage are in billions; the reinsurance asset is in the hundreds of millions; in most years we agree several individual settlements involving over one hundred million pounds and every year we agree dozens involving tens of millions; every year we have many reserve movements in the tens of millions, sometimes in hundreds. While, in the final reckoning, all of our activities may come close to balancing out, as has been the case in the last two years, there can be no assurance they always will. Many difficult and potentially volatile matters remain, and may well remain for many years to come. While we continually seek to resolve the largest and most volatile matters, and we have had considerable success in doing so, the risk of severe adverse developments is likely to be with us for many years.

Operating performance

Although our surplus and solvency margin reduced slightly, the operating performance of the Group was again positive. When we settle claims, whether those coming into us, or those we make on reinsurance policies, sometimes we pay or receive more than we had reserved, and other times less. In the aggregate, those settlements produced contribution to surplus of £81 million. We did this while paying £744 million in settlement of claims, including settlement of 32 direct asbestos claims and 16 direct pollution claims, and, on the collections side, commuting with 86 reinsurers in addition to effecting traditional reinsurance collections. In all of these categories some deals were 'winners' (producing a contribution to surplus) while others were 'losers', but in the aggregate we achieved a win.

Our successes included settling more direct claims, both by number and value, than we expected. Our disappointments included commuting fewer claims liabilities with US insurers, both by number and value, than we had hoped.

Asbestos claims

As we have said for many years, asbestos claims represent the most serious threat to Equitas. While this remains true, last year we made continued progress in resolving such claims and reducing our overall exposure. Since April 2001, Equitas has completed 46 major direct asbestos settlements involving the payment of

over £1.8 billion and completed commutations that extinguished more than £550 million in undiscounted asbestos liabilities.

We hoped that the US Congress would establish a trust to handle asbestos claims and assign to Equitas a fair and affordable share of insurer payments to that trust. Unfortunately, efforts to advance such legislation in the US Senate stalled and legislation now seems highly unlikely in 2006. In 2007, there will be a new Congress and there is no way to know whether it will have any interest in asbestos reform. We continue to work for asbestos reforms in individual US states, however, and we have seen some progress since the year end.

Asbestos reserves

At 31 March 2006, gross undiscounted asbestos reserves amounted to £3.4 billion (2005: £3.4 billion). Asbestos reserves, discounted to take account of the time value of money, amounted to £2.2 billion (2005: £2.3 billion). Asbestos claim payments last year were £103 million (2005: £116 million). The discounted value of asbestos liabilities extinguished through policy buyouts and commutations during the past year amounted to £362 million (2005: £546 million).

In these accounts we have increased gross discounted asbestos reserves by £128 million, primarily as a result of greater than expected levels of US asbestos claims notified by US insurers. Non-US asbestos reserves have remained relatively stable and represent approximately 13 per cent (2005: 14 per cent) of our gross discounted asbestos reserves.

Gross discounted asbestos reserves

	£m
Reserve at 1 April 2005	2,314
Payments & commuted liability	(465)
Reassessment of reserves	128
Unwinding of the discount	66
Exchange	167
Reserve at 31 March 2006	2,210

Scott Moser
Chief Executive Officer

Chief Executive Officer's review (continued)

Some commentators express surprise over the need for reserve changes each year. Equitas still faces a complex and difficult book of long tail claims – none more complex and difficult than the asbestos claims which comprise approximately 53 per cent of our gross discounted reserves. We operate in a volatile and dynamic environment. Many of the claims for which we have established reserves will not be paid for decades. Thus, it is not surprising that our reserves are subject to fluctuation, and are likely to remain so in future years.

Claims management

Gross claims paid for all types of coverage, an amount which includes claims resolved through commutation agreements as well as the Group's operating costs, amounted to £744 million (2005: £1.0 billion). This is a significant decrease in the value of claims resolved. A number of factors have caused this decrease:

- We have historically been very successful in resolving our highest value direct claims. This success continued in the last year, with more asbestos-driven policy buyouts completed than in any previous year. However, since we settled the largest direct claims in previous years (for example with Babcock & Wilcox, Halliburton and Honeywell) the values involved in last year's settlements are significantly lower.

- Similarly, the value of claims paid is expected to decrease over time simply because we have a lower total value of claims to resolve.

- We have been unable to reduce inwards reinsurance liabilities as much as we hoped.

- Last year's claims paid figure is reduced by two significant reimbursements with respect to claims paid in previous years.

We have had to increase pollution reserves in these accounts for the first time since March 1999. We have resolved a significant number of our major pollution cases since 1996 and reserves have decreased as a consequence. During the last year, however, we experienced adverse developments in a small number of cases requiring us to increase reserves.

Overall we continue to make good progress in resolving claims. Our claims handling philosophy continues to be 'fair but firm', resisting claims for unjustified sums but, where payments are appropriate, seeking to resolve every claim on appropriate terms at the earliest possible opportunity.

Even with all our settlements last year, we only managed to reduce net liabilities from £3.9 billion to £3.8 billion (two per cent). Liabilities would have been reduced much more – by about eight per cent – but for the effect of exchange rate movements.

Glenn Brace reviews claims developments in more detail in the Claims Director's review on pages 9 to 11.

Reinsurance management

Reinsurers' share of claims paid amounted to £190 million in the year ended 31 March 2006 (2005: £209 million).

We have again made good progress in reinsurance collection. We have realised close to one third of the asset that existed at the beginning of the year. We continue to believe that it is in the best interests of Equitas and reinsurers to commute reinsurance contracts whenever appropriate terms can be agreed. In the last year we reached agreements for full or partial commutations with 86 counterparties (2005: 85) and we collected a significant amount of reinsurance in the traditional, claim by claim, method.

We recognise that some reinsurers are unwilling to enter into commutation agreements. We are prepared to collect the reinsurance owed by these companies through traditional means. However, we are not prepared to accept delay when amounts fall due. During the last year we have increased the amount of litigation to collect reinsurance. We see a growing trend for some reinsurers to dispute claims for no other reason than to demand discounts in the hope we will be afraid of the costs of collecting these balances. Those reinsurers should be assured we cannot be blackmailed. We will engage in all litigation necessary to collect what we believe is rightfully due.

We continue to extract funds from insurance brokers which have been collected by them but not passed across to Equitas. We recognise the difficulty that the brokers have had dealing with thousands of transactions over the years but they have a duty to account properly for the monies that they have received on our behalf. Unfortunately in a few cases we have had to commence legal proceedings to compel the brokers to fulfil their duties.

Investment management

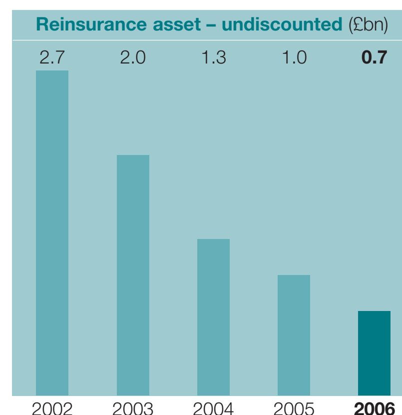
Investment return for the year ended 31 March 2006 amounted to £189 million (2005: £133 million). Because Equitas discounts its liabilities, the key measure for our investment performance is a comparison of the investment return and the unwinding of the discount. In the year ended 31 March 2006, investment return exceeded the unwinding of the discount by £88 million (2005: £88 million).

Although rising interest rates towards the end of the year caused bond values to fall, our fixed income portfolio managers outperformed the benchmarks that we set. This performance contributed towards the investment return above the unwinding of the discount, with the balance being contributed by the strong performance of our equity portfolios.

Expense management

We continued to reduce our operating costs significantly year on year: last year we reduced those costs to £72 million, an 11 per cent saving from the prior year. We expect to achieve significant savings in the current year as well. Such savings, of course, are driven significantly by headcount. Over the past year we reduced our total headcount from 387 to 312.

Equitas faces unique challenges as a run-off company which consistently needs to reduce headcount. To help us manage this challenging process we have developed a contractual redundancy programme which enables employees to remain at Equitas confident that they will be well compensated when their position becomes redundant. Our retention levels are good, with over 85 per cent of current staff being with Equitas for more than five years. We have managed to maintain high operational performance despite significant reductions in staff. We have a highly committed and professional team which understands that success for Equitas means working



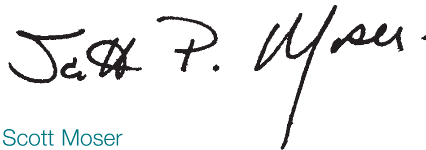
Chief Executive Officer's review (continued)

ourselves out of a job. This reflects enormous credit on all Equitas employees, both past and present, and I sincerely thank them for their efforts.

We are committed to having open communication throughout the organisation. During the year all employees were invited to participate in an informal process for discussing virtually any aspect of our operations. We have taken a number of actions in response to that consultation, including a new employee appraisal system, changes to our internal communications processes and enhancements to our redundancy programme as applied to part time workers.

Conclusion

The last year has yet again been challenging. We have once again produced solid operational results. However, as in previous years, we have had to increase reserves, including those for asbestos claims. We have continued the significant progress made since Equitas began in September 1996. But we continue to face serious threats to our ultimate success. All of us are committed to achieving the best possible outcome for Reinsured Names as we address the difficult and complex issues that remain.



Scott Moser
Chief Executive Officer
1 June 2006

Claims Director's review

In the year ended 31 March 2006 we settled some of our largest direct claims, continuing the progress made in previous years. We have also seen further improvement in the atmosphere surrounding the adjudication of mass tort claims like asbestos and silica. In fact, one US periodical described these improvements as a "sea change".

However, the climate in which Equitas operates is unpredictable and serious challenges remain. We continue our efforts to commute inwards reinsurance liabilities although those negotiations remain difficult. In addition, there are, as in the past, new efforts to impose liabilities on Equitas. We spend considerable effort resisting policyholders' attempts to recover more than the relevant contracts of insurance allow.

Settlement successes

Last year we again resolved some of our largest asbestos claims. We have now resolved the 10 largest direct asbestos claims that faced us in March 2001. Of the top 25 direct asbestos claims that we identified a year ago, we resolved 12 in this single year. While our largest settlements involved asbestos claims, we have again concluded numerous smaller settlements involving other types of liabilities including pollution.

Commutation challenges

We have also continued to pursue our long-standing goal of commuting reinsurance liabilities. Settlement discussions with other insurance companies are notoriously complicated and difficult. They usually involve the quantification, not only of Equitas' liabilities, but also of any reinsurance that is owed to Equitas from that insurer.

Some insurance companies resist commutation with Equitas. We are convinced that the ongoing uncertainty involving the FAIR Act has inhibited some of these discussions. However, while external factors such as FAIR may have slowed the pace of commutations, we also recognise that we must do more to convince other companies of the benefits of commutation.

Glenn Brace
Claims Director

Claims Director's review (continued)

We need to convince insurance companies that commutations are good for them as well as for us. Commutations are efficient, allowing simultaneous resolution of liabilities and assets. They avoid the cost and delay that are inherent when claims are processed transaction by transaction. Uncertainties about the future are removed for both parties.

We are challenging ourselves to deliver this message clearly and persuasively. We recognise, however, that some companies may never be persuaded. They will continue to present individual claims to Equitas and we will deal with each one – fairly but firmly.

Some companies routinely choose litigation or arbitration over the hard (and often tedious) task of negotiation. Last year one company filed 19 arbitrations. These filings did more to enrich the lawyers hired by the parties than they did to resolve disputes or to expedite the payment of contested claims. We will vigorously defend our position in litigation or arbitration. We would, however, rather spend our resources negotiating a lasting resolution of our reinsurance obligations.

Changed attitude to mass torts

There have been further positive changes in the atmosphere surrounding the adjudication of mass torts like asbestos and silica. We have previously seen a number of US states enact important legislative reforms. Last year, courts assumed a leading role. The US Congress has also begun to question the mass screening culture that underlies asbestos and silica claim abuses.

A court in Florida has ended the so called asbestos "rocket docket". Over the last three years that court disposed of over 2,400 asbestos cases, many thrown out because they lacked a connection to that jurisdiction. As a result, the judge dismantled a special division of the court that was intended to speed asbestos cases through to trial.

Last year we mentioned that a federal judge in Texas received national attention for exposing multiple silica claims that were not supported by appropriate medical evidence. The 249 page opinion issued by Judge Janice Graham Jack has clearly influenced other courts and the US Congress.

Following the proceedings in Judge Jack's court, Congress called for testimony from some of the doctors and screening companies involved in those Texas proceedings. Three doctors singled out by Judge Jack for supporting invalid silicosis claims were subpoenaed. Before Congress, they refused to testify, invoking the Fifth Amendment, a provision of the US Constitution providing that no one may be forced to give self-incriminating evidence.

A different doctor did testify that his reports contained boilerplate language provided by the X-ray screening company that hired him. The owner of that company, also before Congress, said that the boilerplate language was provided to him by a Texas law firm. As a result of this testimony, Congress has sent out more requests for information about the financial arrangements between plaintiffs' law firms, doctors and screening companies.

Other courts have taken up where Judge Jack left off. In response to her decision, a judge in Mississippi dismissed 4,200 silicosis-related cases all filed by a single law firm. That firm was later sued for "fraudulent conduct and pursuit of baseless claims".

Another judge ordered silica plaintiffs to provide extensive information about any prior asbestos lawsuits. Like Judge Jack, he recognised that, statistically, it is almost impossible for a claimant to have both asbestosis and silicosis. He further remarked that the effect of illegitimate cases on the economic well being of the US was "mind-boggling".

Even prior to the proceedings in Judge Jack's courtroom, Equitas recognised that silica claims, like asbestos claims, must be carefully reviewed to ensure that they are supported by proper evidence of injury and causation. For years, Equitas has questioned the findings of some of the doctors singled out in the Texas proceedings. The powerful response to those proceedings is eroding judicial tolerance for mass tort abuses. This response is also an affirmation of Equitas' claims handling practices.

Equitas will fight to enforce contracts

There will always be efforts by policyholders to increase improperly the number and size of Equitas' liabilities. We will respond vigorously to any such attempts. That alone is not enough. We also recognise that enforcing the terms of the policies requires persistence and patience.

In 2003, an asbestos policyholder in California asserted that the limits of an insurance policy should be immediately payable to a policyholder that declares bankruptcy. The trial court accepted that erroneous position and issued a decision accordingly. We felt certain that this decision was wrong and knew that it was not nearly the final word on this issue. We appealed the decision to the intermediate appellate court in California.

The appellate court has since overturned that decision and the California Supreme Court refused further appeal. The case must now return to the trial court – three years after it was first filed.

We keep an eye out for new categories of claims that might be asserted against the contracts we reinsure. We respond to these assertions with careful analysis.

We do not allow that analysis to be influenced by sensational press reports or self serving public statements. Over the past decade, there have been various claim types depicted as the "next asbestos". In each case, the description has been inaccurate.

Silica was billed as the "next asbestos". We disagreed with that characterisation and we stated so publicly. We have always recognised that some silica claims will impact Equitas and we are prepared to pay covered silica claims. The events of the last two years have confirmed our analysis about silica.

At the turn of the millennium, many predicted extensive computer problems (so called Y2K failures) and some asserted that these failures would give rise to long tail insurance claims. We conducted an intensive analysis and concluded otherwise. Those claims never materialised.

Over the years we have also witnessed efforts to impose liabilities on fast food retailers, computer chip manufacturers and the mobile phone industry. We have seen claims involving breast implants, blood factor concentrate, pesticides and a variety of drugs. None of these, despite the predictions, has become the "new asbestos".

Most recently, some have speculated that claims arising out of the manufacture of lead pigment used in paint will ultimately impose a massive liability on certain corporations and their insurers. A recent trial court decision in Rhode Island found those manufacturers liable for lead paint abatement in a potentially large number of buildings in that state. We believe the manufacturers have good defences and expect them to prosecute vigorously an appeal before ever carrying out any abatement.

What is more, we do not believe that the contracts we reinsure provide coverage for any abatement ordered by the Rhode Island court. Unsurprisingly, pigment manufacturers are asserting contrary positions. The ultimate resolution of this dispute will take a long time and a great deal of effort. However, as we said earlier, persistence and patience are our watchwords in dealing with efforts to impose liabilities on Equitas that are not covered by the contracts that we reinsure.

Conclusion

We have had another year of success in resolving direct asbestos claims. This settlement progress was certainly advanced by growing intolerance for the submission or payment of illegitimate claims.

Despite those advances, Equitas still faces many challenges. We will renew our efforts to commute inwards reinsurance liabilities. We know that commutations benefit both parties and we will work hard to convert that message into deals.

We also know that there will be future attempts to increase improperly Equitas' liabilities. We keep a watchful eye on emerging claims and we will respond vigorously to enforce the contracts that Equitas reinsures.

Glenn Brace
Claims Director
1 June 2006

Financial review

This review is designed to help explain the accounts and the financial performance of the Group. We have set out below the methods we employ to monitor and measure the financial performance of the Group as well as providing commentary on the financial result for the year. In addition we have set out the prime insurance and other financial risks that the Group faces and the techniques employed to monitor and control those risks.

Jane Barker
Finance Director

Accounting standards

As a result of the convergence project undertaken by the Accounting Standards Board in the UK, the Group is adopting a number of new UK standards. These are derived from the equivalent International Financial Reporting Standards. In these accounts we have voluntarily adopted Financial Reporting Standard (FRS) 23 – The effect of changes in foreign exchange rates, FRS 26 – Financial instruments: Measurements and FRS 29 – Financial instruments: Disclosures. It remains unclear whether International Financial Reporting Standards will be mandatory for the Group in the future.

Measuring performance

Our strategy is directed towards finally satisfying the insurance obligations of Reinsured Names. To that end we settle valid claims, negotiating policy buyouts where we can; we realise the reinsurance assets, negotiating commutations where we can; and we invest the financial assets on a prudent basis but with the objective of earning a return that is greater than the unwinding of the discount. These activities make up our operations and we define any surpluses arising from our operations as contribution. We monitor progress against this strategy using the key performance measures set out on the opposite page.

Key measure	What does it show?
Solvency margin	The relative strength of the Group by expressing the retained surplus as a percentage of net claims outstanding
Retained surplus	The surplus available to cover potential future reserve deteriorations
Contribution	Our operating performance before the annual reassessment of insurance provisions
Surplus/deficit for the year	Annual performance after the reassessment of insurance provisions
Net claims outstanding	The movement from one year to the next shows the progress made in concluding the run-off

The Group's key performance measures as defined above for the year to 31 March 2006 are set out in the table below:

	2006	2005
Solvency margin	12.0%	12.2%
	£m	£m
Retained surplus	458	476
Contribution	169	183
(Deficit)/surplus for the year	(18)	16
Net claims outstanding	3,816	3,892

Surplus

The investment return, including the investment return on the surplus, exceeded the unwinding of the discount by £88 million. The contribution of the claims and commutation activities amounted to £81 million. In the table below claims and commutation contribution has been more than offset by the reassessment of reserves for claims and reinsurances.

	£m	£m
Retained surplus at 1 April 2005		**476**
Investment return in excess of the unwinding of the discount	88	
Reassessment of:		
Claims	(114)	
Reinsurances	(19)	
Timing of net future payments	2	
Exchange gains	25	
Result for the year		**(18)**
Retained surplus at 31 March 2006		**458**

Financial review (continued)

Provision for claims outstanding

The provision for claims outstanding remains the most significant item on the Group's balance sheet. It should be considered together with the reinsurers' share of claims outstanding. Movements in these discounted provisions from one year to the next comprise the following:

	Claims £m	Reinsurance £m	Net £m
Provisions at 1 April 2005	**4,406**	**(514)**	**3,892**
Payments, receipts and accruals	(744)	190	(554)
Unwinding of the discount	117	(16)	101
Reassessment of:			
Liabilities and reinsurances	114	19	133
Timing of net future payments	2	(4)	(2)
Exchange and other movements	281	(35)	246
Provisions at 31 March 2006	**4,176**	**(360)**	**3,816**

Operating expenses, which have been reduced by 11 per cent from £81 million to £72 million, are included in payments of claims in the table above.

Since we expect the liabilities to be settled over a long period of time, they have been discounted to acknowledge the time value of money. The calculation of the appropriate discount rate is based on the prospective yield on our fixed income investments which are held in what is essentially a duration and currency matched fixed income portfolio. The methodology we adopt includes the following steps:

- the discounting of liabilities using yields on government securities of appropriate currency and duration; and
- the application of an appropriate margin for prudence.

For convenience, we translate the results of this work into a uniform flat rate of discount to give the same total result as in the steps above.

The discount rate is reviewed each year to ensure that it remains a prudent estimate of the average annual return expected to be achieved for the period for which these assets are likely to be held. For the year under review, the discount rate has increased to 4.30 per cent per annum from 4.10 per cent per annum, as a direct result of rising bond yields.

Two elements make up what we refer to as the 'unwinding of the discount':

	£m
Reduction of one year in period over which net liabilities are discounted	153
Effect of increase in the discount rate	(52)
Unwinding of the discount	**101**

Financial risk

The Group is exposed to financial risk through its financial assets, reinsurance assets and liabilities. The Group recognises the importance of having efficient and effective risk management systems in place to identify, manage and monitor these risks.

Insurance risk

The key area of risk for the Group is insurance risk. The insurance provisions are subject to significant uncertainty and are based on estimates of future events, which are not all within the Group's control. The Group has adopted strategies to manage insurance risk, notably by commuting insurance assets and liabilities and by seeking to settle at the earliest opportunity with major policyholders. The techniques adopted to estimate insurance liabilities are explained in detail in note 2 on page 35.

Interest rate risk

Interest rate risk would normally arise from any fixed income investments. In the case of Equitas, because we discount our liabilities, we are able to minimise any interest rate risk. We do this by adopting close matching criteria between the duration and currency of our assets and the future cash flows and currency of our liabilities.

The investment portfolios are managed by external fund managers whose performance is closely monitored throughout the year. Benchmarks for the managers are set to achieve the matching criteria as closely as possible. In this way, the values of the expected liabilities and the matching assets are expected to move in similar directions and by similar magnitudes over time.

Interest rate risk is further mitigated by applying an appropriate margin for prudence when calculating the discount rate. The margin takes account of the fact that the liabilities are not perfectly matched, since the investment benchmarks we set our fund managers cannot precisely reflect our liability payments and these cash outflows themselves cannot be precisely predicted.

Price risk

The Group is exposed to price risk as a result of its holdings in fixed income and equity investments. As discussed under interest rate risk, our exposure to changes in fixed income prices is limited as we aim to match assets and liabilities by duration and currency.

The assets that represent the surplus are held in several types of investment in order to spread risk. Equities are held in the expectation that they will deliver a better return than fixed income investments over the long term and to increase diversification. Our portfolio is invested in a wide range of listed companies in both the UK and the US.

At 31 March 2006 equities represented approximately 6.8 per cent of the market value of our investment portfolio. The equity portfolios are subject to changes in market value.

Our equity portfolios closely follow the FTSE All Share index for investments in UK equities and the S&P500 index for investments in US equities; as a result, a rise or fall in those indices will have a corresponding impact on the values of our equity holdings. At 31 March 2006, equity investments were apportioned 61 per cent to UK equities and 39 per cent to US equities (2005: 55 per cent and 45 per cent respectively).

Equity portfolio performance is monitored against the benchmarks we have set and also to ensure that the values do not move significantly away from the targeted proportion of the surplus. As a result of gains made during the year the portfolio was reduced by £50 million in order to keep close to the target.

Our equity fund managers are permitted to use derivative financial instruments for efficient portfolio management purposes. There are strict limits placed on the type, value and term of such contracts; these contracts are included in the accounts on a fair value basis. The exposure to such instruments at 31 March 2006 was £2 million (2005: £2 million) and did not exceed £10 million at any point in the year.

The balance of assets that represent the surplus is held in fixed income bonds and deposits. These investments, valued at £175 million at 31 March 2006, are subject to fluctuations in interest rates.

Liquidity risk

Liquidity risk is the risk that cash may not be available to pay obligations as they fall due at reasonable cost. The Group manages its liquidity in order to maintain sufficient financial resources to meet obligations as they fall due. A high proportion of our investments is in readily realisable securities and thus liquidity risk is considered to be low.

Foreign currency exchange risk

Liabilities are denominated in a number of foreign currencies so we are exposed to foreign currency exchange risk. The Group's policy has always been to match our assets to the currencies of our liabilities as closely as possible in order to minimise this risk. This remains the case for liabilities measured in US dollars, sterling, Canadian dollars and euros.

We match all other liabilities with sterling assets. This exposes Equitas to a small currency risk which we believe is acceptable since investing relatively small amounts in various currencies would not be efficient.

Financial review (continued)

A large part of our business is conducted in US dollars and so we aim to hold approximately 50 per cent of our surplus in US dollar assets. This policy exposes Equitas, as a sterling denominated Group, to movements in the US dollar exchange rate against sterling. The closing exchange rate for US dollars used for translation of the balance sheet at 31 March 2006 was US$1.74 compared with US$1.89 at 31 March 2005. Regulatory requirements in certain other overseas countries also require us to maintain surpluses in those currencies, and this creates further exposures.

The overwhelming majority of our liabilities is matched by currency. Although there is some exposure, foreign currency exchange risk is considered to be low.

Credit risk

Credit risk is the risk that a counterparty will be unable to pay amounts in full when due. The primary sources of credit risk within the Group are investment activities and reinsurance counterparty risk.

Strict credit quality and counterparty limits for investments are set by the Investment Committee of the Board. These limits are supported by procedures designed to ensure our exposure is rigorously monitored and the limits are not exceeded.

Our fixed income listed investments at 31 March 2006 were valued at £3,529 million (2005: £3,367 million). Over 71 per cent (2005: 74 per cent) of these investments are of the highest credit quality, i.e. government or government guaranteed securities. The balance of the listed fixed income investments and all of our unlisted investments are rated ‘A’ or better by the major rating agencies.

The largest exposure to a financial institution within our financial investments was £139 million to HSBC Holdings plc (2005: £185 million to Citigroup Inc) whilst the largest exposure to a non-financial institution was £37 million to General Electric Company (2005: £90 million to General Electric Company).

We monitor closely the creditworthiness of reinsurance counterparties to assess their ability to pay our reinsurance claims in full. Reinsurance assets are stated net of a provision for recoverability which incorporates the results of this review. We believe our estimate remains a prudent provision.

Integrated Prudential Sourcebook

Equitas Reinsurance Limited and Equitas Limited are authorised and regulated by the Financial Services Authority. From 1 January 2005 the Financial Services Authority’s Integrated Prudential Sourcebook has required insurers to maintain overall financial resources which are adequate to ensure there is no significant risk that liabilities cannot be met as they fall due. Equitas is in run-off and there is a risk that it may not be able to meet its liabilities in the future. Accordingly, the Directors do not believe that Equitas can comply with this rule. The Directors have informed the Financial Services Authority, which has noted the position.

Before approving the accounts, the Board addresses the question of going concern and whether to continue to pay liabilities in full. In deciding that the assets should be sufficient over the lifetime of Equitas to meet the liabilities, the Board concludes that the Group is solvent and thus has a duty to pay valid claims in full.

Jane Barker
Finance Director
1 June 2006

Board of Directors

Hugh Stevenson ‡§
Chairman; joined the Board in 1998. He was formerly Chairman of Mercury Asset Management Group plc, a Managing Director of S G Warburg Group plc's investment banking business and with Linklaters. He is Chairman of The Merchants Trust PLC and a Non-Executive Director of the Financial Services Authority and The Standard Life Assurance Company. Age 63.

Scott Moser #△*
Chief Executive Officer since December 2003; joined the Board as Claims Director in 1997; appointed Managing Director in 2003. He was formerly President of Envision Claims Management Corporation; Vice President of Environmental/Excess Claims at Aetna Casualty & Surety Company; and a Partner with the law firm Day, Berry & Howard. Age 55.

Ian Agnew #
Lloyd's Appointed Non-Executive Director; joined the Board in 2002. He is Chairman of the Jubilee Group of Companies at Lloyd's, Chairman of British Marine Holdings (Bermuda) Limited and a member of the Lloyd's Market Supervision and Review Committee. He was formerly Chairman of Wellington Underwriting plc; Chairman of I C Agnew Underwriting Limited; and underwriter of Lloyd's syndicate 672. He is a past Deputy Chairman of Lloyd's. Age 62.

Dick Barfield †△
Non-Executive Director; joined the Board in 1997. He is currently a Director of Umbro plc, a number of investment trusts and a member of the Public Oversight Board. He was formerly Chief Investment Manager of The Standard Life Assurance Company. Age 59.

Jane Barker △*
Finance Director; joined the Board in 1995. She is a Non-Executive Director of Alliance & Leicester plc. She was formerly Chief Financial Officer and Chief Operating Officer of the London Stock Exchange and Chief Financial Officer of the insurance broking operations of Marsh & McLennan Inc outside the Americas. Age 56.

Glenn Brace *
Claims Director; joined the Board in 2003. From 1998 until his appointment as Claims Director, he was Head of Asbestos Pollution and Health Hazard Claims. He was formerly a Partner with the law firm Day, Berry & Howard. Age 44.

Jon Collins *
Chief Actuary; joined the Board in 2003. With Equitas since 1996, he was formerly seconded to the Lloyd's Reconstruction and Renewal Project with Watson Wyatt, consulting actuaries. Age 40.

Michael Crall #
Non-Executive Director; he was Chief Executive Officer from 1995 to 2003. He is a Non-Executive Director of the Catlin Group of companies and Royal & Sun Alliance USA, Inc. He was formerly President and Chief Executive Officer of Argonaut Insurance Company and a senior executive at CIGNA Corporation. Age 62.

Michael Deeny #‡§
Trustees-nominated Non-Executive Director; joined the Board in 1996. He is Chairman of the Association of Lloyd's Members and Deputy Chairman of The Equitas Trust. Age 61.

Jeremy Heap *
Reinsurance Recoveries Director; joined the Board in 2003. With Equitas since 1996 holding responsibilities in both the Finance Division and as Head of Commutations. He was formerly seconded to the Lloyd's Reconstruction and Renewal Project with Coopers & Lybrand. Age 44.

James Joll †§
Non-Executive Director; joined the Board in 1996. He was formerly Finance Director of Pearson plc, a Director of N M Rothschild & Sons Limited and a member of the editorial staff of the Financial Times. Age 69.

Richard Spooner †△
Trustees-nominated Non-Executive Director; joined the Board in 1996. He is Chairman of Euractiv.com plc and Managing Director of Team User Systems Company Limited. He was formerly a member of the Names Committee and the Assistance and Recovery Committee of Lloyd's. Age 59.

† Member of Audit Committee
# Member of Claims and Commutations Committee
△ Member of Investment Committee
‡ Member of Nominations Committee
§ Member of Remuneration Committee
* Executive office held with Equitas Limited

Directors' report for the year ended 31 March 2006

The Directors present their report and the audited financial statements for the financial year ended 31 March 2006.

Principal activities

The Equitas Group was formed as part of the Lloyd's Reconstruction and Renewal Plan to reinsure the liabilities of Lloyd's of London syndicates allocated to the 1992 and prior years of account, other than life syndicates, and to perform the run-off of these liabilities. Equitas Reinsurance Limited completed the reinsurance of the 1992 and prior years' business, except business previously reinsured by Lioncover Insurance Company Limited ('Lioncover business'), with effect from 3 September 1996 and reinsured the Lioncover business with effect from 18 December 1997. It retroceded these businesses to Equitas Limited, which is the main operating company of the Group. Equitas Reinsurance Limited and Equitas Limited are only authorised to effect these reinsurances and related activities and to perform the run-off of the reinsured liabilities. Equitas Reinsurance Limited and Equitas Limited are authorised and regulated under the Financial Services and Markets Act 2000 by the Financial Services Authority.

Business review

The Chairman's statement, the Chief Executive Officer's review, the Claims Director's review and the Financial review on pages 2 to 16 report on the development and performance of the business during the financial year and the position of the Group at the end of the year. Those reviews, which are incorporated by reference in this report, also outline the principal risks and uncertainties facing the Group and the key performance indicators necessary for an understanding of the development, performance and position of the Group.

Results

The Equitas Group incurred a deficit of £18 million after tax for the year ended 31 March 2006 (2005: £16 million surplus). The Company's Articles of Association do not permit the payment of a dividend.

Share capital

The share capital of the Company comprises two ordinary shares of £50 each, which were issued at par on incorporation and which are fully paid, and one deferred share of £1, which was allotted on 2 September 1996 and which is fully paid. The ordinary shares carry voting rights, but no dividends may be paid on these shares. The deferred share carries neither voting nor dividend rights.

Substantial shareholding

Ownership of the entire issued ordinary share capital of the Company was transferred on 3 September 1996 from the Corporation of Lloyd's to the then seven Trustees of The Equitas Trust jointly.

The current Trustees are Sir Adam Ridley (Chairman), Mr ME McL Deeny (Deputy Chairman), CHL Bathurst QC (Third Viscount Bledisloe) and Messrs GD Gilchrist, RJR Keeling and RB Spooner. Mr GD Gilchrist was appointed a Trustee with effect from 6 May 2005. Mr JPD Heyward also served as a Trustee during the year, and retired on 13 April 2005.

The Corporation of Lloyd's owns the one deferred share in the capital of the Company, which carries the right to appoint one Director.

Directors

The names of the Directors at the date of this report, together with brief biographical details, are listed on page 17.

Sir Bryan Nicholson also served as a Director during the year. He retired from the Board on 31 December 2005.

Mr JAB Joll is the Senior Independent Director.

Mr IC Agnew is the Lloyd's Appointed Director.

Messrs ME McL Deeny and RB Spooner are the Trustees-nominated Directors.

Messrs MJ Crall and RB Spooner and Mrs JV Barker retire by rotation at the forthcoming Annual General Meeting. Mr Spooner and Mrs Barker will offer themselves for reappointment. Mr Crall does not intend to seek reappointment.

All Directors of the Company also hold office as Directors of Equitas Reinsurance Limited and Equitas Limited.

Directors' interests

Mr ME McL Deeny has an interest in the business of the Company as an underwriting member of Lloyd's who resumed underwriting in 1999 after having ceased to do so in 1994. Messrs IC Agnew, JAB Joll and RB Spooner each has an interest in the business of the Company as a former underwriting member of Lloyd's who ceased underwriting in 1998, 1991 and 1993, respectively. Mr Agnew also has an interest in the business of the Company through his shareholding in Fortw Underwriting Limited, a corporate member of Lloyd's which is a member of a number of syndicates, through his shareholding in members of the Jubilee Group of Companies at Lloyd's and by the provision of capital to CBSICP Capital Limited, which is a corporate member of Lloyd's with a spread portfolio.

Each Director has the benefit of a standard indemnity under the Articles of Association of the Company, Equitas Limited and Equitas Reinsurance Limited in respect of liabilities (including legal fees and expenses) incurred in defending proceedings, whether civil or criminal, in which he is acquitted, judgment is given in his favour or certain other relief is granted. These indemnities do not cover liability attaching to a Director in connection with any finding of negligence,

default, breach of duty or breach of trust by him in relation to the Company, Equitas Limited or Equitas Reinsurance Limited. These companies have also entered into indemnities with the Directors in respect of liabilities (including legal fees and expenses) incurred to third parties relating to their position as a Director. These indemnities do not apply where a court in the United Kingdom determines that the Director did not act honestly nor do they cover criminal fines or regulatory penalties payable by the Director. These contractual indemnities and similar indemnities in favour of employees are secured by a charge over a £50 million bank deposit.

None of the Directors has an interest in shares in any Group company other than Messrs ME McL Deeny and RB Spooner who, since 3 September 1996, have held the two ordinary shares in the Company jointly with the other Trustees of The Equitas Trust.

Corporate governance

The Company and its subsidiaries are not listed entities and are therefore not subject to the requirements of the Combined Code. The Board is nevertheless committed to high standards of corporate governance and during the year it reiterated its previously expressed support for the Combined Code. Accordingly the principles and provisions of the Combined Code have been taken into account in these statements and reports.

Under the Combined Code, the Trustees-nominated Directors, the Lloyd's Appointed Director and Messrs Crall and Joll are not deemed to be independent. These appointments are important to the unique circumstances and structure of the Company. Moreover, in the opinion of the Board, all Non-Executive Directors are, in fact, independent of management except Mr MJ Crall by virtue of his previous service as Chief Executive Officer. The Board has therefore concluded that it is neither necessary nor appropriate to attempt to achieve strict compliance with the provisions of the Combined Code in relation to the number of 'independent' directors.

In the light of the foregoing, the Board does not report on areas of non-compliance by exception. It does, however, aim to reflect in this report those elements of the Combined Code with which the Company is able to comply and which are relevant to its circumstances.

The Group has in place a framework for sound corporate governance that incorporates many of the principles and provisions of the Combined Code. The Board's policy is to keep that framework under review.

The importance of adhering to the highest ethical standards is reinforced by a formal Code of Ethical Conduct, which applies to all employees. The Group has also established confidential 'whistle blowing' arrangements, which are reviewed and monitored by the Audit Committee.

The Board

The Board currently comprises the Chairman, five Executive Directors and six Non-Executive Directors. The Non-Executive Directors include two Trustees-nominated Directors and one Director appointed by the Corporation of Lloyd's. As noted on page 18, Mr Crall will leave the Board at the forthcoming Annual General Meeting.

The Board is responsible for policy and strategy and for monitoring the performance of executive management. There is a formal schedule of matters reserved to the Board for collective decision. In addition, there are matters that require the consent of The Equitas Trustees as holders of the ordinary shares pursuant to the Company's Articles of Association.

The Board met on 10 occasions during the year. It receives detailed reports from management, including in those months in which no Board meeting is held. Messrs JA Collins, MJ Crall and RB Spooner attended nine meetings. Sir Bryan Nicholson attended six of the seven meetings held in the year prior to his retirement from the Board. All other Directors attended all meetings.

The roles of Chairman and Chief Executive Officer are split. Day to day management is delegated to the Chief Executive Officer. The Chairman leads the Board and is responsible, in consultation with the Executive Directors, for setting its agenda. During the year the Chairman met the Non-Executive Directors without Executive Directors being present.

During the year the Board carried out a formal evaluation of its own performance and that of its Committees, the Chairman and the Non-Executive Directors. The results of these evaluations support the Board's view that the Group's corporate governance arrangements, including its systems and controls, are consistent with the key principles of the Combined Code, to the extent applicable to the Company's circumstances. Certain areas for improvement were identified and have been or will be addressed. None of these issues causes the Board to alter its view that the existing practices and procedures are adequate and appropriate.

Non-Executive Directors are appointed for an initial three-year term, which may be renewed, and all Directors, except the Lloyd's Appointed Director, are subject to the re-election provisions of the Company's Articles of Association.

A procedure is in place for Directors to take independent professional advice, if necessary.

Directors' report (continued)

Company Secretary

The Board is supported in its work by the Company Secretary who co-ordinates the supply of timely information and provides advice.

The Equitas Trustees

The Board keeps The Equitas Trustees, as holders of all of the issued ordinary shares of the Company, informed of significant developments affecting the Group through a range of scheduled and ad hoc meetings. This process, which facilitates an exchange of views, is supported by the presence on the Board of the two Trustees-nominated Directors.

Board committees

The Board has established five committees with clearly defined written terms of reference. These committees and their respective responsibilities and activities during the year are as follows:

- *Audit Committee*

  Members
  James Joll (Chairman)
  Dick Barfield
  Richard Spooner

  Secretary
  Stephen Britt

  The Audit Committee helps to ensure that good practice is maintained throughout the Group with respect to financial and internal control matters and, on behalf of the Board, monitors the Group's system of internal control (including risk management, financial, operational and compliance controls). The committee also independently reviews the Group's accounting policies and the presentation of financial information. The Chief Executive Officer, the Finance Director, the Chief Actuary and the Head of Internal Audit are generally invited to attend meetings of the committee. The committee receives regular reports from the Group's internal audit function and is responsible for reviewing the effectiveness of the internal audit function. During the year, the committee met the Head of Internal Audit in the absence of other members of management.

  The committee is responsible for overseeing the process for selecting the external auditors and for making appropriate recommendations to the shareholders through the Board. The committee has implemented a policy on the provision of non-audit services by the external auditors and has reviewed their objectivity and independence. The committee concluded that in all the circumstances the external auditors ought properly to be regarded as independent. The committee, with the assistance of the external auditors, also reviewed the effectiveness of the audit process during the year.

  The external auditors are invited to attend certain meetings of the committee. They contribute an independent perspective on aspects of financial control and annually report their findings to the committee and the Board. The committee met the external auditors during the year in the absence of management.

  The committee met four times during the year. All members attended all meetings of the committee held during the year.

- *Claims and Commutations Committee*

  Members
  Michael Deeny (Chairman)
  Scott Moser
  Ian Agnew
  Michael Crall

  Secretary
  Stephen Britt

  Sir Bryan Nicholson chaired this committee during the year, until his retirement from the Board on 31 December 2005.

  The committee has certain decision making authorities delegated to it by the Board in respect of the approval of the settlement of major claims or commutations. It met four times during the year. Sir Bryan Nicholson attended both meetings of the committee held before his retirement from the Board on 31 December 2005. Messrs IC Agnew and MJ Crall each attended three meetings. Messrs ME McL Deeny and SP Moser attended all meetings of the committee held during the year.

  Mr MJ Crall will cease to be a member of the committee when he leaves the Board at the forthcoming Annual General Meeting.

- *Investment Committee*

  Members
  Dick Barfield (Chairman)
  Scott Moser
  Jane Barker
  Richard Spooner

  Secretary
  Stephen Britt

  The committee formulates and decides the strategy for the management of the Group's investment assets within a broad framework agreed by the Board, develops policies for the management of investment risks, appoints external fund managers and custodians, and monitors their performance. It met four times during the year. All members attended all meetings of the committee held during the year.

- *Nominations Committee*
  Members
  Hugh Stevenson (Chairman)
  Michael Deeny

  Secretary
  Stephen Britt

  Sir Bryan Nicholson served as a member of this committee during the year, until his retirement from the Board on 31 December 2005.

  The committee is responsible for making recommendations to the Board on the appointment of new Board members other than Directors nominated by the Trustees or appointed by the Corporation of Lloyd's. It was not necessary for this committee to meet during the year.

- *Remuneration Committee*
  Members
  Hugh Stevenson (Chairman)
  Michael Deeny
  James Joll

  Secretary
  Stephen Britt

  The role and responsibilities of the committee are set out in the Board report on Directors' remuneration on page 23. The committee met three times during the year. All members attended all meetings of the committee held during the year.

The terms of reference of the audit, nominations and remuneration committees will be made available to Reinsured Names and their representatives upon written request to the Company Secretary at the Company's registered office.

Internal control framework

The Board has overall responsibility for the system of internal control and for reviewing its effectiveness. Management is responsible for the implementation and maintenance of the internal control system.

The management of risk is a key part of that system. A process for identifying, evaluating and managing significant business, operational, financial, compliance and other risks faced by the Group has been in place throughout the year and up to the date of these financial statements. The internal control framework is in accordance with the guidance issued by the Turnbull Committee. That framework is monitored and, where appropriate, adjusted to reflect relevant developments in the regulatory environment.

The Group has in place a system of controls over insurance transactions such as claims, reinsurance and commutations, investment transactions and other operational transactions. These are reviewed and changed where necessary in the light of any new circumstances.

Insurance claims and associated reinsurance recoveries are periodically assessed by major category and currency against provisions held. New types of claims and any changes in settlement trends are examined carefully and their impact on provisions evaluated.

Other financial risks include counterparty risks such as amounts due from reinsurers, balances at banks and custodians, and obligations of specific insurers. The means by which these risks are managed include regular reviews and assessment of relevant balances against established criteria.

The Group undertakes a regular review of the effectiveness of its system of internal control. During the year, that included a quarterly systematic self-appraisal carried out across all business areas, involving consideration of both risk exposures and the effectiveness of controls. The results of the reviews are reported to executive management, the Audit Committee and the Board. As with any such system, the Group's internal control system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.

The nature of insurance risk is that events that are unexpected as regards amount or timing will occur. The key risks to the Group are not fully within its control. The principal risk remains that the Group may not be able to settle its liabilities in full.

The Board supports and endorses the Statements of Principle and Codes of Practice promulgated by the Financial Services Authority, to the extent they are relevant to the activities carried on within the Group.

Financial instruments

The Group's financial risk management objectives and policies in relation to the use of financial instruments is in line with the objectives and policies applied to other risks of commensurate scale, and is outlined in the review of the Internal Control Framework.

The exposure of the Group to price risk, liquidity risk, currency risk and credit risk arising out of the use of financial instruments is outlined in the Financial review on pages 14 to 16.

Directors' report (continued)

Directors' responsibilities

The Directors are required by the Companies Act 1985 to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Group and of the profit or loss of the Group for that period.

In preparing the financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments 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 financial statements; and
- prepare the financial statements on a going concern basis unless it is inappropriate to do so.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities. The Directors' responsibility for the accounting records in relation to the reinsured liabilities commenced on 3 September 1996 on execution of the Reinsurance and Run-Off Contract. The accounting policies on page 33 set out the issues relevant to the going concern basis for the preparation of the financial statements.

Indemnification of Trustees

The Trust Deed constituting The Equitas Trust provides for indemnification of the Trustees against liabilities arising from or connected with the proper performance of their duties as Trustees. The Trustees have been granted a charge over a £20 million bank deposit as security for this indemnity.

Employees

The Group is committed to a pro-active programme for involving employees. This includes regular communication through briefings and consultation with staff at all levels. The Group maintains a computer based internal communications system which provides information to all employees on work related issues and on matters of general interest. Employees are encouraged to provide suggestions for improving efficiency and performance.

The Group recognises its responsibilities towards disabled people, who receive full and fair consideration for job vacancies for which they are suitable applicants. The Group will take reasonable steps to help employees who become disabled during their working life to continue in employment.

Suppliers

It is the policy of the Group to establish terms of payment with suppliers when agreeing the terms of business transactions. The aim is to effect payment in accordance with agreed terms.

Charitable and political donations policy

The Group has not made any charitable or political donations in the year and will not make any political donations. The Directors do not intend to make any charitable donations, but will keep this under review.

Auditors

A resolution to reappoint PricewaterhouseCoopers LLP as auditors to the Company will be put to the forthcoming Annual General Meeting.

As permitted by the Company's Articles of Association, indemnities have been given to PricewaterhouseCoopers LLP against costs and liabilities incurred or arising out of their work as auditors in circumstances where a court finds in their favour.

Disclosure of information to Auditors

Each Director confirms that so far as he is aware there is no relevant audit information of which the Company's auditors are unaware. Each Director also confirms that he has taken all the steps that he ought to have taken as a Director in order to make himself aware of any such information and to establish whether the auditors are aware of that information.

By Order of the Board
Stephen Britt
Company Secretary
1 June 2006

Board report on Directors' remuneration for the year ended 31 March 2006

Policy on Executive Directors' remuneration

The Equitas Group operates in an international environment. In framing its policy on remuneration, the Group aims to:

- set reward structures which enable the Group to attract, retain and motivate executives with the appropriate skills, background and experience to operate effectively in a run-off environment;
- pay basic salaries approximately at the median of market rates for comparable companies; and
- provide a significant bonus opportunity based on the achievement of measurable goals and an executive's personal contribution to the Group's overall performance.

The Remuneration Committee is responsible for setting the remuneration and other terms of service of the Executive Directors within a framework agreed by the Board. It advises on remuneration policy for senior executives and consults with the Chief Executive Officer regarding executive remuneration and general staff remuneration. Information about market remuneration was obtained from Watson Wyatt during the year.

The remuneration of the Non-Executive Directors is determined by the Board as a whole, having regard to the provisions of the Company's Articles of Association. No Director is involved in setting his own remuneration.

Performance related incentive arrangements

The Group has an annual cash bonus plan in which all employees participate. Awards are subject to achievement of financial goals and personal performance criteria.

In addition, the Group operates a long-term incentive plan ('LTIP') for selected senior employees. This provides for cash payments in recognition of the performance of the Group during a financial year. Payments are deferred for two additional years and are dependent on the continued performance of the Group during this period. The payment of an award is also conditional upon the employee continuing in the employment of the Group throughout the three-year period or leaving the Group by virtue of retirement or redundancy.

Details of provisional awards made under the LTIP in respect of those Directors who held executive office during the year are shown on page 24.

The Remuneration Committee administers the annual cash bonus plan and the LTIP under its delegated powers and decides on participation and the amounts of incentive payments. The Board determines at its discretion the amount that is available to be awarded under the LTIP.

Payments under performance related incentive arrangements are not pensionable.

Service agreements

The Group's policy is that Executive Directors' service agreements should generally be terminable on 12 months' notice on a rolling basis. Messrs SP Moser, GE Brace, JA Collins, JW Heap and Mrs JV Barker all have service agreements with Equitas Management Services Limited which reflect that policy.

The Executive Directors are required under the terms of their service agreements to assign to a Group company the benefit of any fees received in respect of outside directorships.

It is not the Group's policy to make ex-contractual payments to Executive Directors on termination of their service agreements.

Non-Executive Directors' fees

Non-Executive Directors, including the Chairman, do not have service agreements but do have letters of appointment. They do not have bonus or pension arrangements. The Chairman's fee is £175,000 per annum, inclusive of his Director's fee and is fixed for the duration of his three-year appointment. Non-Executive Directors receive a fee of £35,000 per annum. Non-Executive Directors who chair Board committees receive an additional fee of £10,000 per annum for these services. Mr HA Stevenson did not receive an additional fee for chairing committees. With effect from 1 January 2006 Mr RA Barfield receives an additional fee of £10,000 per annum for acting as chairman of the Trustees of the Equitas Group Pension Plan.

The terms and conditions of appointment of the Non-Executive Directors, including the Chairman, will be made available to Reinsured Names and their representatives upon written request to the Company Secretary at the Company's registered office.

Board report on Directors' remuneration (continued)

Directors' remuneration

Directors' remuneration, excluding LTIP payments, was:

	Salary/ Fees £	Bonus £	Benefits-in-kind £	Total emoluments £	Pension costs £	Total for year ended 31 March 2006 £	Total for year ended 31 March 2005 £
Chairman							
HA Stevenson	175,000			175,000		175,000	160,417
Executive Directors							
SP Moser	430,000	300,000	7,207	737,207	107,500	844,707	800,183
JV Barker	326,500	185,000	3,173	514,673	81,625	596,298	569,301
GE Brace	360,000	220,000	2,807	582,807	90,000	672,807	635,826
JA Collins	271,250	150,000	2,058	423,308	67,813	491,121	445,513
JW Heap	268,750	150,000	2,492	421,242	67,188	488,430	430,115
Non-Executive Directors							
IC Agnew	35,000			35,000		35,000	35,000
RA Barfield	47,500			47,500		47,500	45,000
MJ Crall	35,000			35,000		35,000	35,000
ME McL Deeny	37,500			37,500		37,500	35,000
JAB Joll	45,000			45,000		45,000	45,000
Sir Bryan Nicholson[1]	33,750			33,750		33,750	45,000
RB Spooner	35,000			35,000		35,000	35,000
Total	2,100,250	1,005,000	17,737	3,122,987	414,126	3,537,113	3,316,355

[1] Sir Bryan Nicholson retired from the Board on 31 December 2005.

Mrs JV Barker was entitled to fees of £62,750 in respect of her services as a Non-Executive Director of Alliance & Leicester plc. In accordance with the terms of her service agreement, this amount was paid directly to a Group company.

LTIP awards relating to the year ended 31 March 2003, for which provision was made in the year ended 31 March 2004, were paid in July 2005. These payments, amounting to £1,245,000 are analysed below and are included in note 7 on page 38.

No LTIP awards have yet been made in respect of the year ended 31 March 2006.

Based on the results for the year ended 31 March 2005, a total amount of £1,600,000 has been provided as follows for awards under the LTIP to the Executive Directors:

	Total provisional awards outstanding at 31 March 2005 £	Paid during the year £	Provisional awards made during the year in respect of year ended 31 March 2005 £	Total provisional awards outstanding £
SP Moser	670,000	270,000	400,000	800,000
JV Barker	502,500	202,500	300,000	600,000
GE Brace[2]	487,500	187,500	300,000	600,000
JA Collins[2]	400,000	150,000	300,000	550,000
JW Heap[2]	400,000	150,000	300,000	550,000
MJ Crall (as executive)[3]	285,000	285,000	–	–
Total	2,745,000	1,245,000	1,600,000	3,100,000

[2] Messrs Brace, Collins and Heap were appointed Directors with effect from 1 April 2003.
[3] Mr Crall retired from executive office with effect from 30 November 2003 but continues in a non-executive capacity.

LTIP awards relating to the year ended 31 March 2004, for which provision was made in the year ended 31 March 2005, will be paid in 2006 if confirmed by the Board. LTIP awards relating to the year ended 31 March 2005, for which provision was made in the year ended 31 March 2006, are not payable until 2007. Payments are subject to the Board's determination that all of the conditions governing the plan have been met.

Messrs GE Brace, JA Collins and JW Heap were appointed to the Board with effect from 1 April 2003 and their total provisional LTIP awards have been included in the above table. Mr MJ Crall's LTIP entitlements are included as they were earned in respect of his services as Chief Executive Officer.

Messrs ME McL Deeny and RB Spooner also received fees for services as Trustees of The Equitas Trust. Details are shown opposite.

The Group provides Executive Directors with benefits-in-kind, including medical and death-in-service benefits, and contributes towards their pension arrangements, which are based on defined contributions.

The Equitas Trustees

The Trust Deed constituting The Equitas Trust contains provisions entitling the Trustees to remuneration and the discharge of expenses properly incurred by them in acting as Trustees. These are met by the Group and are defined as related party transactions under Financial Reporting Standard 8.

The remuneration and expenses of the Trustees met by the Group in the year ended 31 March 2006 were in respect of the following:

	Year ended 31 March 2006 £	Year ended 31 March 2005 £
Trustees' fees	220,181	223,000
Trustees' legal, professional and other costs and expenses	797,426	567,272
Total	1,017,607	790,272

Messrs ME McL Deeny and RB Spooner, who are also Directors of the Company, received Trustees' fees of £41,000 each for the year ended 31 March 2006 (2005: £41,000 each). They received expenses for secretarial, office and other overheads of £17,696 and £17,977, respectively (2005: £15,886 and £14,427, respectively).

Independent Auditors' report to the members of Equitas Holdings Limited

1. We have audited the financial statements of Equitas Holdings Limited for the year ended 31 March 2006 which comprise the Group profit and loss account, the Group balance sheet, the Group cash flow statement, the Company balance sheet and the related notes. These financial statements have been prepared in accordance with the accounting policies set out in note 1 to the financial statements.

Respective responsibilities of directors and auditors

2. The directors' responsibilities for preparing the annual report and the financial statements in accordance with applicable United Kingdom law and accounting standards are set out in the statement of Directors' responsibilities.

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

4. We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We report to you whether in our opinion the information given in the Directors' report is consistent with the financial statements. We also report to you if, in our opinion, 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 is not disclosed.

5. We read 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. The other information comprises only the Directors' report, the Chairman's statement, the Chief Executive Officer's review, the Claims Director's review and the Financial review.

Basis of audit opinion

6. We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. However in light of the exceptional circumstances of the Group and the significance of the matters involved, our opinion is qualified in respect of the uncertainties described in paragraph 8 below. This is a modification of the reporting guidance in Auditing Standards because in our opinion it would be inappropriate to issue a disclaimer of opinion and there is no disagreement with management to report. 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 Group's circumstances, consistently applied and adequately disclosed.

7. 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.

Uncertainties in our audit of claims outstanding, reinsurers' share of claims outstanding and reinsurance debtors

8. In forming our opinion, we have considered the uncertainties, described in notes 1 and 2 to the financial statements, relating to the provision for claims outstanding of £4,176 million, reinsurers' share of claims outstanding of £360 million and reinsurance debtors of £193 million. Future experience may show material adjustments are required to these amounts particularly in respect of:

a) assumptions made in estimating provisions and the reliability of the underlying data upon which estimates are based;

b) the potential for unforeseen change in the legal, judicial, technological or social environment: the risk of unexpected outcomes on disputed claims and court decisions and the potential for new sources or types of claim to emerge;

c) assumptions in relation to the timing of settlement of claims and reinsurance recoveries which influence the discount calculation; and

d) assumptions in relation to estimating the reinsurers' share of claims outstanding and the extent to which these and amounts due from reinsurers will be collected.

Consequences of uncertainties

9. The potential adjustments referred to in paragraph 8, if adverse in the aggregate, could be material enough to exceed the amount of shareholders' funds at 31 March 2006 of £458 million. If at any time the directors determine that there are insufficient assets to meet liabilities in full as they fall due then, under the contract by which the Group reinsured the 1992 and prior years' liabilities, the directors may implement a proportionate cover plan under which the Group will then be entitled to pay claims at a reduced rate, and liabilities will be restricted in aggregate to assets available such that shareholders' funds would not become negative though they may be reduced to nil.

Qualified opinion arising from uncertainties in our audit

10. Except for material adjustments in respect of the matters described in paragraph 8 above, which may ultimately be required to the provision for claims outstanding, reinsurers' share of claims outstanding, reinsurance debtors and consequent adjustments to shareholders' funds and the deficit for the year, in our opinion:

- the financial statements give a true and fair view of the state of the Company's and of the Group's affairs at 31 March 2006 and of the deficit and cash flows of the Group for the year then ended;

- the financial statements have been properly prepared in accordance with the Companies Act 1985; and

- the information given in the Directors' report is consistent with the financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants
and Registered Auditors
London
1 June 2006

Group profit and loss account for the year ended 31 March 2006

Technical account – general business

	Note	£m	2006 £m	£m	2005 £m
Investment return transferred from non-technical account			**189**		133
Claims paid					
Gross amount		**(744)**		(1,030)	
Reinsurers' share		**190**		209	
Net claims paid		**(554)**		(821)	
Change in the provision for claims					
Gross amount		**630**		919	
Reinsurers' share		**(209)**		(165)	
Unwinding of the discount		**(101)**		(45)	
Timing of net future payments		**2**		(2)	
Change in the net provision for claims	*16*	**322**		707	
Claims incurred, net of reinsurance			**(232)**		(114)
Other technical charges	*4*		**25**		(3)
Balance on the technical account for general business			**(18)**		16

The accounting policies and notes on pages 33 to 43 form an integral part of these financial statements.

Group profit and loss account for the year ended 31 March 2006

Non-technical account

	Note	£m	2006 £m	£m	2005 £m
Balance on the technical account for general business			**(18)**		16
Income from financial investments		**194**		190	
Gains on the realisation of investments		**53**		63	
Unrealised losses on investments		**(58)**		(120)	
Investment return		**189**		133	
Allocated investment return transferred to general business technical account		**(189)**		(133)	
Investment return retained			**–**		–
(Deficit)/surplus on ordinary activities before tax	*5*		**(18)**		16
Tax on (deficit)/surplus on ordinary activities	*8*		**–**		–
(Deficit)/surplus for the year	*15*		**(18)**		16

No gains and losses have been recognised other than through the profit and loss account and the Group has no discontinued activities.

The accounting policies and notes on pages 33 to 43 form an integral part of these financial statements.

Group balance sheet as at 31 March 2006

Assets

	Note	2006 £m	2005 £m
Investments			
Financial investments	*9*	**4,137**	4,087
Financial reinsurances	*10*	**28**	32
		4,165	4,119
Reinsurers' share of technical provisions			
Claims outstanding	*16*	**360**	514
Debtors			
Debtors arising out of reinsurance operations	*12*	**264**	317
Other debtors		**7**	21
		271	338
Other assets			
Tangible assets		**1**	3
Cash at bank and in hand		**17**	8
		18	11
Prepayments and accrued income			
Accrued interest		**32**	29
Other prepayments and accrued income	*13*	**20**	20
		52	49
Total assets		**4,866**	5,031

The accounting policies and notes on pages 33 to 43 form an integral part of these financial statements.
The Company's balance sheet is shown on page 44.

Group balance sheet as at 31 March 2006

Liabilities

	Note	2006 £m	2005 £m
Capital and reserves			
Called up share capital	*14*	**–**	–
Retained surplus	*15*	**458**	476
Shareholders' funds – non-equity interests		**458**	476
Technical provisions			
Claims outstanding	*16*	**4,176**	4,406
Creditors			
Creditors arising out of reinsurance operations	*17*	**202**	112
Other creditors including taxation and social security		**30**	37
		232	149
Total liabilities		**4,866**	5,031

The financial statements on pages 28 to 43 were approved by the Board on 1 June 2006 and were signed on its behalf by:

HA Stevenson
SP Moser
JV Barker

The accounting policies and notes on pages 33 to 43 form an integral part of these financial statements.

Group cash flow statement for the year ended 31 March 2006

Reconciliation of (deficit)/surplus on ordinary activities before tax to net cash outflow from operating activities

	Note	£m	2006 £m	£m	2005 £m
(Deficit)/surplus on ordinary activities before tax			**(18)**		16
Depreciation of tangible fixed assets	*5*	**1**		1	
Profit on disposal of tangible fixed assets	*5*	**(1)**		–	
Exchange (gains)/losses, including (gains)/losses on retranslation of opening balances*		**(24)**		(2)	
Unrealised losses on investments		**58**		120	
Decrease in reinsurers' share of technical provisions – claims outstanding		**194**		158	
Decrease in provision for claims outstanding		**(529)**		(850)	
Decrease in debtors		**92**		108	
Increase/(decrease) in creditors		**77**		(331)	
			(132)		(796)
Net cash outflow from operating activities			**(150)**		(780)
Proceeds from disposal of tangible fixed assets			**2**		–
Net cash outflow for the year			**(148)**		(780)
Cash flows were (realised)/invested as follows:					
Increase/(decrease) in cash holdings	*19*		**11**		(4)
Net portfolio investment					
Shares and other variable yield securities and units in unit trusts		**(26)**		(16)	
Debt securities and other fixed interest securities		**25**		(334)	
Deposits with credit institutions		**(151)**		(86)	
Financial reinsurances		**(7)**		(340)	
	19		**(159)**		(776)
Net realisation of cash flows	*20*		**(148)**		(780)

* The effect of the retranslation of opening balances has been eliminated from all the relevant cash flow categories and is included within these amounts.

The accounting policies and notes on pages 33 to 43 form an integral part of these financial statements.

Notes to the financial statements for the year ended 31 March 2006

1 Accounting policies

Going concern

The financial statements have been prepared on a going concern basis. Significant uncertainties exist as to the accuracy of the provision for claims outstanding established by Equitas Limited and recoveries due from reinsurers shown in the balance sheet, further details of which are set out in note 2 on page 35. The ultimate cost of claims and the amounts ultimately recovered from reinsurers could vary materially from the amounts established and could, therefore, have a materially adverse effect on the ability of Equitas Limited to meet the reinsured liabilities in full.

If at any time the Directors of Equitas Reinsurance Limited believe that the reinsured liabilities cannot be met in full, they may implement a proportionate cover plan. At the date of this report, the Directors believe that the assets should be sufficient to meet all liabilities in full.

Basis of presentation

The financial statements of the Group have been prepared in accordance with the provisions of Section 255A of, and Schedule 9A to, the Companies Act 1985, and with the Statement of Recommended Practice on accounting for insurance business issued by the Association of British Insurers dated December 2005. The balance sheet of the Parent Company has been prepared in accordance with Section 226 of, and Schedule 4 to, the Companies Act 1985.

The financial statements have been prepared in accordance with applicable United Kingdom accounting standards. The Group has voluntarily adopted FRS 23 – The effects of changes in foreign exchange rates, FRS 26 – Financial instruments: Measurements (as amended in October 2005) and FRS 29 – Financial instruments: Disclosures.

Changes in accounting policy

Following the adoption of FRS 26 – Financial instruments: Measurements (as amended in October 2005), listed investments are valued at bid prices, rather than mid-market prices. This change in accounting policy did not have any material impact on the results of the current or prior year.

Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and its subsidiaries from 1 April 2005 to 31 March 2006.

Other important accounting policies

A summary of the more important accounting policies is set out below. Except for the change in the policy on the valuation of investments resulting from the adoption of FRS 26 as stated above, the other accounting policies have been applied consistently.

(a) Basis of accounting

The financial statements have been prepared in accordance with the historical cost convention modified by the revaluation of certain assets and liabilities. An annual basis of accounting has been adopted.

(b) Claims and related reinsurance recoveries

The provision for claims outstanding in the consolidated balance sheet is based upon the estimated ultimate cost of all claims, including those incurred but not reported ('IBNR') at the balance sheet date, together with related claims handling expenses. Provisions for claims outstanding are stated gross of recoveries to be made on reinsurance contracts purchased by the reinsured syndicates in recognition of the fact that they are separate liabilities and assets of the Group.

Notes to the financial statements (continued)

Claims incurred include all operational expenses relating to the run-off of the reinsured liabilities. Deductions are made for salvage and other recoveries. Additional premiums receivable and payable by syndicates in respect of risks accepted under the Reinsurance and Run-Off Contract are included within the movement of claims incurred.

(c) Discounting

As the reinsured liabilities will not be fully settled for many years, the provisions for claims outstanding and related reinsurance recoveries have been discounted. The Group has structured its investment portfolio to match its expected net liability stream. Accordingly, the rate of discount applied to those liabilities is calculated having regard to the current prospective yields associated with its investment portfolio.

(d) Tangible assets

Tangible assets are stated at cost less accumulated depreciation. The cost of tangible assets is their purchase cost together with any incidental costs of acquisition. Depreciation is calculated so as to write off the cost of tangible assets, less their estimated residual values, on a straight line basis over the expected useful economic lives of the assets concerned.

(e) Deferred taxation

Provision is made for deferred taxation, using the liability method, on all material timing differences. Deferred tax, which is calculated at the rates at which it is expected that the tax will arise, is recognised in the profit and loss account for the period. Deferred tax balances are not discounted.

(f) Investments

Investments are classified at fair value through the profit and loss account as investments that are held for trading. Listed investments are stated at market value based on bid (previously mid-market) prices quoted by the relevant exchanges following the adoption of FRS 26 by the Group. Other investments are stated at bid prices provided by various recognised sources. For short term money market instruments, where market values are not available, fair values have been calculated by discounting expected cash flows at prevailing interest rates at the balance sheet date. The fair value of forward currency contracts has been determined based on market forward exchange rates at the balance sheet date. Purchases and sales of investments are accounted for on a trade date basis.

Securities lent, where substantially all the risks and rewards of ownership remain with the Group, are retained on the balance sheet. Collateral received in respect of securities lent is not recorded in the balance sheet.

In the Company's accounts, investments in Group undertakings are stated at cost.

(g) Financial reinsurances

In accordance with FRS 5 – Reporting the Substance of Transactions, financial reinsurance policies are accounted for as investment assets. They are stated at the value of the expected receipts discounted at market yields to recognise the period until receipt. The change in the amount by which these assets are discounted from one period end to the next is recognised as investment return.

(h) Investment return

The return from investments is reported on an accruals basis and includes realised gains and losses, movements on unrealised gains and losses, net income from securities lent and dividends. Dividends are recorded on the date on which the shares are quoted ex-dividend. The investment return is transferred together with the related foreign withholding taxes to the technical account.

(i) Foreign exchange

Assets and liabilities are translated into sterling at the rates of exchange prevailing at the balance sheet date and the exchange differences taken to the profit and loss account. Transactions during the period are

translated into sterling using the rate of exchange prevailing at the time of the transaction, with the exchange differences taken to the profit and loss account.

(j) Pension costs

The Group makes pension contributions on a defined contribution basis on behalf of employees at the direction of the employee concerned. Contributions are charged in the period in which they are incurred.

The Group provides no other post-retirement benefits to employees.

(k) Leases

Operating lease costs are charged in the period in which they are incurred.

(l) Financial risk management

The Group permits limited use of derivative contracts for the purposes of efficient portfolio management. All obligations are covered by cash and open contracts and are reported at market value.

2 Estimation techniques and uncertainties

Introduction

During the year the Group continued to refine many assumptions and estimation techniques used to establish the provision for claims outstanding and the reinsurers' share of those claims. Because of the uncertainties inherent in the Group's liabilities, there are many assumptions and estimation techniques described below which individually could have a material impact on the amounts of liabilities, related reinsurance assets and reported surplus disclosed in the financial statements. Actual experience will often vary from these assumptions, and any consequential adjustments to amounts previously reported will be reflected in the results of the year in which they are identified. Potential adjustments arising in the future could, if adverse in the aggregate, exceed the amount of shareholders' funds. In that event, and as stated under 'Going concern' in note 1, the Directors of Equitas Reinsurance Limited may implement a proportionate cover plan.

The provision for claims outstanding is based upon actuarial and other studies of the ultimate cost of liabilities including exposure based and statistical estimation techniques.

Significant delays occur in the notification and settlement of certain claims, and a substantial measure of experience and judgment is involved in making the assumptions for assessing outstanding liabilities, the ultimate cost of which cannot be known with certainty at the balance sheet date. The gross provision for claims outstanding and related reinsurance recoveries is estimated on the basis of information currently available.

The provision for claims outstanding includes significant amounts in respect of notified and potential IBNR claims for long tail liabilities. The settlement of most of these claims is not expected to occur for many years, and there is considerable uncertainty as to the amounts at which they will be settled.

While many claims are clearly covered and are paid quickly, many other claims are subject to significant disputes. The provisions for disputed claims are based on the Group's view as to the expected outcomes of such disputes. In a number of instances an outcome that differs substantially from the Group's expectation could have a material impact on the Group's liabilities. Claim types impacted by such disputes include asbestos, pollution and certain health hazards such as lead pigment and silica.

Uncertainty is further increased because of the potential for unforeseen changes in the legal, judicial, technological or social environment, which may increase or decrease the cost, frequency or reporting of claims, and because of the potential for new sources or types of claim to emerge.

Notes to the financial statements (continued)

Asbestos claims

In estimating asbestos liabilities, the Group follows a highly developed actuarial framework. The majority of asbestos reserves is estimated by modelling the expected claims from policyholders of the reinsured syndicates.

The number of future claims is projected for direct policyholders based on past claims experience combined with the results of epidemiological and other relevant studies that predict the incidence of asbestos related diseases into the future. This is then combined with estimates of the average cost of settling different types of claims for each policyholder to give a total value of claims to the relevant underlying policyholders. The results of these projections are then applied to the insurance coverage available for those policyholders, resulting in an estimation of the Group's liabilities arising from claims against those policyholders. The results are then adjusted to take into account liabilities in respect of policyholders that are not modelled explicitly, including an amount for those liabilities of which the Group may be currently unaware.

A similar modelling process is used to estimate asbestos liabilities for the largest inwards reinsurance accounts ceded to the reinsured syndicates, but with the additional step of applying the ceding companies' expected liabilities to the reinsurance cover available. The ceded liabilities that cannot be explicitly modelled are estimated by reference to the current and historical claims experience of the cedants, taking into account cedant specific characteristics where appropriate.

The techniques described above require a number of important assumptions, including:

- the projected level of future valid claims filings for each policyholder by disease type;
- future levels of claims settlement values;
- the impact of bankruptcy of policyholders on the amount and timing of claims payments;
- the legal interpretation of insurance policies and the outcome of litigation, based upon legal advice received; and
- the period between the filing and payment of claims.

The assumptions on the proportion of claims filings that will ultimately lead to claims payments reflect an assessment that the claims management strategies adopted by the Group will reduce claims payments below the level that they would otherwise have been.

Pollution and health hazard claims

Pollution liabilities are estimated for policyholders of the reinsured syndicates by evaluating the expected costs to be incurred by the policyholders in cleaning up polluted sites and then applying these costs to the insurance coverage available. The pollution liabilities expected by means of inwards reinsurance are evaluated in a similar manner, but with the additional step of applying the ceding companies' expected liabilities to the reinsurance cover available.

Allowance is then made for liabilities in respect of policyholders for which either sufficient information is unavailable to carry out the above analysis or which have not yet been identified.

Health hazard liabilities are estimated using similar principles to the above, in that the liabilities of the policyholder are estimated for the majority of reserves and then applied to the insurance coverage.

These evaluation techniques involve a number of important assumptions, including:

- the validity and quantum of the claims potentially faced by the policyholder;
- the legal interpretation of insurance policies and the outcome of litigation, based upon legal advice received; and
- the degree to which potential or unforeseen health hazards may have an effect on the liabilities.

Other claims
The estimation of the majority of other liabilities involves a projection, based upon historical claims experience, of separate homogeneous sub-divisions by underwriting year. The techniques used include calendar year projections and curve-fitting.

Operating expenses
The provision for the cost of handling and settling the claims to extinction is based on an analysis of the expected costs to be incurred in run-off activities, incorporating expected savings from the reduction of transaction volumes over time.

Reinsurance recoveries
Reinsurance recoveries on claims outstanding (including IBNR claims) are estimated based upon the recovery rate experience for notified and paid claims by class of business for all reinsured syndicates. In assessing the level of reinsurance to be recovered from future claims, the actual recoveries experience for notified and paid claims is compared with previous expectations of those claims.

Individual reinsured syndicates are further analysed where recovery rates do not conform to the expected result. Recovery rates are adjusted, if necessary, as a result of this work. The reinsurance asset is then adjusted, if necessary, in respect of any bad debt provision required where reinsurance companies are currently, or are considered to be at risk of being in the future, unable to settle their liabilities in full when due. This adjustment is made using the Group’s and published information on the security of counterparties.

These evaluation techniques involve a number of important assumptions, including:
- the distribution of claims and how this will impact the reinsurance programmes of the reinsured syndicates;
- the provision required for bad debt; and
- the period required to recover the reinsurance asset through traditional means.

Discounting
The provision for claims outstanding, related reinsurance recoveries and the cost of undertaking the run-off is discounted. The period of time that will elapse before the liabilities are settled is modelled using the estimated settlement patterns of the claims and associated reinsurance recoveries separately.

The ability to settle the liabilities in full is dependent upon the generation of sufficient investment income to match the increase in insurance liabilities that will result each year from the unwinding of the discount. Assumptions made with regard to the generation of such investment income include:
- interest rates;
- exchange rates; and
- the timing of claims settlements and reinsurance recoveries.

The calculation of an appropriate discount rate assumes that the prospective return on what is essentially a duration and currency matched fixed income portfolio, if held to maturity, can be estimated based upon current market yields to maturity.

The discount rate is reviewed each year to ensure that it remains a prudent estimate of the average annual return expected to be achieved for the period for which the investment assets are likely to be held.

3 Segmental information
The Group transacts only one class of business, being 100 per cent proportional reinsurance written in the United Kingdom.

4 Other technical charges
Other technical charges relate to foreign exchange movements.

Notes to the financial statements (continued)

5 (Deficit)/surplus on ordinary activities before tax

The (deficit)/surplus is stated after charging/(crediting):

	Group 2006 £000	Group 2005 £000
Auditors' remuneration – audit fees	**898**	950
– non-audit fees	**38**	38
	936	988
Depreciation – tangible owned fixed assets	**567**	745
Profit on disposal of tangible fixed assets	**(933)**	(100)
Operating lease rentals incurred – property	**5,784**	5,648
– other	**13**	13
Operating lease rentals receivable – property	**(1,185)**	(399)

The audit fees for the Company of £2,000 (2005: £2,000) were borne by a subsidiary company.

Details of related party transactions, as defined by FRS 8, are given on page 25.

6 Employees

The monthly average number of persons employed by the Group, including Directors, was 347 for the year ended 31 March 2006 (2005: 439), all of whom were engaged in run-off and related activities.

Total staff costs, including those for Directors, comprised the following:

	Group 2006 £000	Group 2005 £000
Wages and salaries	**28,641**	32,272
Social security costs	**3,096**	3,557
Other pension costs	**4,460**	4,753
	36,197	40,582

The Group makes pension contributions on a defined contribution basis on behalf of employees at the direction of the employee concerned.

An amount of £2 million (2005: £1 million) was included in creditors in respect of pension costs.

7 Directors' emoluments

The aggregate remuneration of the Directors was as follows:

	Group 2006 £000	Group 2005 £000
Executive Directors – remuneration	**2,679**	2,491
– LTIP awards paid	**1,245**	1,013
– pension costs	**414**	390
Non-Executive Directors – fees	**444**	435
	4,782	4,329

In addition to the above amounts, provisional awards under the LTIP were made to the Executive Directors as detailed on page 24. Full details of the remuneration of, and transactions with, Directors are given in the Board report on Directors' remuneration on page 23.

8 Tax on (deficit)/surplus on ordinary activities

Analysis of charge/(credit) in the year

	Group 2006 £m	Group 2005 £m
United Kingdom corporation tax at 30% (2005: 30%)		
Current tax	**–**	–
Deferred tax – origination and reversal of timing differences	**–**	–
	–	–

Factors affecting the tax charge/(credit) for the year

The tax assessed for the year differs from the standard rate of corporation tax in the UK. The differences are explained below:

	Group 2006 £m	Group 2005 £m
(Deficit)/surplus on ordinary activities before tax	**(18)**	16
(Deficit)/surplus on ordinary activities multiplied by the standard rate of corporation tax in the UK of 30% (2005: 30%)	**(5)**	5
Effects of:		
Unrealised losses on revaluation of equity investments	**(1)**	(1)
Tax losses brought forward utilised during the year	**–**	(6)
Unutilised tax losses carried forward	**3**	–
Other permanent differences	**3**	2
Current tax charge/(credit) for the year	**–**	–

There is an unrecognised deferred tax asset of £157 million (2005: £145 million) arising from losses carried forward within the Group, which are not expected to be utilised in the foreseeable future.

9 Investments: financial investments, held for trading

	Group 2006		Group 2005	
	Market value £m	Cost £m	Market value £m	Cost £m
Listed				
Shares and other variable yield securities and units in unit trusts	**283**	**249**	267	265
Debt securities and other fixed interest securities	**3,529**	**3,535**	3,367	3,284
	3,812	**3,784**	3,634	3,549
Unlisted				
Deposits with credit institutions	**325**	**325**	453	453
	4,137	**4,109**	4,087	4,002

Further disclosures relating to financial instruments and financial risk management are included in the Financial review on pages 14 to 16.

Notes to the financial statements (continued)

The Group receives collateral for all securities lent as a condition of the transaction. Included in the table are lent securities with a market value of £1,155 million (2005: £1,190 million), which were collateralised at over 100 per cent of their value. A further £10 million (2005: £9 million) of accrued interest on lent securities and, for 2005 only, £14 million of debtors, also collateralised at over 100 per cent of their value, are included respectively under accrued interest and other debtors. The total market value of the collateral received was £1,189 million (2005: £1,233 million). A proportion of this collateral was sold and reinvested. The market value of the reinvested collateral was £936 million (2005: £921 million). The value of the retained collateral was £256 million (2005: £313 million).

Deposits with credit institutions include £70 million (2005: £70 million) that is subject to charge.

Certain investments are held in trust funds as described in note 11.

10 Investments: financial reinsurances

The average prospective rate of return on financial reinsurances is 4.88 per cent (2005: 4.31 per cent) per annum. The mean term is four (2005: four) years. The value of the expected receipts from financial reinsurances, before discounting at market yields to recognise the period until receipt, is £35 million (2005: £38 million).

11 Trust funds

Financial investments and cash amounting to £2,078 million (2005: £2,053 million) were held in trust funds in the United States and Canada. In addition, all proceeds of financial reinsurances are assigned to a trust fund in the United States. These trust funds were established under the laws of those countries for the settlement of claims relating to those jurisdictions. The amounts held in these trust funds cannot be used for any other purpose and can only be released with the appropriate regulatory consent if there is a surplus of assets over the liabilities they support.

The Equitas Australian Trust Fund supports obligations undertaken in Australia. It is financed by a letter of credit, which is secured by a charge over certain sterling denominated financial investments. As at 31 March 2006, the value of the letter of credit was A$170 million (2005: A$95 million).

12 Debtors arising out of reinsurance operations

	Group 2006 £m	Group 2005 £m
Reinsurance recoveries	**193**	245
Other	**71**	72
	264	317

Reinsurance recoveries are stated after elimination of inter-syndicate transactions.

13 Other prepayments and accrued income

Other prepayments and accrued income include an amount of £15 million (2005: £17 million) which is due after more than one year.

14 Called up share capital

	Company 2006 £	Company 2005 £
Authorised, allotted and called up		
1 deferred share of £1	**1**	1
2 ordinary shares of £50 each	**100**	100
	101	101

All of these shares were issued at par and are fully paid.

The deferred share carries the right to appoint and remove one Director of the Company (who will also serve as a Director of Equitas Reinsurance Limited and Equitas Limited) and is held by the Corporation of Lloyd's. On winding up, the deferred share carries no rights to any portion of surplus assets of the Company other than a return of the par value. Accordingly, it is a non-equity share.

The ordinary shares bear the right to appoint and remove the remaining Directors of the Company and to decide all matters reserved for decision by shareholders. The Articles of Association do not permit the payment of a dividend on the ordinary shares. Accordingly, these are non-equity shares.

15 Retained surplus

	Company £	Group £m
At 1 April 2005	–	476
Deficit for the year	–	(18)
At 31 March 2006	**–**	**458**

The retained surplus is not distributable.

16 Provision for claims outstanding

	Claims £m	Reinsurance £m	Group 2006 Net £m	Claims £m	Reinsurance £m	Group 2005 Net £m
Provision before discounting	**6,132**	**533**	**5,599**	6,257	751	5,506
Discount	**(1,956)**	**(173)**	**(1,783)**	(1,851)	(237)	(1,614)
	4,176	**360**	**3,816**	4,406	514	3,892

(a) Claims

Claims are stated after elimination of inter-syndicate transactions.

Provisions for asbestos, pollution and health hazard ('APH') liabilities comprised 77 per cent (2005: 77 per cent) of the net discounted provision for claims outstanding. These liabilities are expected to be paid out over a period in excess of 40 years.

Provisions for non-APH liabilities comprised 23 per cent (2005: 23 per cent) of the net discounted provision for claims outstanding.

Notes to the financial statements (continued)

(b) Reinsurance recoveries

Reinsurance recoveries are stated after elimination of inter-syndicate transactions.

(c) Discounting

The provision for claims outstanding, related reinsurance recoveries and the cost of undertaking the run-off has been discounted at a rate of 4.30 per cent (2005: 4.10 per cent) per annum compound to reflect the time value of money. An adjustment for non-interest bearing assets has been made. As at 31 March 2006, the mean term of the liabilities, that is the weighted average period to settlement where the weights are the undiscounted expected cash flows in each future period, was approximately 11 years (2005: 10 years).

(d) Estimation techniques and uncertainties

Details of the estimation techniques employed in the setting of the provision for claims outstanding and the associated uncertainties appear in note 2 on page 35.

17 Creditors arising out of reinsurance operations

Creditors arising out of reinsurance operations include £nil (2005: £40 million) which is due after more than one year.

18 Reconciliation of movements in shareholders' funds

	Group 2006 £m	Group 2005 £m
Opening shareholders' funds	**476**	460
(Deficit)/surplus for the year (see note 15)	**(18)**	16
Closing shareholders' funds	**458**	476

The Company made neither a profit nor a loss for the year. As permitted by Section 230 of the Companies Act 1985, the Company does not present its own profit and loss account.

19 Movement in portfolio investments net of financing

	Group 2006 £m	Group 2005 £m
Net cash inflow/(outflow) for the year (see note 20)	**11**	(4)
Movement arising from cash flows of portfolio investments	**(159)**	(776)
Changes to market values and discount (see note 20)	**(58)**	(120)
Other changes, including exchange rate effects (see note 20)	**264**	(83)
Total movement in portfolio investments net of financing	**58**	(983)
Opening portfolio investments net of financing (see note 20)	**4,123**	5,106
Closing portfolio investments net of financing (see note 20)	**4,181**	4,123

20 Movement in cash, portfolio investments and financing

	At 31 March 2005 £m	Cash flow £m	Changes to market values £m	Other changes, including exchange rate effects £m	At 31 March 2006 £m
Cash at bank and in hand	4	**11**	**–**	**1**	**16**
Shares and other variable yield securities and units in unit trusts	267	**(26)**	**31**	**11**	**283**
Debt securities and other fixed interest securities	3,367	**25**	**(89)**	**226**	**3,529**
Deposits with credit institutions	453	**(151)**	**–**	**23**	**325**
Financial reinsurances	32	**(7)**	**–**	**3**	**28**
	4,123	**(148)**	**(58)**	**264**	**4,181**

During the year shares and other variable yield securities and units in unit trusts of £337 million (2005: £123 million) were purchased and £363 million (2005: £139 million) were sold. For the same period debt securities and other fixed interest securities of £4,801 million (2005: £6,934 million) were purchased and £4,776 million (2005: £7,268 million) were sold. Cash at bank and in hand as at 31 March 2006 shown above is stated net of £1 million (2005: £4 million) of overdrafts.

21 Contingent liabilities and assets

The Group has granted certain indemnities to Trustees, Directors, Employees and the Auditors.

In view of the uncertainties surrounding potential US federal asbestos legislation the Group has negotiated the right to recover certain payments made if such legislation is passed by certain dates. These recoveries would result in an increase to both the Group's financial investments and provision for claims. These rights total approximately £280 million (2005: £150 million).

The Group had no other material contingent liabilities or assets outside the normal course of business at the balance sheet date.

22 Investments in Group undertakings

Company Name	Class and proportion of shares held	Country of incorporation	Business activities
Equitas Reinsurance Limited	Ordinary 100%	England	Reinsurance
Equitas Limited*	Ordinary 100%	England	Reinsurance run-off
Equitas Management Services Limited	Ordinary 100%	England	Provision of administrative services
Equitas Policyholders Trustee Limited	Ordinary 100%	England	Trustee

*Held via a subsidiary

No dividends may be paid or capital distributions made by Equitas Reinsurance Limited or Equitas Limited. Any surplus assets would be applied by Equitas Reinsurance Limited towards the payment of a return premium to Reinsured Names. Such a payment would require the consent of the Financial Services Authority.

23 Financial commitments

The Group had annual commitments under non-cancellable operating leases in respect of land and buildings, expiring in one year of £2 million (2005: £nil) and expiring in over five years of £3 million (2005: £6 million). A number of leases contain break clauses, which may be exercised at the Group's discretion. The amount relating to leases expiring in one year is as a result of the Group's decision to exercise break clauses on two of the leases on the premises at St Mary Axe.

Company balance sheet as at 31 March 2006

	Note	2006 £	2005 £
Fixed assets			
Investments – investments in Group undertakings	*22*	**300**	300
Current assets			
Amounts due from a Group undertaking		**1**	1
Net current assets		**1**	1
Total assets less current liabilities		**301**	301
Creditors – amounts falling due after more than one year			
Amounts owed to Group undertakings		**200**	200
Net assets		**101**	101
Capital and reserves			
Called up share capital	*14*	**101**	101
Profit and loss account	*15*	**–**	–
Shareholders' funds – non-equity interests		**101**	101

The financial statements on pages 33 to 44 were approved by the Board on 1 June 2006 and were signed on its behalf by:

HA Stevenson
SP Moser
JV Barker

The accounting policies and notes on pages 33 to 43 form an integral part of these financial statements.

Notice to Reinsured Names

Reinsured Names should note that the Reinsurance and Run-Off Contract dated 3 September 1996 calls for Equitas to request confirmation of, or notification of any amendment to, Reinsured Names' addresses annually. A separate card seeking such information accompanies this report.

Pursuant to Clause 22.2 of the Reinsurance and Run-Off Contract, Reinsured Names must provide Equitas Reinsurance Limited with such information within 21 business days of this request.

Reinsured Names whose addresses change during the year are asked to report these changes promptly in writing to the Company Secretary, Equitas Reinsurance Limited, 33 St Mary Axe, London EC3A 8LL, United Kingdom.

Open Meeting of Reinsured Names

The annual Open Meeting of Reinsured Names will be held at 10.30am on Friday 8 September 2006 at the Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1. All Reinsured Names are invited to attend. A card with complete details of the meeting accompanies this report. Reinsured Names who wish to attend the meeting are asked to return the reply-paid section of the card by 1 September 2006.

Designed and produced by Fishburn Hedges

Equitas Holdings Limited
Registered Office and Operating Head Office:
33 St Mary Axe
London EC3A 8LL
United Kingdom
Telephone: +44 (0)20 7342 2000
Facsimile: +44 (0)20 7342 2001

Registered in England; Registered Number 3136296