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Challenger Limited ACN 106 842 371

Interim Financial Report 2017

Challenger Limited – providing our customers with financial security for retirement.

CHALLENGER.COM.AU

Key Dates

28 March 2017
Interim dividend payment date

15 August 2017
Full year financial results
Final dividend announcement

27 September 2017
Final dividend payment date

26 October 2017
2017 Annual General Meeting

Dates may be subject to change.
A full listing of key dates can be found at:

challenger.com.au/share/keydates

ABOUT THIS REPORT

The Interim Financial Report 2017 can be downloaded from Challenger's Shareholder Centre at:

challenger.com.au/share

1 Directors

The names and details of the Directors of Challenger Limited (the Company) holding office during the six months to 31 December 2016 and as at the date of this report are listed below. Directors were in office for this entire period unless otherwise stated.

Name	Position
Peter Polson	Independent Chair
Brian Benari	Managing Director and Chief Executive Officer
Graham Cubbin	Independent Non-Executive Director
Steven Gregg	Independent Non-Executive Director
Jonathan Grunzweig	Independent Non-Executive Director
Brenda Shanahan	Independent Non-Executive Director
JoAnne Stephenson	Independent Non-Executive Director
Leon Zwier	Independent Non-Executive Director

2 Review of operations

Challenger has continued its growth momentum during the first half of the 2017 financial year, delivering increased sales in its Life segment, increased funds under management in its FM segment and an overall growth in net income.

2.1 Key performance indicators (KPIs)

KPIs for the period ended 31 December 2016 (with the 6 months to 31 December 2015 being the prior comparative period, unless otherwise stated) include:

	31 Dec 2016	31 Dec 2015	change %
Profitability			
Statutory profit attributable to equity holders ($M)	201.5	234.3	(14.0)
Normalised NPAT ($M)	196.6	182.1	8.0
Statutory EPS (cents)	35.8	41.9	(14.6)
Normalised EPS (cents)	35.0	32.6	7.4
Interim dividend (cents)	17.0	16.0	6.3
Interim dividend franking	100%	100%	-
Normalised cost to income ratio	32.9%	33.8%	(0.9)
Statutory RoE after tax	14.8%	18.0%	(3.2)
Normalised RoE after tax	14.5%	14.0%	0.5
Growth			
Total Life sales ($M)	2,758.4	2,050.8	34.5
Total Life net flows ($M)	843.4	347.1	Large
Total Life net book growth%	7.8%	3.6%	4.2
Total FM net flows ($bn)	3.2	(4.4)	Large
Total AUM ($bn)	64.7	57.6	12.3

Challenger's statutory profit attributable to equity holders of $201.5 million was lower for the period ended 31 December 2016 than the prior comparative period primarily as a result of lower investment experience and no significant item gains.

Normalised net profit after tax grew by 8% compared to the prior period, reflecting AUM growth and disciplined cost management.

An interim dividend of 17.0 cents was announced, franked at 100%, up from 16.0 cents (100% franked).

Statutory EPS has decreased for the period when compared to the prior period, reflecting the lower profit attributable to equity holders as a result of higher normalised earnings offset by the impact of fair value changes on Challenger Life Company's (CLC's) assets and liabilities together with the impact of one-off significant item gains in the prior period.

Challenger's normalised cost to income ratio of 32.9% remains within the targeted range and is 0.9% lower than the ratio in the prior period. This is a result of continued cost discipline combined with revenue growth. Challenger's medium-term expected normalised cost to income ratio target is a range of 32-36%.

Statutory return on equity (RoE) after tax of 14.8% has decreased compared to the prior period (31 December 2015: 18.0%) as a result of higher earnings offset by lower investment experience and no significant item gains (31 December 2015: $22.1 million). Normalised ROE after tax increased from 14.0% in the prior period to 14.5% reflecting the increased normalised NPAT.

2 Review of operations (continued)

2.2 Normalised profit and investment experience

Normalised framework

CLC and its consolidated entities are required by AASB 1038 *Life Insurance Contracts* to value all assets and liabilities at fair value where permitted by other accounting standards.

This gives rise to fluctuating valuation movements on assets and liabilities being recognised in the profit and loss in CLC and on consolidation in Challenger Limited. CLC is generally a long-term holder of assets, due to holding assets to match the term of life contract liabilities. As a result, Challenger takes a long-term view of the expected capital growth of the portfolio rather than focusing on short-term movements. Investment experience represents the difference between actual investment gains/losses (both realised and unrealised) and expected gains/losses based on CLC's medium to long-term expected returns. Investment experience also includes any impact from changes in economic and actuarial assumptions.

A reconciliation between statutory revenue and the management view of revenue and net income is included in the financial report as part of Note 3 Segment information. This note also includes a reconciliation of statutory profit after tax and normalised net profit after tax (the management view of post-tax profit). The application of the normalised profit framework has been reviewed by Challenger's independent auditor to ensure that the reported results are consistently applied in accordance with the methodology described in Note 3 Segment information in the financial report.

Management analysis – normalised results

	31 Dec 2016 $M	31 Dec 2015 $M	change $M	change %
Net income[1]	382.1	360.6	21.5	6.0
Comprising:				
– Life normalised COE	316.4	292.9	23.5	8.0
– FM net income	65.3	67.1	(1.8)	(2.7)
– Corporate and other net income	0.4	0.6	(0.2)	(33.3)
Operating expenses[1]	(125.7)	(121.9)	3.8	3.1
Normalised EBIT	**256.4**	**238.7**	**17.7**	**7.4**
Comprising:				
– Life normalised EBIT	267.0	248.9	18.1	7.3
– FM normalised EBIT	20.7	21.6	(0.9)	(4.2)
– Corporate and other normalised EBIT	(31.3)	(31.8)	0.5	1.6
Interest and borrowing costs	(2.3)	(2.3)	-	-
Tax on normalised profit	(57.5)	(54.3)	3.2	5.9
Normalised NPAT	**196.6**	**182.1**	**14.5**	**8.0**
Investment experience after tax	4.9	30.1	(25.2)	(83.7)
Significant items after tax	-	22.1	(22.1)	Large
Statutory net profit after tax attributable to equity holders	**201.5**	**234.3**	**(32.8)**	**(14.0)**

[1] 'Net income' and 'Operating expenses' are internal classifications and are defined in Note 3 Segment information in the interim financial report. These differ from the statutory revenue and expenses classifications, as certain costs (including distribution expenses, property expenses, management fees and special purpose vehicle expenses and finance costs) are netted off against gross revenues. These classifications have been made in the Directors' report and in Note 3 Segment information to reflect how management measures business performance. Whilst the classification of amounts to the above items, investment experience and significant items differs to the statutory view, both approaches result in the same total net profit after tax attributable to equity holders.

Life normalised cash operating earnings (COE) and EBIT increased as a result of higher Life investment assets combined with a slightly decreased margin being earned on those assets. Life's average assets under management (AUM) increased by 9.9% as a result of the net book growth in annuities and valuation movements on those assets.

Funds Management net income decreased (down $1.8 million) due to reduced performance fee revenue. Funds Management average FUM increased by 7.8% as a result of inflows throughout the year together with mark-to-market gains on investments.

Operating expenses increased marginally for the period ended 31 December 2016 (up $3.8 million) primarily due to additional expenses incurred to support the Company's growth ambitions. Challenger's employee numbers increased by 14 (or 2.3%) to 632 when compared to the prior period.

Normalised tax for the period was $57.5 million, reflecting a normalised effective tax rate for the period of 22.6% (23.0% at 31 December 2015).

2 Review of operations (continued)

2.2 Normalised profit and investment experience (continued)

Management analysis – investment experience

	31 Dec 2016 $M	31 Dec 2015 $M
Actual capital growth[1]		
– Cash and fixed income	52.9	(79.6)
– Infrastructure	(29.9)	2.8
– Property (net of debt)	48.0	76.3
– Equity and other investments	16.1	(32.1)
Total actual capital growth	**87.1**	**(32.6)**
Normalised capital growth[2]		
– Cash and fixed income	(16.6)	(14.8)
– Infrastructure	10.9	11.2
– Property (net of debt)	32.1	31.4
– Equity and other investments	24.7	20.6
Total normalised capital growth	**51.1**	**48.4**
Investment experience		
– Cash and fixed income	69.5	(64.8)
– Infrastructure	(40.8)	(8.4)
– Property (net of debt)	15.9	44.9
– Equity and other investments	(8.6)	(52.7)
Annuity valuation experience[3]	(27.5)	124.0
Investment experience before tax	8.5	43.0
Tax expense	(3.6)	(12.9)
Investment experience after tax	**4.9**	**30.1**

[1] Actual capital growth represents net realised and unrealised capital gains or losses and includes the attribution of interest rate, inflation and foreign exchange derivatives that are used to hedge exposures.
[2] Normalised capital growth is determined by multiplying the normalised capital growth rate for each asset class by the average investment assets for the period. The normalised capital growth rates represent Challenger's expectations for each asset class over the investment cycle. The normalised growth rate is +4.5% for equity and other investments, +4.0% for infrastructure, +2.0% for property and -0.35% for cash and fixed income in order to allow for credit defaults. The rates have been set with reference to medium to long-term market growth rates and are reviewed to ensure consistency with prevailing market experience.
[3] Annuity valuation experience represents the impact of changes in macroeconomic variables, including bond yields and inflation factors, expense assumptions, losses on new business and other factors applied in the valuation of life contract liabilities.

Investment experience after tax relates to changes in the fair value of Life's assets and liabilities adjusted for any tax benefit or expense. Investment experience is a mechanism employed to remove the volatility arising from asset and liability valuation movements from Life business earnings so as to more accurately reflect the underlying performance of the business.

31 December 2016 investment experience comprises a $36.0 million gain in relation to fair value movements on Life's assets and a $27.5 million loss in relation to fair value movements on Life's liabilities. Continued property valuation gains (net of related transaction costs) combined with fixed income investment gains were offset by negative infrastructure and equity and other investments as a result of volatile global equity markets during the period.

2.3 Life segment results

The Life segment includes CLC, Australia's leading provider of annuities and guaranteed retirement income products and Accurium Actuarial Pty Limited. CLC has won the Association of Financial Advisers/Plan for Life annuity provider of the year for the past eight years.

CLC is regulated by APRA, and its financial strength is rated by Standard & Poor's, with an 'A' credit rating and stable outlook. CLC is strongly capitalised, with significant excess capital above APRA's minimum regulatory requirements.

Life normalised results	31 Dec 2016 $M	31 Dec 2015 $M	change $M	change %
Normalised COE				
– Cash earnings	265.3	244.5	20.8	8.5
– Normalised capital growth	51.1	48.4	2.7	5.6
Operating expenses	(49.4)	(44.0)	(5.4)	12.3
Normalised EBIT	**267.0**	**248.9**	**18.1**	**7.3**

Life normalised EBIT increased by $18.1 million (up 7.3%) due to higher normalised COE (up $20.8 million or 8.5%), which was partially offset with operating expenses increasing by $5.4 million (or 12.3%). The higher normalised COE was as a result of higher investment assets, with Life average investment assets increasing at 9.9%.

Life annuity sales increased strongly when compared to the prior period (up 33.8%), with both increased fixed term sales (up 16.2%) and a substantial increase in lifetime sales (up 142.3%) resulting from the impact of annuity sales on platforms.

Life annuity sales have benefited during the period from the sales of annuities on the Colonial First State and VicSuper platforms. In addition, relationships with Local Government Super, ClearView Wealth Solutions, CareSuper, Legal Super and Suncorp all went live during the period and are beginning to drive annuity sales. During the period, Life also announced new relationships with AMP and Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary). The relationship with AMP is to provide the full range of Life's annuity products through AMP's investment administration platforms. The opportunity is currently in development and is expected to begin delivering sales during the 2018 financial year.

In November 2016, Life began issuing Australian dollar fixed rate annuities with a 20 year term to support its reinsurance agreement with MS Primary. Under the terms of the new product the customer can choose an annuity payment period of 5, 10 or 20 years, with a benefit payable upon death. MS Primary has contributed $125.1 million of annuity sales in the period and sales are expected to grow as MS Primary's distribution network gains momentum with the new product.

2 Review of operations (continued)

2.3 Life segment results (continued)

Life sales	31 Dec 2016 $M	31 Dec 2015 $M	change $M	change %
Fixed-term annuities	1,641.9	1,412.4	229.5	16.2
Lifetime annuities	554.2	228.7	325.5	Large
Total Life annuity sales	2,196.1	1,641.1	555.0	33.8
Other Life sales	562.3	409.7	152.6	37.2
Total Life sales	**2,758.4**	**2,050.8**	**707.6**	**34.5**
Annuity net flows	448.9	270.5	178.4	66.0
Other Life net flows	394.5	76.6	317.9	Large
Total Life net flows	**843.4**	**347.1**	**496.3**	**Large**

Annuity net flows (new annuity sales less capital repayments) increased by 66.0% to $448.9 million driven by higher annuity sales. Based on the opening Life annuity book for the 2017 financial year ($9,558.5 million), annuity net book growth for the period was 4.7%, which was up from 3.1% in the prior period.

Other Life sales represents Challenger's Guaranteed Index products. Other Life sales increased primarily due to sales in the new Challenger Index Plus Fund of $150.0 million.

Other Life net flows for the period were $394.5 million increasing significantly compared to $76.6 million in the prior period. Total Life net flows were $843.4 million representing total Life net book growth of 7.8% (2015: $347.1 million or 3.6% book growth).

2.4 Funds Management segment results

Challenger's Funds Management segment is Australia's seventh[1] largest investment manager and second largest fixed income manager by FUM.

Fidante Partners' multi-boutique platform comprises separately branded investment management businesses. The model aligns the interests of investors, boutique investment managers and Fidante Partners. Fidante Partners includes Australian and UK based investment managers investing in equities, fixed income, infrastructure and alternatives.

Funds Management also includes Challenger Investment Partners (CIP), a fixed income and property institutional investment manager, investing on behalf of both CLC and third party institutional investors.

FM normalised results	31 Dec 2016 $M	31 Dec 2015 $M	change $M	change %
Net income				
– Fidante Partners	40.6	41.3	(0.7)	(1.7)
– CIP	24.7	25.8	(1.1)	(4.3)
Operating expenses	(44.6)	(45.5)	(0.9)	(2.0)
Normalised EBIT	**20.7**	**21.6**	**(0.9)**	**(4.2)**

[1] Rainmaker – Consolidated FUM for Australian Fund Managers September 2016.

Funds Management normalised EBIT decreased for the period by 4.2%, with lower net income offset by lower expenses. Net income was impacted by lower Fidante Partners performance fees being earned during the period. Expenses reduced by 2.0%, reflecting improved cost discipline.

Fidante Partners' net income includes distribution fees, administration fees, transaction fees and a share in the equity accounted profits for the boutique fund managers in which it has an equity interest. Fidante Partners net income reduced in 2016 despite strong growth in FUM, primarily as a result of lower performance fees ($1.1 million compared to the prior period of $3.8 million).

Challenger Investment Partners' (CIP) net income decreased (down $1.1 million) due to higher net management fees, being offset by lower fee income.

Funds Management normalised return on equity (RoE) (pre-tax) for the period was 23.2%, down by 520 bps from the prior period. This reduction comes as a result of the lower EBIT during the period and increased capital invested into the business to support future growth. Notwithstanding this, RoE continues to benefit from strong FUM growth and capturing the benefits of scale.

Funds Management	31 Dec 2016 $bn	31 Dec 2015 $bn	change $bn	change %
FUM				
– Fidante Partners	47.0	41.6	5.4	13.0
– CIP	15.1	13.1	2.0	15.3
Total FUM	**62.1**	**54.7**	**7.4**	**13.5**
Flows				
– Fidante Partners	1.7	(4.0)	5.7	Large
– CIP	1.5	(0.4)	1.9	Large
Total flows	**3.2**	**(4.4)**	**7.6**	**Large**

Fidante Partners' FUM (up $5.4 billion) was driven by net flows (up $3.1 billion) and positive impact from investment markets (up $2.7 billion), net of distributions.

CIP FUM growth (up $2.0 billion) is primarily a result of additional fixed income flows (up $1.8 billion) and additional real estate flows (up $0.2 billion).

2.5 Corporate and other segment results

The Corporate and other segment comprises central functions such as the group executive, finance, treasury, legal, human resources, risk management and strategy.

The financial results also include interest received on Group cash balances and any interest and borrowing costs associated with Group debt facilities.

2 Review of operations (continued)

2.5 Corporate and other segment results (continued)

Corporate and other normalised results	31 Dec 2016 $M	31 Dec 2015 $M	change $M	change %
Net income	0.4	0.6	(0.2)	(33.3)
Operating expenses	(31.7)	(32.4)	(0.7)	(2.2)
Normalised EBIT	**(31.3)**	**(31.8)**	**0.5**	**1.6**
Interest and borrowing costs	(2.3)	(2.3)	-	-
Normalised loss before tax	**(33.6)**	**(34.1)**	**0.5**	**1.5**

Normalised EBIT for the Corporate and other segment was higher (up $0.5 million) as a result of a decrease in expenses.

2.6 Capital management

Challenger's capital position is managed at both the Group and the prudentially-regulated CLC level, with the objective of maintaining the financial stability of the Group and CLC whilst ensuring that shareholders earn an appropriate risk adjusted return. Refer to Note 9 Contributed equity for further information on the Group's Internal Capital Adequacy Assessment process.

The following table highlights the key capital metrics for CLC and the Group:

Capital	31 Dec 2016	30 June 2016	change
Net assets attributable to equity holders ($M)	2,780.5	2,680.9	99.6
CLC excess capital over PCA ($M)	772.3	1,010.4	(238.1)
Group cash ($M)	80.7	84.2	(3.5)
CLC excess capital over PCA + Group cash ($M)	853.0	1,094.6	(241.6)
CLC PCA ratio (times)	1.39	1.57	(0.18)
CLC CET1 ratio (times)	1.02	1.12	(0.10)

CLC regulatory capital base

CLC holds capital in order to ensure that, under a range of adverse scenarios, it can continue to meet its regulatory and contractual obligations to its customers. CLC is regulated by APRA and is required to hold a minimum level of regulatory capital. CLC has ongoing and open engagement with APRA.

CLC maintains a level of capital representing APRA's PCA plus a target surplus. The target surplus is a level of excess capital that CLC seeks to carry over and above APRA's minimum requirement in order to provide a buffer against adverse market conditions, having regard to CLC's credit rating. CLC uses internal capital models to determine its target surplus, which are risk-based and are responsive to changes in CLC's asset allocation and market conditions. While CLC does not target a specific PCA ratio, CLC's internal capital models result in a PCA ratio under current circumstances in the range of 1.3 to 1.6 times. This range will change over time and is dependent on a number of factors.

In addition to CLC's excess regulatory capital, Challenger maintains cash at a Group level which can be used to meet regulatory capital requirements. Challenger further maintains an undrawn Group corporate debt facility of $400.0 million in order to provide additional financial flexibility. The facility remained undrawn at the end of the period.

Subordinated debt

CLC's total regulatory capital base includes $386.7 million of admissible subordinated debt. US$150 million of subordinated debt (A$190.3 million) was repaid during the period in accordance with its terms.

CLC's remaining subordinated debt has a call date in November 2017. As such, this tranche will continue to be fully eligible as Tier 2 regulatory capital until its call date in November 2017 and will continue to be partially eligible until November 2021.

APRA's Level 3 (conglomerate) proposals

The Group is a Level 3 entity under the APRA conglomerates framework. Level 3 groups are groups of companies that perform material activities across more than one APRA-regulated industry and /or in one or more non-APRA regulated industries. APRA's non capital conglomerate prudential standards relating to measurement, management, monitoring and reporting aggregate risk exposures and intragroup transactions and exposures comes into effect 1 July 2017. In March 2016, APRA announced that it would defer the implementation of conglomerate capital requirements until a number of other domestic and international policy initiatives were further progressed. Challenger is well progressed in applying APRA's governance and risk management standards across the Group.

2.7 Credit ratings

Challenger Limited and CLC are rated by Standard & Poor's (S&P). In November 2016, S&P reaffirmed both Challenger Limited and CLC's credit ratings.

Ratings were confirmed as:

- CLC: 'A' with a stable outlook; and
- Challenger Limited: 'BBB+' with a stable outlook.

The S&P ratings reflect the financial strength of Challenger Limited and CLC. In particular, the report noted that Challenger Life has an extremely strong capital and earnings position with financial flexibility.

3 Dividends and dividend reinvestment plan

Dividends	31 Dec 2016	31 Dec 2015	change	change %
Interim dividend (cents)	17.0	16.0	1.0	6.3
Interim dividend franking	100%	100%	-	-

The Company targets a dividend payout ratio of 45% to 50% of normalised profit after tax over the medium term, subject to prevailing market conditions and alternative uses of capital. The dividend payout ratio for the period ended 31 December 2016 was 48.6%.

3 Dividends and dividend reinvestment plan (continued)

The Company also seeks to frank its dividend to the maximum extent possible and expects future dividends to be fully franked. However, the actual dividend payout ratio and franking will depend on prevailing market conditions and capital allocation priorities at the time.

The Company continued to operate its dividend reinvestment plan (DRP) for the 2016 final dividend. The DRP participation rate was 4% of all issued shares and 455,140 ordinary shares were issued to satisfy the DRP requirements on 28 September 2016.

The DRP will continue in operation for the 2017 interim dividend and the Board has determined that new shares will be issued to fulfil DRP requirements in respect of the interim dividend. However, the new shares will not be issued at a discount to the prevailing Challenger share price.

4 Likely developments and expected results

The Group intends to continue with its current strategy of providing Australians with financial security for retirement. To continue to achieve this vision, the Group is focused on the following four core strategic objectives:

1 to increase the Australian retirement savings pool allocation to secure and stable incomes;
2 to be recognised as the leader and partner of choice in retirement income solutions with a broad product offering;
3 to provide clients with relevant investment strategies exhibiting consistently superior performance; and
4 to deliver superior returns to shareholders by maintaining a highly engaged, diverse and agile workforce committed to outstanding client service with a strong risk and compliance culture.

Life segment outlook

The Australian retirement incomes market is expected to grow strongly over the next 20 years as Australia's Baby Boomers (born 1946 to 1964) move from retirement 'saving' to retirement 'spending'. Over the next 20 years the number of Australians over 65, which is Life's target demographic, is expected to increase by 75%[1].

Challenger Life is well positioned to benefit from changes in retiree risk preferences, including the focus on longevity risk by retirees and their advisers. Annuities address many of the financial concerns retirees face in retirement.

The retirement phase of superannuation is a high growth market driven by ageing demographics and rising superannuation balances from mandatory superannuation contributions.

The annual transfer from the accumulation (or savings) phase to the retirement (or spending) phase of superannuation is expected to be $58 billion in 2017, forecast to increase by a compound annual growth rate of ~13%[2] per year for the next 10 years. This will result in the annual transfer to the retirement phase increasing from ~$58 billion in 2017 to ~$240 billion by 2030.

There is a growing recognition that retirees need to take a different approach to investing in retirement and there is a move toward income layering and objectives-based investing. As retirees transition from Government funded aged pensions to private pensions, retirees are demanding safe, secure retirement income products that convert savings to income and provide financial security. Annuities provide safe, secure and reliable retirement income.

Of the total annual transfer from the accumulation to retirement phase each year, currently less than 5% is invested in annuities, which is significantly less than the average for OECD countries. As Australian retirees seek secure retirement income products that convert savings to income, there is a significant opportunity to increase the proportion of retirement savings invested in annuities.

The industry is responding to consumer demand with a range of new retirement income products, including the emergence of Comprehensive Income Products for Retirement (CIPR), as recommended by the Financial System Inquiry (FSI).

The Australian Federal Government commissioned the FSI to provide a 'blueprint' for Australia's financial system over the next decade. The FSI report (released December 2014) recommended the retirement phase of superannuation would benefit greatly from pre-selected retirement products for members. These products would provide regular and stable income streams with longevity protection.

The Federal Government responded to the FSI recommendation in October 2015, supporting all major retirement income recommendations, including implementation of CIPRs. The Government released a consultation paper in December 2016, with industry submissions due by April 2017.

As part of the Federal Budget in May 2016, the Australian Government announced a new superannuation framework that will address current longevity product impediments and facilitate a wider range of retirement income products. The new retirement income product rules remove the impediments to longevity products, including deferred lifetime annuities, and are expected to provide the building blocks for superannuation funds to develop CIPRs. The key new retirement income rules were legislated by the Federal Government in late calendar year 2016 and are scheduled to come into effect on 1 July 2017.

Challenger's distribution strategy includes adding its products to the investment and administration platforms of leading superannuation funds.

[1] Deloitte – Dynamics of the Australian superannuation system: the next 20 years 2015-2035.

[2] Rice Warner 2015 Super Projections – forecasted growth over next 10 years.

4 Likely developments and expected results (continued)

Life segment outlook (continued)

In the retail superannuation segment, Challenger annuities have been launched on the Colonial First State (CFS) platform, ClearView Wealth Solutions platform, and are scheduled to be launched by both AMP and BT in the September 2017 quarter. These retail platform initiatives will result in approximately two thirds of Australian financial advisers being able to access Challenger annuities via an investment administration platform.

In the industry fund segment, Challenger backed term and lifetime annuities have been integrated with VicSuper account based pensions to effectively create Australia's first CIPR. Challenger has also formed a partnership with the Link Group, which services the needs of 10 million Australian industry superannuation member accounts. Three of Link Group's clients (Local Government Super, Legalsuper and Caresuper) have commenced offering to their members guaranteed retirement incomes backed by Challenger annuities.

Consistent with the strategy to diversify its range of products and expand its distribution relationships, in October 2016 Challenger announced a new annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary). MS Primary is a leading provider of Australian dollar denominated annuity products in Japan.

Japan's rapidly ageing population is seeking income from longer dated products due to the low Japanese interest rate environment. This has driven a significant increase in demand for foreign currency annuities, including Australian dollar denominated annuities.

Sales of Australian dollar annuities in Japan have tripled over the last three years and were approximately A$29 billion in 2016, over seven times the size of the Australian annuities market.

Commencing on 1 November 2016, Challenger issued Australian dollar fixed rate annuities with a 20 year term in order to support a reinsurance agreement with MS Primary. This new relationship has started strongly, with $125.1 million of sales for the first two months ending 31 December 2016.

Australia's retirement income market is a high growth market, driven by Australia's ageing population and mandatory nature of superannuation contributions. As Australia's leading retirement income specialist, Challenger is uniquely positioned to benefit from growth in Australia's retirement income market. Challenger's growth is being amplified through expanding its product and distribution capability, including increasing access to products through leading administration and investment platforms.

Funds Management segment outlook

The Australian funds management market remains an attractive market underpinned by mandated superannuation contributions. Contributions are currently 9.5% of gross salaries and are scheduled to increase to 12% by 2025. The mandated nature of Australia's superannuation system is expected to significantly grow the size of Australia's superannuation assets from $2 trillion to $10 trillion over the next 20 years[1].

Funds Management's superior FUM growth can be partly attributed to the strength of Challenger's retail and institutional distribution teams, and investor alignment across investors, boutique investment managers and Fidante Partners.

The expansion of Fidante Partners into Europe has substantially expanded Fidante Partners' successful multi-boutique model into the European market, whilst opening up global distribution opportunities for existing boutique investment managers.

Challenger Investment Partners continues to build out its client base and product offering. There are opportunities to add new mandates from domestic and international institutions, superannuation funds and sovereign wealth funds. As a result of the low (or negative) interest rate environment across the globe, there is high demand from foreign investors seeking higher absolute return Australian assets.

Challenger's Funds Management business is very well positioned to benefit from growth in Australia's superannuation system. The Funds Management platform has multiple brands and strategies with scalable platforms in both Australia and Europe.

Funds Management has approximately $110 billion of available FUM capacity, and when coupled with Challenger's distribution capability, institutional strength administration platform and long term boutique investment manager performance, provides a strong base to continue to grow the business.

Risks

The above outlook for the Life and Funds Management segments is subject to the following key business risks:

- regulatory and political changes impacting financial services participants;
- demand for and competition with Challenger products, including annuities and managed funds;
- market volatility; and
- general uncertainty around the global economy and its impact on markets in which Challenger operates and invests.

Guidance for the 2017 financial year

Life cash operating earnings

Life COE guidance for 2017 is a range of $620 million to $640 million.

Challenger Group ROE and dividend

Challenger continues to target a normalised return on equity of 18% (pre-tax) and expects to achieve a fully franked dividend payout ratio of 45% to 50% of normalised profit, subject to prevailing market conditions and capital allocation priorities.

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[1] Deloitte – Dynamics of the Australian superannuation system: the next 20 years 2015-2035.

5 Significant events after the balance date

Challenger intends to launch a subordinated, convertible, unsecured note offer (Notes) during the first quarter of the calendar year subject to market conditions. The Notes will be listed and traded on the ASX and will pay quarterly floating distributions based on a margin over BBSW. Distributions will be reduced for franking credits with the Notes expected to be fully franked. Challenger is targeting to raise $350 million with the ability to raise more or less. The proceeds will be used for Additional Tier 1 capital issued by CLC to support the forecast growth of its annuity business. CLC's capital position will be materially strengthened and on a proforma basis, at 31 December 2016, CLC's PCA ratio would increase to 1.52 times. Following the issue of the Notes, Challenger expects to recognise an interest bearing liability to the value of the proceeds raised less the related expenses which are capitalised and amortised over the life of the Notes.

6 Rounding

The amounts contained in this report and the financial report have been rounded to the nearest $100,000 unless otherwise stated, under the option available to the Group under Australian Securities and Investments Commission (ASIC) Corporations Instrument 2016/191.

7 Auditor's independence declaration

The Directors received the following declaration from the auditor of Challenger Limited:

EY
Building a better working world

Ernst & Young
200 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
ey.com/au

Auditor's independence declaration to the Directors of Challenger Limited

As lead auditor for the review of Challenger Limited for the half-year ended 31 December 2016, I declare to the best of my knowledge and belief, there have been:

a) no contraventions of the auditor independence requirements of the Corporations Act 2001 in relation to the review; and

b) no contraventions of any applicable code of professional conduct in relation to the review.

This declaration is in respect of Challenger Limited and the entities it controlled during the financial period.

Ernst & Young

S J Ferguson
Partner
Sydney
13 February 2017

Liability limited by a scheme approved under Professional Standards Legislation.

8 Authorisation

Signed in accordance with a resolution of the Directors of Challenger Limited:

G A Cubbin
Director
Sydney
13 February 2017

B R Benari
Managing Director & Chief Executive Officer
Sydney
13 February 2017

This financial report covers Challenger Limited (the Company) and its controlled entities (the Group or Challenger).

Statement of comprehensive income

For the six months ended 31 December	Note	2016 $M	2015 $M
Revenue	1	940.7	950.0
Expenses	2	(645.2)	(566.9)
Finance costs		(45.1)	(99.0)
Share of profits of associates		8.6	7.3
Profit before income tax		**259.0**	**291.4**
Income tax expense	4	(57.4)	(60.8)
Profit for the period		**201.6**	**230.6**
Profit attributable to shareholders of Challenger Limited		201.5	234.3
Profit/(loss) attributable to non-controlling interests		0.1	(3.7)
Profit for the period		**201.6**	**230.6**
Other comprehensive income			
Items that may be reclassified to profit and loss, net of tax			
Translation of foreign entities		(11.2)	18.2
Hedge of net investment in foreign operations		14.1	(18.2)
Cash flow hedges – SPV[1]		0.3	(0.8)
Other comprehensive income for the period		3.2	(0.8)
Total comprehensive income for the period		**204.8**	**229.8**
Comprehensive income attributable to shareholders of Challenger Limited		204.7	233.5
Comprehensive income attributable to non-controlling interests		0.1	(3.7)
Total comprehensive income for the period		**204.8**	**229.8**
Earnings per share attributable to ordinary shareholders of Challenger Limited		cents	cents
Basic	12	35.8	41.9
Diluted	12	34.1	39.0

[1] SPV = Special Purpose Vehicles.

The statement of comprehensive income should be read in conjunction with the accompanying notes.

Statement of financial position

As at	Note	31 Dec 2016 $M	30 June 2016 $M	31 Dec 2015 $M
Assets				
Cash and cash equivalents		553.0	526.9	836.6
Cash and cash equivalents – SPV		148.8	146.9	166.4
Receivables		328.5	257.8	180.8
Mortgage assets – SPV		1,458.7	1,677.6	1,916.3
Derivative assets		646.1	788.3	500.6
Financial assets – fair value through profit and loss	5	14,280.4	13,104.3	11,342.1
Investment property held for sale	6	34.5	70.6	58.1
Investment and development property	6	3,512.3	3,499.3	3,324.5
Finance leases		51.9	57.8	85.8
Property, plant and equipment		110.9	145.4	162.5
Current tax asset		-	13.1	-
Investment in associates		49.1	51.5	30.2
Other assets		56.9	54.9	59.2
Goodwill		571.6	571.6	571.6
Other intangible assets		16.8	12.3	13.9
Total assets of shareholders of Challenger Limited, policyholders, external unit holders and non-controlling interests		**21,819.5**	**20,978.3**	**19,248.6**
Liabilities				
Payables		360.7	607.0	267.2
Derivative liabilities		742.4	843.6	560.2
Interest bearing financial liabilities	10	4,947.9	4,148.8	3,648.8
Interest bearing financial liabilities – SPV		1,356.9	1,628.4	1,876.7
External unit holders' liabilities		1,633.2	1,315.5	1,035.1
Provisions		17.4	12.5	21.3
Current tax liability		3.0	-	15.4
Deferred tax liabilities		179.1	180.0	171.3
Life contract liabilities	7	9,784.9	9,558.5	8,868.4
Total liabilities of shareholders of Challenger Limited, policyholders, external unit holders and non-controlling interests		**19,025.5**	**18,294.3**	**16,464.4**
Net assets of shareholders of Challenger Limited and non-controlling interests		**2,794.0**	**2,684.0**	**2,784.2**
Equity				
Contributed equity	9	1,560.1	1,546.7	1,576.8
Reserves		(29.9)	(7.9)	(19.7)
Retained earnings		1,250.3	1,142.1	1,139.1
Total equity of shareholders of Challenger Limited		**2,780.5**	**2,680.9**	**2,696.2**
Non-controlling interests		13.5	3.1	88.0
Total equity of shareholders of Challenger Limited, policyholders, external unit holders and non-controlling interests		**2,794.0**	**2,684.0**	**2,784.2**

The statement of financial position should be read in conjunction with the accompanying notes.

Statement of changes in equity

For the period ended 31 December 2015	Note	Attributable to shareholders of Challenger Limited Contributed equity $M	Share-based payment reserve $M	Cash flow hedge reserve – SPV $M	Foreign currency translation reserve $M	Adjusted controlling interest reserve $M	Retained earnings $M	Total shareholder equity $M	Non-controlling interests $M	Total equity $M
Balance at 1 July 2015		1,527.2	10.0	1.4	(6.6)	18.9	992.3	2,543.2	95.4	2,638.6
Profit for the period		-	-	-	-	-	234.3	234.3	(3.7)	230.6
Other comprehensive income for the period		-	-	(0.8)	-	-	-	(0.8)	-	(0.8)
Total comprehensive income for the period		**-**	**-**	**(0.8)**	**-**	**-**	**234.3**	**233.5**	**(3.7)**	**229.8**
Other equity movements										
Ordinary shares issued[1]	9	6.3	-	-	-	-	-	6.3	-	6.3
Shares purchased in the CPP Trust	9	(37.5)	-	-	-	-	-	(37.5)	-	(37.5)
Vested shares released from the CPP Trust	9	50.8	-	-	-	-	-	50.8	-	50.8
CPP deferred share purchases	9	30.0	-	-	-	-	-	30.0	-	30.0
Share-based payment expense less releases		-	(44.9)	-	-	-	-	(44.9)	-	(44.9)
Dividends paid	11	-	-	-	-	-	(87.5)	(87.5)	-	(87.5)
Other movements		-	-	-	1.3	1.0	-	2.3	(3.7)	(1.4)
Balance at 31 December 2015		**1,576.8**	**(34.9)**	**0.6**	**(5.3)**	**19.9**	**1,139.1**	**2,696.2**	**88.0**	**2,784.2**
For the period ended 31 December 2016										
Balance at 1 July 2016		1,546.7	(12.9)	-	(7.1)	12.1	1,142.1	2,680.9	3.1	2,684.0
Profit for the period		-	-	-	-	-	201.5	201.5	0.1	201.6
Other comprehensive income for the period		-	-	0.3	2.9	-		3.2	-	3.2
Total comprehensive income for the period		**-**	**-**	**0.3**	**2.9**	**-**	**201.5**	**204.7**	**0.1**	**204.8**
Other equity movements										
Ordinary shares issued[1]	9	4.1	-	-	-	-	-	4.1	-	4.1
Shares purchased in the CPP Trust	9	(43.9)	-	-	-	-	-	(43.9)	-	(43.9)
Vested shares released from the CPP Trust	9	41.2	-	-	-	-	-	41.2	-	41.2
CPP deferred share purchases	9	12.0	-	-	-	-	-	12.0	-	12.0
Share-based payment expense less releases		-	(25.2)	-	-	-	-	(25.2)	-	(25.2)
Dividends paid	11	-	-	-	-	-	(93.3)	(93.3)	-	(93.3)
Other movements		-	-	-	-	-		-	10.3	10.3
Balance at 31 December 2016		**1,560.1**	**(38.1)**	**0.3**	**(4.2)**	**12.1**	**1,250.3**	**2,780.5**	**13.5**	**2,794.0**

[1] The Company issued 455,140 and 890,868 ordinary shares on 28 September 2016 and 14 October 2015 respectively to shareholders who took part in the Company's Dividend Reinvestment Plan (DRP).

The statement of changes in equity should be read in conjunction with the accompanying notes.

Statement of cash flows

For the six months ended 31 December	Note	2016 $M	2015 $M
Operating activities			
Receipts from customers		325.5	290.4
Annuity and premium receipts	7	2,218.1	1,650.0
Annuity and claim payments	7	(1,920.8)	(1,542.3)
Payments to reinsurer	7	(5.6)	(5.2)
Receipts from external unit holders		562.3	409.7
Payments to external unit holders		(217.3)	(339.7)
Payments to vendors and employees		(295.2)	(296.3)
Dividends received		36.0	32.2
Interest received		327.1	345.4
Interest paid		(52.2)	(46.1)
Income tax paid		(38.0)	(30.5)
Net cash inflows from operating activities	8	**939.9**	**467.6**
Investing activities			
Payments on net purchases of investments		(1,599.1)	(640.8)
Net mortgage loan repayments		251.5	317.2
Payments for net purchases of property, plant and equipment		(8.8)	(10.0)
Payments for purchases of controlled entities		-	(36.5)
Proceeds from sale of associate		-	45.0
Net cash outflows from investing activities		**(1,356.4)**	**(325.1)**
Financing activities			
Proceeds from issue of ordinary shares	9	4.1	6.3
Net proceeds from borrowings – interest bearing financial liabilities[1]	10	573.2	379.5
Payments for Treasury shares		(39.5)	(31.4)
Dividends paid		(93.3)	(87.5)
Net cash inflows from financing activities		**444.5**	**266.9**
Net increase in cash and cash equivalents		**28.0**	**409.4**
Cash and cash equivalents at the beginning of the period		673.8	593.6
Cash and cash equivalents at the end of the period		**701.8**	**1,003.0**
Cash and cash equivalents		553.0	836.6
Cash and cash equivalents – SPV		148.8	166.4
Cash and cash equivalents at the end of the period		**701.8**	**1,003.0**

The statement of cash flows should be read in conjunction with the accompanying notes.

[1] Includes $262.0m outflow relating to SPV's in the current period.

Basis of preparation and overarching significant accounting policies

Challenger Limited (the Company or the parent entity) is a company limited by shares, incorporated in Australia, whose shares are publicly traded on the Australian Securities Exchange (ASX).

The interim financial report for Challenger Limited and its controlled entities (the Group or Challenger) for the six months ended 31 December 2016 was authorised for issue in accordance with a resolution of the Directors of the Company on 13 February 2017.

(i) Basis of preparation and statement of compliance

This is a general purpose interim financial report for the six months ended 31 December 2016 that has been prepared in accordance, and complies with the requirements of the *Corporations Act 2001* and AASB 134 *Interim Financial Reporting.* Challenger Limited is a for-profit entity for the purposes of preparing financial statements.

The interim financial report does not include all the notes normally included in an annual financial report. It is recommended that this interim financial report be read in conjunction with the financial report for the year ended 30 June 2016 and any public announcements made by the Group in accordance with the continuous disclosure obligations of the ASX listing rules.

Unless otherwise stated, amounts in this financial report are presented in Australian dollars and have been prepared on an historical cost basis. The assets and liabilities disclosed in the statement of financial position are grouped by nature and listed in an order that reflects their relative liquidity.

(ii) New and revised accounting standards and interpretations

The accounting policies applied in these interim financial statements are the same as those applied in the Group's financial statements as at and for the year ended 30 June 2016.

There have been no new or revised accounting standards or interpretations which are effective from the period on or after 1 July 2016 that materially impact the interim financial results.

Note 1 Revenue

	31 Dec 2016 $M	31 Dec 2015 $M
Investment revenue		
Fixed income securities and cash[1]	30.5	324.9
Investment property and property securities	231.3	261.5
Equity and infrastructure investments	17.5	7.5
Realised and unrealised gains on hedges and foreign exchange translation	131.0	18.3
Management fee revenue	104.1	89.1
Other revenue		
Life insurance contract premiums and related revenue[2]	426.3	208.7
Gain on sale of associate	-	40.0
Total revenue	**940.7**	**950.0**

[1] Includes fair value movements in subordinated debt (Note 13 Fair values of financial assets and liabilities).
[2] Changes in life insurance and investment contract liabilities arising from discount rates, inflation rates and other assumptions are recognised as revenue, with other movements being included in Note 2 Expenses.

Note 2 Expenses

	31 Dec 2016 $M	31 Dec 2015 $M
Life contract and reinsurance expenses[1]	361.0	281.6
Investment property related expenses[2]	55.9	59.3
Fee expenses	42.6	42.1
Distribution expenses	22.0	17.5
Employee benefits expenses	89.5	88.0
Impairment loss on equity accounted associates	-	10.6
Other expenses	74.2	67.8
Total expenses	**645.2**	**566.9**

[1] Cost of life contract liabilities recognised as an expense consists of the interest expense on the liability and any loss on the initial recognition of new business less the release of liability in respect of expenses incurred in the current period. The interest expense on the liability represents the unwind of the discount on the opening liability over the period, whereas the impacts of changes in the discount rate applied for the current valuation are included in the change in life contract liabilities disclosed in Note 1 Revenue.
[2] Investment property-related expenses relate to rental income generating investment properties.

Note 3 Segment information

The reporting segments[1] of the Group have been identified as follows:

For the six months ended 31 December	Life		Funds Management		Total reporting segments		Corporate and other[2]		Total	
	2016 $M	2015 $M	2016 $M	2015 $M	2016 $M	2015 $M	2016 $M	2015 $M	2016 $M	2015 $M
Net income	316.4	292.9	65.3	67.1	381.7	360.0	0.4	0.6	382.1	360.6
Operating expenses	(49.4)	(44.0)	(44.6)	(45.5)	(94.0)	(89.5)	(31.7)	(32.4)	(125.7)	(121.9)
Normalised EBIT	**267.0**	**248.9**	**20.7**	**21.6**	**287.7**	**270.5**	**(31.3)**	**(31.8)**	**256.4**	**238.7**
Interest and borrowing costs	-	-	-	-	-	-	(2.3)	(2.3)	(2.3)	(2.3)
Normalised net profit/(loss) before tax	**267.0**	**248.9**	**20.7**	**21.6**	**287.7**	**270.5**	**(33.6)**	**(34.1)**	**254.1**	**236.4**
Tax on normalised profit									(57.5)	(54.3)
Normalised net profit after tax									**196.6**	**182.1**
Investment experience after tax									4.9	30.1
Significant items after tax									-	22.1
Profit attributable to the shareholders of Challenger Ltd									**201.5**	**234.3**
Other statutory segment information										
Revenue from external customers	519.3	467.9	74.7	118.7	599.2	586.6	7.7	0.4	601.7	587.0
Interest revenue	326.6	353.3	-	-	326.6	353.3	12.4	9.7	339.0	363.0
Interest expense	(35.4)	(88.7)	(0.4)	-	(35.8)	(88.7)	(9.3)	(10.3)	(45.1)	(99.0)
Intersegment revenue	(18.1)	(16.7)	18.1	16.7	-	-	-	-	-	-
Depreciation and amortisation	(2.7)	(3.5)	(0.1)	(0.2)	(2.8)	(3.7)	(4.5)	(4.4)	(7.3)	(8.1)
As at 31 December										
Segment assets	14,996.6	13,607.2	284.3	201.7	15,280.9	13,808.9	6,525.1	5,293.5	21,806.0	19,102.4
Segment liabilities	(12,443.2)	(11,040.1)	(106.5)	(50.8)	(12,549.7)	(11,090.9)	(6,475.8)	(5,315.3)	(19,025.5)	(16,406.2)
Net assets attributable to shareholders	**2,553.4**	**2,567.1**	**177.8**	**150.9**	**2,731.2**	**2,718.0**	**49.3**	**(21.8)**	**2,780.5**	**2,696.2**

[1] Refer below for definitions of the terms used in the management view of segments.
[2] Corporate and other includes corporate companies, corporate SPV, non-controlling interests and Group eliminations.

Definitions

Operating segments

The following segments are identified on the basis of internal reporting to key management personnel, including the Chief Executive Officer (the chief operating decision maker) of the Group, and comprise component parts of the Group that are regularly reviewed by senior management in order to allocate resources and assess performance:

Life

The Life segment principally includes the annuity and life insurance business carried out by CLC and Accurium Actuarial Pty Limited (provision of self-managed superannuation fund actuarial certificates). CLC offers fixed rate retirement and superannuation products that are designed for investors who are seeking a low-risk, fixed term or lifetime investment and seek capital protection. CLC invests in assets providing long-term income streams for customers.

Funds Management

Funds Management earns fees from its Fidante Partners and Challenger Investment Partners operations, providing an end-to-end funds management business as well as managing a number of unlisted fund mandates. Funds Management has equity investments in a number of the Fidante Partners boutique fund managers and, through the Challenger Investment Partners business, offers a range of managed investments across fixed income and property.

Corporate and other

Consists of other income and costs that fall outside the day-to-day operations of the reportable segments. These include the costs of the Group CEO and CFO, shared services across the Group, long-term incentive costs, Directors' fees, corporate borrowings and associated borrowing costs and shareholder registry services.

To reconcile to Group results, the Corporate and other segment also includes eliminations and non-core activities of the Group.

Note 3 Segment information (continued)

Normalised vs. statutory results

Net income and operating expenses differ from revenue and expenses as disclosed in the statement of comprehensive income as certain direct costs (including distribution expenses, property expenses and management fees) included in expenses are netted off against revenues in deriving the management view of net income above. Net income consists of the following sub-categories of management views of revenue:

- Normalised cash operating earnings (Life segment).
- Net income (Funds Management segment).
- Other income (Corporate and other segment).

In addition, the revenues, expenses and finance costs from Special Purpose Vehicles (SPV) are separately disclosed in the statutory view but are netted off in net income.

Revenue also includes investment gains and losses which are excluded from the management view as they form part of investment experience (refer below) or significant items (refer below).

Normalised cash operating earnings

This is calculated as cash earnings plus normalised capital growth (refer below). Cash earnings represents the sum of investment yield (being the management view of revenue from investment assets, such as net rental income, dividends and interest), interest expense, distribution expenses and fees.

Normalised EBIT

Normalised earnings before interest and tax (EBIT) comprises net income less operating expenses, as defined above. It excludes investment experience, corporate interest and borrowing costs, significant items and tax.

Interest and borrowing costs differ from finance costs as disclosed in the statement of comprehensive income for similar reasons to revenue and expenses, with the major difference arising from the netting of SPV finance costs against SPV revenue in net income in the management view.

Tax on normalised profit

Represents the consolidated statutory tax expense or benefit for the period, less tax attributable to non-controlling interests, less the tax applied to investment experience.

Investment experience after tax

The Group is required by accounting standards to value applicable assets and liabilities supporting the life insurance business at fair value. This can give rise to fluctuating valuation movements being recognised in the statement of comprehensive income, particularly during periods of market volatility. As the Group is generally a long-term holder of assets, due to assets being held to match the term of life contract liabilities, the Group takes a long-term view of the expected capital growth of the portfolio rather than focusing on short-term volatility. Investment experience is a mechanism employed to isolate the volatility arising from asset and liability valuation within the results so as to more accurately reflect the underlying performance of the Group.

Investment experience is calculated as the difference between the actual investment gains/losses (both realised and unrealised) and the normalised capital growth (refer below) plus annuity valuation changes. Investment experience after tax is investment experience net of tax at the prevailing income tax rate.

Normalised capital growth

This is determined by multiplying the normalised capital growth rate for each asset class by the average investment assets for the period. The normalised growth rates represent the Group’s medium to long-term capital growth expectations for each asset class over the investment cycle.

The normalised growth rates for the year are +4.5% for equity, +4.0% for infrastructure, +2.0% for property and -0.35% for cash and fixed income and are unchanged since 30 June 2016. The rates have been set with reference to medium to long-term market growth rates and are reviewed to ensure consistency with prevailing market experience.

Annuity valuation assumption changes represent the impact of changes in macroeconomic variables, including bond yields and inflation factors, expense assumptions, losses on new business and other factors applied in the valuation of life contract liabilities. It also includes the attribution of the corresponding interest rate, foreign exchange and inflation derivatives used to hedge interest rate volatility.

Significant items after tax

The group presents additional non-IFRS financial information to the market to provide meaningful insights into the financial condition of the business. Due consideration has been given to ensure that disclosure of Challenger’s normalised profit framework is explained, reconciled and calculated consistently period-on-period. Within this framework, Challenger defines significant items as non-recurring or abnormal income or expense items. None of these items are deemed to have occurred as part of normal operating activities and are considered by management to be non-recurring or abnormal items and have therefore been classified as significant items in accordance with the definition.

Major customers

The Group does not rely on any large individual customers and consequently there is no significant concentration risk.

Geographical areas

The Group operates predominantly in Australia; hence, no geographical split is provided to the chief operating decision maker.

Note 3 Segment information (continued)

	31 Dec 2016 $M	31 Dec 2015 $M
Reconciliation of management to statutory view of after-tax profit		
Operating segments normalised net profit before tax	287.7	270.5
Corporate and other normalised net loss before tax	(33.6)	(34.1)
Normalised net profit before tax (management view of pre-tax profit)	**254.1**	**236.4**
Tax on normalised profit	(57.5)	(54.3)
Normalised net profit after tax	**196.6**	**182.1**
Investment experience after tax	4.9	30.1
Significant items after tax	-	22.1
Profit attributable to the shareholders of Challenger Limited	**201.5**	**234.3**
Profit/(loss) attributable to non-controlling interests excluded from management view	0.1	(3.7)
Statutory view of profit after tax	**201.6**	**230.6**
Reconciliation of management view of revenue to statutory revenue		
Operating segments	381.7	360.0
Corporate and other	0.4	0.6
Net income (management view of revenue)	**382.1**	**360.6**
Expenses and finance costs offset against revenue		
SPV expenses and finance costs offset against SPV income	18.7	28.4
Distribution expenses offset against related income	22.0	17.5
Change in life contract liabilities and reinsurance contracts recognised in expenses	361.0	281.6
Property related expenses offset against property income	50.3	44.9
Interest and loan amortisation costs	16.6	70.5
Fee expenses	42.6	42.1
Gain on sale of associate	-	40.0
Adjustment for non-controlling interests and other items	38.9	21.4
Difference between management view of investment experience and statutory recognition		
Actual capital growth	87.1	(32.6)
Normalised capital growth	(51.1)	(48.4)
Annuity valuation experience	(27.5)	124.0
Statutory revenue (refer Note 1 Revenue)	**940.7**	**950.0**

Note 4 Income tax

Analysis of income tax expense	31 Dec 2016 $M	31 Dec 2015 $M
Current income tax expense for the period	(61.3)	(23.6)
Current income tax benefit prior period adjustment	0.2	9.6
Deferred income tax benefit/(expense)	3.7	(46.8)
Income tax expense	**(57.4)**	**(60.8)**
Income tax benefit/(expense) on translation of foreign entities	5.8	(7.4)
Income tax (expense)/benefit on hedge of net investment in foreign entities	(6.0)	8.2
Income tax (expense)/benefit from other comprehensive income	**(0.2)**	**0.8**
Reconciliation of income tax expense		
Profit before income tax	259.0	291.4
Prima facie income tax based on the Australian company tax rate of 30%	(77.7)	(87.4)
Tax effect of amounts not assessable/deductible in calculating taxable income:		
– non-assessable and non-deductible items[1]	3.8	21.5
– tax rate differentials	5.1	(2.9)
– tax adjustment in respect of non-controlling interests	-	(1.1)
– other items	11.4	9.1
Income tax expense	**(57.4)**	**(60.8)**
Underlying effective tax rate[2]	**22.2%**	**20.6%**

[1] The 31 December 2015 amount includes a reduction in the tax expense for $13.5 million in respect of previously unbooked capital losses brought onto the balance sheet in respect of the capital gain on sale of Kapstream.

[2] The calculation of the underlying effective tax rate excludes the non-controlling interests profit of $0.1 million (loss of $3.7 million for the six months ended 31 December 2015).

Unused revenue losses

All remaining revenue losses of the Challenger tax consolidated group were fully utilised in the year to 30 June 2016. A deferred tax asset in relation to $15.4 million (30 June 2016: $23.4 million) of revenue losses (net) has been recognised in respect of non-tax consolidated group entities. A further deferred tax asset of $19.5 million has not been recognised in respect of non-tax consolidated group entities as it is unlikely sufficient assessable gains will be derived by these entities to utilise the losses.

Unused capital losses

The Group has $322.3 million (30 June 2016: $422.3 million) of gross unused capital losses for which no deferred tax asset has been recognised. The decrease in the period is attributable to a capital gain arising in the period.

Note 5 Financial assets – fair value through profit and loss

	31 Dec 2016 $M	30 June 2016 $M	31 Dec 2015 $M
Domestic sovereign bonds and semi-government bonds	5,197.2	4,364.4	1,900.0
Floating rate notes and corporate bonds	4,843.3	4,788.0	5,802.0
Residential mortgage and asset-backed securities	2,329.2	2,065.2	1,895.0
Non-SPV mortgage assets	224.4	245.9	276.9
Fixed income securities	**12,594.1**	**11,463.5**	**9,873.9**
Shares in listed and unlisted corporations	93.8	54.8	77.8
Unit trusts, managed funds and other	617.5	545.4	453.1
Equity securities	**711.3**	**600.2**	**530.9**
Units in listed and unlisted infrastructure trusts	361.4	369.4	311.2
Other infrastructure investments	306.5	331.7	309.2
Infrastructure investments	**667.9**	**701.1**	**620.4**
Indirect property investments in listed and unlisted trusts	307.1	339.5	316.9
Property securities	**307.1**	**339.5**	**316.9**
Total financial assets – fair value through profit and loss	**14,280.4**	**13,104.3**	**11,342.1**

Note 6 Investment and development property

	31 Dec 2016 $M	30 June 2016 $M	31 Dec 2015 $M
Investment property held for sale[1]	34.5	70.6	58.1
Investment property in use	3,372.6	3,378.7	3,217.2
Investment property under development	102.6	83.3	53.4
Total investment property	**3,509.7**	**3,532.6**	**3,328.7**
Development property held for resale[2]	37.1	37.3	53.9
Total investment and development property	**3,546.8**	**3,569.9**	**3,382.6**

[1] Held for sale properties: 12-30 Toll Drive and Spotlight (30 June 2016: Innaloo Cinema and Elder House).

[2] Development property held for resale is held at the lower of cost or net realisable value.

Note 7 Life contract liabilities

Fair value of life contract liabilities	31 Dec 2016 $M	30 June 2016 $M	31 Dec 2015 $M
Life investment contract liabilities – at fair value	6,694.2	6,915.3	6,655.3
Life insurance contract liabilities – at margin on services value	3,011.6	2,555.3	2,166.8
Reinsurance contract liabilities – at margin on services value	79.1	87.9	46.3
Total life contract liabilities	**9,784.9**	**9,558.5**	**8,868.4**

	Life investment contract liabilities		Life insurance contract liabilities		Outward reinsurance contract liabilities		Total life contract liabilities	
Movement in life contract liabilities	31 Dec 2016 $M	31 Dec 2015 $M	31 Dec 2016 $M	31 Dec 2015 $M	31 Dec 2016 $M	31 Dec 2015 $M	31 Dec 2016 $M	31 Dec 2015 $M
Balance at the beginning of the period	6,915.3	6,626.9	2,555.3	2,013.3	87.9	52.8	9,558.5	8,693.0
Deposits and premium receipts	1,517.9	1,412.4	700.2	237.6	-	-	2,218.1	1,650.0
Payments and withdrawals	(1,774.0)	(1,432.3)	(146.8)	(110.0)	(5.6)	(5.2)	(1,926.4)	(1,547.5)
Revenue per Note 1	(77.3)	(64.6)	(344.5)	(142.0)	(4.5)	(2.1)	(426.3)	(208.7)
Expenses per Note 2	112.3	112.9	247.4	167.9	1.3	0.8	361.0	281.6
Balance at the end of the period	**6,694.2**	**6,655.3**	**3,011.6**	**2,166.8**	**79.1**	**46.3**	**9,784.9**	**8,868.4**

Life investment contract liabilities

Life investment contracts are contracts regulated under the *Life Insurance Act 1995* (Life Act) but which do not meet the definition of life insurance contracts under AASB 1038 *Life Insurance Contracts* and similar contracts issued by entities operating outside of Australia.

For fixed term policies, the liability is based on the fair value of the income payments and associated expenses, being the net present value of the payments and expenses using an appropriate discount rate curve as determined by the Appointed Actuary.

Life insurance contract liabilities

Life insurance contracts are contracts regulated under the Life Act that involve the acceptance of significant insurance risk. Insurance risk is defined as significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (i.e. have no discernible effect on the economics of the transaction).

The financial reporting methodology used to determine the value of life insurance contract liabilities is referred to as margin on services (MoS). Under MoS, the excess of premiums received over payments to customers and expenses (the margin) is recognised over the life of the contract in a manner that reflects the pattern of risk accepted from the policyholder (the service) unless future margins are negative, in which case the future losses are recognised. The planned release of this margin is recognised in the statement of comprehensive income as part of the movement in life insurance contract liabilities.

Life insurance contract liabilities are usually determined using a projection method, whereby estimates of policy cash flows (payments and expenses) are projected into the future. The liability is calculated as the net present value of these projected cash flows using a risk-free discount rate curve.

The key areas of judgement in the determination of the actuarial assumptions are the duration of claims/policy payments, acquisition and maintenance expense levels, and economic assumptions for discount and inflation rates.

Life insurance premium revenue

Life insurance premiums are recognised as revenue when received.

Life insurance claims expense

Life insurance claims expense is recognised in expenses when the liability to the policyholder under the contract has been established.

Reinsurance

The Group has maintained reinsurance arrangements during the period that meet the definition of a life insurance contract. The MoS methodology requires the present value of future cash flows arising from reinsurance contracts to be included in the calculation of life insurance contract liabilities reinsurance.

Valuation

The MoS valuation, calculated in accordance with APRA Prudential Standards, results in the systematic release of planned margins over the life of the policy via a 'profit carrier'. The Group maintains life insurance contracts, being individual lifetime annuities, longevity reinsurance, wholesale mortality and wholesale morbidity. Annuity payments are used as the profit carrier for individual lifetime annuities and premium receipts or best estimate claim payments are used as the profit carrier for wholesale mortality, wholesale morbidity and longevity reinsurance.

Note 7 Life contract liabilities (continued)

Key assumptions applied in the valuation of life contract liabilities

Discount rates

Under APRA Prudential Standards and AASB 1038 *Life Insurance Contracts*, life insurance contract liabilities are calculated by discounting expected future cash flows at a risk-free rate, set at the Commonwealth Government Bond curve plus an illiquidity premium where applicable or for foreign-denominated liabilities, a curve derived from the yields of highly liquid AAA-rated sovereign risk securities in the currency of the policy liabilities plus an illiquidity premium where applicable. The illiquidity premium is determined by reference to observable market rates including Australian sovereign debt, corporate, securitised and collateralised debt publicly placed in the domestic market, and market swap rates.

Life investment contract liabilities are calculated under the fair value through profit and loss provisions of AASB 139 *Financial Instruments: Recognition and Measurement*. The discount rates are determined based on the current observable, objective rates that relate to the nature, structure and term of the future liability cash flows.

For both insurance and investment contracts the approach is the same as adopted in 2016. Discount rates applied for Australian liabilities were between 2.4-4.3% (30 June 2016: 2.3-3.3%) per annum.

Expenses

Maintenance expenses are based on forecasts for the next financial year. The expenses are converted to a per-contract unit cost or percentage of account balance, depending on their nature. Forecasted expenses for the next year are allocated between acquisition, maintenance and investment based on the nature of the expense.

Inflation

Inflation estimates are based on long-term expectations and reviewed at least annually for changes in the market environment based on a comparison of real and nominal yields of instruments of equivalent term and credit risk. The current assumption for Australia is 1.2% for short-term inflation and 2.7% for long-term (30 June 2016: 0.9% short-term, 1.8% long-term) per annum.

Surrenders

No surrenders or voluntary discontinuances are assumed for life investment contracts. Where policyholders have the option to commute a life insurance contract, the value of this option is included within the life contract liabilities.

Mortality

Base mortality rates for individual lifetime annuities are determined as a multiple of annuitant experience based on IML08 and IFL08 tables, adjusted for Challenger's own recent experience. IML08 and IFL08 are mortality tables developed by the Institute and Faculty of Actuaries (UK) based on United Kingdom annuitant lives experience from 2007–2010. The tables refer to male and female lives respectively. Rates are adjusted for expected future mortality improvements based on observed and expected improvements. Rates of future mortality improvement for individual lifetime annuities applied are between 0.0-2.8% (30 June 2016: 0.0-2.8%) per annum.

Base mortality rates for wholesale mortality and longevity reinsurance are determined as a multiple of pensioner mortality rates (based on the self-administered pension schemes or SAPS2 tables mortality investigation developed by the Institute and Faculty of Actuaries (UK) using United Kingdom data collected between 2004–2012) or Vita Curves (proprietary mortality curves developed by Hymans Robertson where mortality rates vary by several rating factors) or population rates as appropriate. Rates are adjusted for expected future mortality improvements based on observed and expected improvements. Rates of future mortality improvement applied are between 0.0-3.2% (30 June 2016: 0.0-4.0%) per annum.

Impact of changes in assumptions on life insurance contracts

Under MoS, changes in actuarial assumptions are recognised by adjusting the value of future profit margins in life insurance contract liabilities. Changes in future profit margins are released over future periods unless that product group is in an expected net loss position (loss recognition), in which case changes in assumptions are recognised in the statement of comprehensive income in the period in which they occur. The valuation impact of changes to discount rate assumptions as a result of market and economic conditions, such as changes in benchmark market yields, are recognised in the statement of comprehensive income in the period in which they occur.

Restrictions on assets

The Life Act requires the Group to hold investments to back life contract liabilities in separate statutory funds. The assets in a statutory fund can only be used to meet the liabilities and expenses of that fund, to acquire investments to further the business of the fund or make distributions when capital adequacy requirements are met.

Statutory fund information

The life contract operations of CLC are conducted within three separate statutory funds as required by the Life Act. Both the shareholders' and policyholders' interests in these statutory funds are reported in aggregate in the financial report of the Group. Fund 1 is a non-investment-linked fund and Fund 3 is investment-linked. Both of these are closed to new business. Fund 2 is the principal operating fund of the Group and contains non-investment-linked contracts, including the Group's term annuity business, lifetime annuity policies and the related reinsurance, plus the wholesale mortality, wholesale morbidity and longevity reinsurance. Life contract liabilities for Funds 1, 2 and 3 are $3.0 million, $9,778.7 million and $3.2 million respectively (30 June 2016: $3.3 million, $9,552.1 million and $3.1 million).

Note 7 Life contract liabilities (continued)

Life insurance risk

The Group is exposed to longevity risk on its individual lifetime annuities and wholesale longevity reinsurance. Longevity risk is the risk that policyholders may live longer than expectations. The Group is exposed to mortality risk on the wholesale mortality reinsurance. This is the risk that death rates in the reference portfolios exceed expectations. The Group is also exposed to morbidity risk on the wholesale morbidity reinsurance. That is the risk that morbidity rates in the reference portfolios exceed expectations. The Group manages the longevity risk by regular reviews of the portfolio to confirm continued survivorship of policyholders receiving income plus regular review of longevity experience to ensure that longevity assumptions remain appropriate. In addition, the Group has entered into reinsurance arrangements to manage longevity risk in respect of closed books of individual lifetime annuities. The Group manages the mortality and morbidity risk by the regular reviews of the portfolio to ensure that mortality and morbidity assumptions remain appropriate.

Actuarial information

Mr A Bofinger FIAA, as the Appointed Actuary of CLC, is satisfied as to the accuracy of the data used in the valuations of life contract liabilities in the financial report and the tables in this note. The life contract liabilities have been determined at the reporting date in accordance with the Life Act.

Note 8 Reconciliation of profit to operating cash flow

Reconciliation of profit to operating cash flow	31 Dec 2016 $M	31 Dec 2015 $M
Profit for the period	**201.6**	**230.6**
Adjusted for		
Net realised and unrealised loss/(gain) on disposal of investment assets	117.4	(59.7)
Share of associates' net profit	(8.6)	(7.3)
Change in life contract liabilities[1]	(65.3)	72.9
Depreciation and amortisation expense	7.3	8.1
Impairment in associates and other investments	23.6	20.7
Share-based payments	11.4	11.7
Dividends from associates	11.5	11.5
Change in operating assets and liabilities		
Decrease in receivables	69.0	13.5
(Increase)/decrease in other assets	(2.0)	16.5
Decrease in payables	(29.3)	(72.1)
Increase/(decrease) in provisions	4.9	(2.5)
Increase in life contract liabilities	291.7	101.9
Increase in external unit holders' liabilities	317.7	90.4
(Decrease)/increase in net tax liabilities	(11.0)	31.4
Net cash flows from operating activities	**939.9**	**467.6**

[1] Changes relate to movements through the statement of comprehensive income.

Note 9 Contributed equity

	6 months to 31 Dec 2016		Year to 30 June 2016		6 months to 31 Dec 2015	
	No. of shares M	Value of shares $M	No. of shares M	Value of shares $M	No. of shares M	Value of shares $M
Analysis of contributed equity						
Ordinary shares issued	571.7	1,638.0	571.2	1,633.9	570.6	1,629.0
CPP Trust shares treated as Treasury shares	(5.4)	(39.0)	(6.1)	(36.3)	(6.1)	(35.4)
CPP deferred share purchases treated as Treasury shares	(4.0)	(38.9)	(6.3)	(50.9)	(2.3)	(16.8)
Total contributed equity	**562.3**	**1,560.1**	**558.8**	**1,546.7**	**562.2**	**1,576.8**
Movements in contributed equity						
Ordinary shares						
Opening balance	571.2	1,633.9	569.7	1,622.7	569.7	1,622.7
Issued under dividend reinvestment plan	0.5	4.1	1.5	11.2	0.9	6.3
Closing balance	**571.7**	**1,638.0**	**571.2**	**1,633.9**	**570.6**	**1,629.0**
CPP Trust						
Opening balance	6.1	36.3	8.7	48.7	8.7	48.7
Shares purchased (including settled forwards)	5.3	43.9	6.9	41.3	6.4	37.5
Vested shares released to employees	(6.0)	(41.2)	(9.5)	(53.7)	(9.0)	(50.8)
Closing balance	**5.4**	**39.0**	**6.1**	**36.3**	**6.1**	**35.4**
CPP deferred share purchases						
Opening balance	6.3	50.9	7.6	46.8	7.6	46.8
CPP deferred share purchases	2.0	21.3	4.0	34.1	-	-
Settled forward purchases	(4.3)	(33.3)	(5.3)	(30.0)	(5.3)	(30.0)
Closing balance	**4.0**	**38.9**	**6.3**	**50.9**	**2.3**	**16.8**

Capital management

Dividend reinvestment plan (DRP)

The Company retained a DRP for the 2016 final dividend. On 28 September 2016, the Company issued 455,140 ordinary shares to shareholders under the DRP. The DRP issue price per share for the 2016 final dividend was $9.2505 and represents the volume weighted average share price over the ten trading days from 6 to 19 September 2016. The DRP participation rate was 4 per cent of all issued shares, resulting in proceeds of $4.1 million.

Internal Capital Adequacy Assessment Process (ICAAP) Summary Statement – CLC

CLC is a life insurance company regulated under the Life Act. The Life Act, via Prudential Standards issued by APRA, imposes minimum statutory capital requirements on all life insurance companies. Under these standards a life company must have in place an ICAAP, documented in an ICAAP Summary Statement. CLC complied with these requirements at all times during the period.

Prescribed capital amount (PCA)

CLC holds capital in order to ensure that under a range of adverse scenarios it can continue to meet its regulatory and contractual obligations to its customers. CLC is regulated by APRA and is required to hold a minimum level of regulatory capital.

CLC's regulatory capital base and PCA have been calculated based on the Life and General Insurance Capital (LAGIC) regulatory standards issued by APRA.

Note 9 Contributed equity (continued)

Capital management (continued)

Prescribed capital amount (PCA) (continued)

While CLC does not target a specific PCA ratio, CLC's internal capital models result in a PCA ratio under current circumstances in the range of 1.3 to 1.6 times. This range can change over time and is dependent on numerous factors. CLC's PCA ratio is currently within this range of 1.3 to 1.6 times.

The PCA ratio at 31 December 2016 was 1.39 times, down from 1.57 times at 30 June 2016, reflecting changes in asset allocation, net AUM growth, changes in retained earnings and the part repayment of Tier 2 regulatory capital.

Challenger intends to launch a subordinated, convertible, unsecured note offer (Notes) during the first quarter of the calendar year subject to market conditions. Challenger is targeting to raise $350 million with the ability to raise more or less. The proceeds will be used for Additional Tier 1 capital issued by CLC to support the forecast growth of its annuity business. CLC's capital position will be materially strengthened and on a proforma basis, at 31 December 2016, CLC's PCA ratio would increase to 1.52 times.

Subordinated debt

CLC's total regulatory capital base includes $386.7 million (30 June 2016: $445.5 million) of admissible subordinated debt. Subordinated debt totalling $190.3 million was repaid during the period. These tranches had an eligible Tier 2 regulatory capital value of $65.7 million.

As at 31 December 2016, CLC's remaining subordinated debt balance has a call date in November 2017. As such, this tranche will continue to be fully eligible as Tier 2 regulatory capital until its call date in November 2017 and will continue to be partially eligible until November 2021.

CLC's target surplus

CLC maintains a target level of capital representing APRA's PCA plus a target surplus. The target surplus is a management guide to the level of excess capital that CLC seeks to hold over and above APRA's minimum requirements. CLC's target surplus is set to ensure that it provides a buffer against adverse market conditions and having regard to CLC's credit rating. CLC uses internal capital models to determine its target surplus, which are risk-based and are responsive to changes in CLC's asset allocation and market conditions.

Details of the CLC capital adequacy multiple are below:

CLC Capital	31 Dec 2016 $M	30 June 2016 $M	31 Dec 2015 $M
CLC's excess capital under LAGIC			
Common Equity Tier 1 regulatory capital	2,046.0	2,003.6	1,951.8
Additional Tier 1 regulatory capital	345.0	345.0	345.0
Tier 2 regulatory capital – subordinated debt[1]	386.7	445.5	477.5
CLC total regulatory capital base	**2,777.7**	**2,794.1**	**2,774.3**
Prescribed capital amount			
Asset risk charge[2]	1,933.3	1,712.0	1,731.3
Insurance risk charge	152.7	168.3	132.7
Operational risk charge	34.9	28.7	22.7
Aggregation benefit	(115.5)	(125.3)	(100.4)
Prescribed capital amount – excluding transition relief	**2,005.4**	**1,783.7**	**1,786.3**
LAGIC transition relief[3]	-	-	(107.6)
CLC prescribed capital amount	**2,005.4**	**1,783.7**	**1,678.7**
CLC excess over prescribed capital amount	**772.3**	**1,010.4**	**1,095.6**
Prescribed capital adequacy ratio (times)	**1.39**	**1.57**	**1.65**

[1] Differs from $384.8 million disclosed in Note 10 Interest bearing financial liabilities due to $1.9 million (30 June 2016: $2.3 million) of accrued interest and nil (30 June 2016: $133.5 million) of inadmissible Tier 2 regulatory capital.
[2] The asset risk charge includes the combined stress test scenarios and default stress adjustments.
[3] LAGIC transition relief reduced by one third ($107.6 million) on each of 1 January 2014, 1 January 2015 and 1 January 2016. The PCA ratio at 31 December 2015, excluding the LAGIC transition relief balance would have been 1.55 times.

Note 10 Interest bearing financial liabilities

	30 June 2016		Cash flows	Non-cash movements			31 Dec 2016	
	Facility	Opening balance	Proceeds/ (repayments)	Foreign exchange	Fair value changes	Other	Closing balance	Facility
	$M	$M	$M	$M	$M	$M	$M	$M
Bank loans								
Corporate[1]	350.0	-	-	-	-	-	-	400.0
Controlled property trusts[2]	568.5	556.3	(0.8)	(36.0)	0.4	0.4	520.3	551.0
Controlled infrastructure trusts	206.0	204.3	(1.4)	-	-	-	202.9	206.0
Repurchase agreements	2,454.2	2,454.2	1,028.7	-	-	-	3,482.9	3,482.9
Total bank loans	**3,578.7**	**3,214.8**	**1,026.5**	**(36.0)**	**0.4**	**0.4**	**4,206.1**	**4,639.9**
Non-bank loans								
Subordinated debt	576.7	576.7	(190.3)	(11.4)	9.8	-	384.8	384.8
Challenger Capital Notes	338.5	338.5	-	-	-	0.7	339.2	339.2
Other finance	18.8	18.8	(1.0)	-	-	-	17.8	18.5
Total non-bank loans	**934.0**	**934.0**	**(191.3)**	**(11.4)**	**9.8**	**0.7**	**741.8**	**742.5**
Total interest bearing financial liabilities	**4,512.7**	**4,148.8**	**835.2**	**(47.4)**	**10.2**	**1.1**	**4,947.9**	**5,382.4**

[1] The Corporate facility increased from $350 million to $400 million effective from 31 August 2016 with maturities extended to 2019 ($150 million) and 2021 ($250 million). The Corporate facility remained undrawn in the period.

[2] Total facility limit consists of redraw loan facilities limits totalling $101.0 million (30 June 2016: $121.0 million) and non-redraw loan facility limits totalling $450.0 million (30 June 2016: $447.5 million).

Note 11 Dividends paid and proposed

	31 Dec 2016 $M	31 Dec 2015 $M
Dividend declared and paid during the period		
Final 30 June 2016 100% franked dividend: 16.5 cents (30 June 2015: 15.5 cents 100% franked)	93.3	87.5
Dividend proposed (not recognised as a liability at 31 December)		
2017 interim 100% franked dividend: 17.0 cents (2016 interim: 16.0 cents 100% franked)	96.3	89.2

A dividend reinvestment plan will be in operation for the interim 2017 dividend.

Group franking credits account	6 months to 31 Dec 2016 $M	Year to 30 June 2016 $M
Franking account balance at the beginning of the period	46.7	57.1
Franking credits from the payment of income tax during the period	31.6	64.0
Franking credits from dividends received during the period	4.9	8.1
Franking debits applied to dividend payments to shareholders	(40.4)	(76.8)
Franking debits applied to Challenger Capital Notes	(2.7)	(5.7)
Franking credits balance	**40.1**	**46.7**

Note 12 Earnings per share

	31 Dec 2016 cents	31 Dec 2015 cents
Basic earnings per share	35.8	41.9
Diluted earnings per share	34.1	39.0
	$M	$M
Profit attributable to ordinary shareholders	201.5	234.3
Add back interest expense on Challenger Capital Notes	6.3	6.7
Total earnings used in the calculation of dilutive earnings per share	**207.8**	**241.0**

Number of shares

	Number	Number
Weighted average of ordinary shares issued	571,672,427	570,108,313
Weighted average number of Treasury shares	(9,391,877)	(10,968,332)
Weighted average ordinary shares for basic earnings per share	562,280,550	559,139,981
Adjusted for potential ordinary shares:		
Weighted average effect of Challenger Performance Plan	14,731,026	17,691,004
Weighted average effect of Challenger Capital Notes	31,772,871	41,585,304
Weighted average ordinary shares for diluted earnings per share	**608,784,447**	**618,416,289**

In determining the weighted average number of ordinary shares used in the calculation of earnings per share, a reduction is made for the average number of Treasury shares held. The weighted average number of Treasury shares for the period was 9.4 million (31 December 2015: 11.0 million).

Diluted earnings per share is calculated by dividing the total profit attributable to equity holders of the Company, after adding back the interest expense on the Challenger Capital Notes, by the weighted average number of ordinary shares outstanding during the period. The weighted average share count is adjusted for the effects of dilutive shares that may be converted under the terms of Challenger Capital Notes of 31.8 million shares (31 December 2015: 41.6 million) and shares granted under the Challenger Performance Plan (CPP) of 14.7 million shares (31 December 2015: 17.7 million). Since the CPP Trust commenced operation in December 2006, no shares have been issued to the CPP Trust. Instead, shares are acquired by the CPP Trust to mitigate shareholder dilution.

Note 13 Fair values of financial assets and liabilities

Fair value determination and classification

Fair value reflects the price that would be received on sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The majority of the Group's financial instruments are held in the life insurance statutory funds of CLC and, as a result, are required by AASB 1038 *Life Insurance Contracts* to be designated at fair value through profit and loss where this is permitted under AASB 139 *Financial Instruments: Recognition and Measurement*.

Financial instruments measured at fair value are categorised under a three level hierarchy, reflecting the availability of observable market inputs when estimating the fair value. If different levels of inputs are used to measure a financial instrument's fair value, the classification within the hierarchy is based on the lowest level that is significant to the fair value measurement. The three levels are:

- Level 1: unadjusted quoted prices in active markets are the valuation inputs for identical assets or liabilities (i.e. listed securities).
- Level 2: valuation inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices) are used.
- Level 3: there are valuation inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The unobservable inputs into the valuation of the Group's Level 3 assets and liabilities are determined based on the best information available, including the Group's own assessment of the assumptions that market participants would use in pricing the asset or liability. Examples of unobservable inputs are estimates about the timing of cash flows, discount rates, earnings multiples and internal credit ratings.

Valuation techniques

The Group's listed and unlisted fixed income securities, government/semi-government securities and over-the-counter derivative financial instruments are all classified as Level 2. This recognises the availability of a quoted price but not from an active market as defined by the standard. Fixed income securities where market observable inputs are not available are classified Level 3.

The Group's derivative financial instruments are traded over-the-counter so, whilst they are not exchange traded, there is a market observable price. All of the listed fixed income and government/semi-government securities have prices determined by a market. Externally rated unlisted fixed income securities are valued by applying market observable credit spreads on similar assets with an equivalent credit rating. Internally-rated (where an external quoted price is not available) fixed income securities are Level 3 as the determination of an equivalent credit rating is a significant non-observable input. Equity, infrastructure and property securities that are exchange traded are classified Level 1. Where quoted prices are available, but are not from an active market, they are classified Level 2. If market observable inputs are not available, they are classified Level 3. Valuations can make use of cash flow forecasts discounted using the applicable yield curve, earnings-multiple valuations or, for managed funds, the net assets of the trust per the most recent financial report.

The interest bearing financial liabilities classified as Level 3 include the subordinated debt that is valued by reference to the trading margin on the Challenger Capital Notes, adjusted to allow for its higher ranking in the capital structure (using market comparable instruments) and illiquidity. External unit holders' liabilities are valued at the face value of the amounts payable and classified as Level 2. The portion of life investment contract liabilities classified as Level 2 represent products or product options for which the liability is determined based on an account balance, rather than a discounted cash flow as applied to the rest of the portfolio.

Cash and cash equivalents are carried at amortised cost. To determine a fair value where the asset is liquid or maturing within three months, the fair value is approximate to the carrying amounts. This assumption is applied to liquid assets and the short-term elements of all other financial assets and financial liabilities.

Note 13 Fair values of financial assets and liabilities (continued)

The following table summarises the carrying amounts and fair values of those financial assets and liabilities not presented on the statement of financial position at fair value. These balances are carried at amortised cost.

All other financial instruments are either designated at fair value through the profit and loss at initial recognition, or the carrying amount materially approximates the fair value.

Difference between amortised cost and fair value	31 Dec 2016		30 June 2016		31 Dec 2015	
	Carrying value $M	Fair value $M	Carrying value $M	Fair value $M	Carrying value $M	Fair value $M
Mortgage assets – SPV	1,458.7	1,482.3	1,677.6	1,703.2	1,916.3	1,965.3
Interest bearing financial liabilities – SPV	1,356.9	1,287.0	1,628.4	1,548.6	1,876.7	1,802.9
Challenger Capital Notes	345.0	345.0	345.0	330.3	345.0	329.0

Valuation process

For financial instruments and investment properties categorised within Level 3 of the fair value hierarchy, the valuation process applied in valuing such instruments is governed by the CLC Practice Note on Investment Asset and Financial Liability Valuation. The Practice Note outlines the Valuation Committee's responsibilities in the valuation of investment assets and financial liabilities for the purposes of financial reporting. All significant Level 3 financial instruments are referred to the Valuation Committee who generally meets monthly, or more frequently if required.

All financial instruments and investment properties are measured on a recurring basis. The table below summarises the financial instruments and investment properties measured at fair value at each level of the fair value hierarchy as at the statement of financial position date:

	Level 1 $M	Level 2 $M	Level 3 $M	Total $M
31 Dec 2016				
Derivative assets	-	646.1	-	646.1
Fixed income securities[1]	-	10,611.9	1,982.2	12,594.1
Equity securities	93.9	209.9	407.5	711.3
Infrastructure investments	64.0	107.1	496.8	667.9
Property securities	163.1	-	144.0	307.1
Investment and development property	-	34.5	3,475.2	3,509.7
Total assets	**321.0**	**11,609.5**	**6,505.7**	**18,436.2**
Derivative liabilities	1.3	741.0	0.1	742.4
Interest bearing financial liabilities	-	65.4	402.6	468.0
External unit holders' liabilities	-	1,633.2	-	1,633.2
Life investment contract liabilities	-	75.9	6,618.3	6,694.2
Total liabilities	**1.3**	**2,515.5**	**7,021.0**	**9,537.8**
30 June 2016				
Derivative assets	-	788.3	-	788.3
Fixed income securities[1]	-	9,455.2	2,008.3	11,463.5
Equity securities	40.6	198.6	361.0	600.2
Infrastructure investments	82.6	109.4	509.1	701.1
Property securities	196.3	-	143.2	339.5
Investment and development property	-	70.6	3,462.0	3,532.6
Total assets	**319.5**	**10,622.1**	**6,483.6**	**17,425.2**
Derivative liabilities	-	843.5	0.1	843.6
Interest bearing financial liabilities	-	70.2	595.5	665.7
External unit holders' liabilities	-	1,315.5	-	1,315.5
Life investment contract liabilities	-	80.1	6,835.2	6,915.3
Total liabilities	**-**	**2,309.3**	**7,430.8**	**9,740.1**

Note 13 Fair values of financial assets and liabilities (continued)

Valuation process (continued)

	Level 1 $M	Level 2 $M	Level 3 $M	Total $M
31 Dec 2015				
Derivative assets	-	500.6	-	500.6
Fixed income securities[1]	-	7,796.8	2,077.1	9,873.9
Equity securities	38.6	168.5	323.8	530.9
Infrastructure investments	150.7	-	469.7	620.4
Property securities	188.4	-	128.5	316.9
Investment and development property	-	12.5	3,316.2	3,328.7
Total assets	**377.7**	**8,478.4**	**6,315.3**	**15,171.4**
Derivative liabilities	-	560.0	0.2	560.2
Interest bearing financial liabilities	-	76.6	596.0	672.6
External unit holders' liabilities	-	1,035.1	-	1,035.1
Life investment contract liabilities	-	78.0	6,577.3	6,655.3
Total liabilities	**-**	**1,749.7**	**7,173.5**	**8,579.6**

[1] The Group has exposures to structured entities (entities designed so that voting or similar rights are not the dominant factor in determining who controls the entity; for example, when any voting rights relate purely to administrative tasks) via investments in asset-backed finance vehicles (where it may act as a lender or purchaser of notes and/or residual income units) and securitisations (such as mortgages, finance leases and other types of collateralised vehicles). For structured entities with asset-backed financing the maximum exposure to loss is limited to the reported fair value of the underlying securities plus any guaranteed undrawn commitments to the counterparties. At 31 December 2016 the carrying value of asset-backed financing assets was $33.2 million (30 June 2016: $33.5 million) with no undrawn commitments (30 June 2016: $nil million) and securitisations was $2,951.6 million (30 June 2016: $2,815.9 million) plus $60.2 million undrawn commitments (30 June 2016: $142.1 million).

Level 3 reconciliation

The following table shows a reconciliation of the movement in the fair value of financial instruments categorised within Level 3 of the fair value hierarchy during the period:

	31 Dec 2016		30 June 2016		31 Dec 2015	
	Assets $M	Liabilities $M	Assets $M	Liabilities $M	Assets $M	Liabilities $M
Balance at the beginning of the period	3,021.6	7,430.8	2,988.5	7,107.2	2,988.5	7,107.2
Fair value gains/(losses)	8.0	33.1	53.3	259.8	(25.8)	61.1
Acquisitions	881.9	1,464.3	1,471.2	2,695.4	418.4	1,389.7
Maturities and disposals	(881.0)	(1,907.2)	(1,413.8)	(2,631.6)	(409.8)	(1,384.6)
Transfers to other categories[1,2]	-	-	(77.6)	-	27.8	-
Balance at the end of the period[3]	**3,030.5**	**7,021.0**	**3,021.6**	**7,430.8**	**2,999.1**	**7,173.5**
Unrealised gains/(losses) included in the statement of comprehensive income for assets and liabilities held at the statement of financial position date	9.3	(25.2)	65.0	260.1	44.3	(61.8)

[1] The Group transfers between levels of the fair value hierarchy as at the end of the reporting period during which the transfer has occurred.
[2] Transfers to/from other categories are due to changes in the market observability of inputs used in the valuation of financial instruments. There were no transfers between Level 1 and Level 2 during the reporting period.
[3] Does not include investment property.

Note 13 Fair values of financial assets and liabilities (continued)

Level 3 sensitivities

The following table shows the sensitivity of Level 3 financial instruments to a reasonable change in alternative assumptions in respect of the non-observable inputs into the fair value calculation:

	Level 3 value[1] $M	Positive impact $M	Negative impact $M	Valuation technique	Reasonable change in non-observable input[2,3]
31 Dec 2016					
Fixed income securities	1,982.2	33.9	(38.1)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(402.6)	(8.5)	8.3	Discounted cash flow	Primarily credit spreads
Net fixed income	**1,579.6**	**25.4**	**(29.8)**		
Equity, infrastructure, property assets	1,048.3	50.6	(51.1)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Investment contract liabilities	(6,618.3)	2.9	(2.9)	Discounted cash flow	Primarily expense assumptions
Derivative liabilities	(0.1)	0.1	(0.1)	Discounted cash flow	Primarily credit spreads
Total Level 3	**(3,990.5)**	**79.0**	**(83.9)**		
30 June 2016					
Fixed income securities	2,008.3	26.7	(43.2)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(595.5)	(9.3)	9.6	Discounted cash flow	Primarily credit spreads
Net fixed income	**1,412.8**	**17.4**	**(33.6)**		
Equity, infrastructure, property assets	1,013.3	53.9	(55.3)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Investment contract liabilities	(6,835.2)	7.2	(7.2)	Discounted cash flow	Primarily expense assumptions
Derivative liabilities	(0.1)	0.2	(0.1)	Discounted cash flow	Primarily credit spreads
Total Level 3	**(4,409.2)**	**78.7**	**(96.2)**		
31 Dec 2015					
Fixed income securities	1,797.1	54.2	(24.5)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(596.0)	(10.6)	10.3	Discounted cash flow	Primarily credit spreads
Net fixed income	**1,201.1**	**43.6**	**(14.2)**		
Equity, infrastructure, property assets	916.7	61.8	(62.3)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Investment contract liabilities	(6,577.3)	3.8	(3.8)	Discounted cash flow	Primarily expense assumptions
Derivative liabilities	(0.2)	0.2	(0.1)	Discounted cash flow	Primarily credit spreads
Total Level 3	**(4,459.7)**	**109.4**	**(80.4)**		

[1] The fair value of the asset or liability would increase/decrease if the credit spread, discount rate or expense assumptions decrease/increase or if the other inputs increase/decrease.
[2] Specific asset valuations will vary from asset to asset as each individual industry profile will determine appropriate valuation inputs to be utilised.
[3] The effect of a change to reflect a reasonable possible alternative assumption was calculated by adjusting the credit spreads by 50bps, discount rates by between 50bps – 100bps, changing the valuation of the unlisted schemes by 5% and adjusting the expense assumption allocation splits by 10%.

Note 14 Contingent liabilities, contingent assets and other commitments

Warranties

Over the course of its corporate activity the Group has given, as a seller of companies and as a vendor of assets, including real estate properties, warranties to purchasers on several agreements that are still outstanding at 31 December 2016. Other than noted below, at the date of this report no material claims against these warranties have been received by the Group.

Parent entity guarantees and undertakings

Challenger Limited has extended the following guarantees and undertakings to entities in the Group:

1. A guarantee supporting the corporate banking facility and certain other financial commitments, such as hedging arrangements;
2. Letters of support in respect of certain subsidiaries in the normal course of business. The letters recognise Challenger Limited's intention to provide support to those subsidiaries so that they can continue to meet their obligations;
3. Australian Financial Services Licence deeds of undertaking as an eligible provider; and
4. Guarantees to support contractual commitments on warranties to certain third parties.

Third party guarantees

Bank guarantees have been issued by a third party financial institution on behalf of the Group and its subsidiaries for items in the normal course of business, such as rental contracts. The amounts involved are not considered to be material to the Group.

Contingent future commitments

CLC has made capital commitments to external counterparties for future investment opportunities such as development or investment purchases. As at 31 December 2016 there are potential future commitments totalling $265.9 million (30 June 2016: $242.4 million) in relation to these opportunities. Currently there are no requests from any of these parties to make payments.

Subsidiary guarantees

CLC has provided a guarantee to a third party regarding the performance of its subsidiary in respect of certain reinsurance arrangements.

Assets pledged as collateral

As part of standard terms of transactions with certain counterparties, the Group has provided collateral to secure liabilities.

Contingent tax assets and liabilities

From time-to-time the Group has interactions with the Australian Taxation Office in relation to the taxation treatments of various matters. Any potential tax liability resulting from these interactions is only provided for when it is probable that an outflow will occur and a reliable estimate of the amount can be made.

Other information

In the normal course of business, the Group enters into various contracts that could give rise to contingent liabilities in relation to performance obligations under those contracts. The information usually required by Australian Accounting Standards is not disclosed for a number of such contracts on the grounds that it may seriously prejudice the outcome of the claims. At the date of this report, significant uncertainty exists regarding any potential liability under these claims.

Note 15 Subsequent events

Challenger intends to launch a subordinated, convertible, unsecured note offer (Notes) during the first quarter of the calendar year subject to market conditions. The Notes will be listed and traded on the ASX and will pay quarterly floating distributions based on a margin over BBSW. Distributions will be reduced for franking credits with the Notes expected to be fully franked. Challenger is targeting to raise $350 million with the ability to raise more or less. The proceeds will be used for Additional Tier 1 capital issued by CLC to support the forecast growth of its annuity business. CLC's capital position will be materially strengthened and on a proforma basis, at 31 December 2016, CLC's PCA ratio would increase to 1.52 times. Following the issue of the Notes, Challenger expects to recognise an interest bearing liability to the value of the proceeds raised less the related expenses which are capitalised and amortised over the life of the Notes.

Directors' declaration

In accordance with a resolution of the Directors of Challenger Limited, we declare that, in the opinion of the Directors:

a. the financial statements and notes of Challenger Limited and its controlled entities (the Group) are in accordance with the *Corporations Act 2001*, including:

   i. giving a true and fair view of the Group's financial position as at 31 December 2016 and of its performance for the six month period ended on that date; and

   ii. complying with Australian Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*; and

b. there are reasonable grounds to believe that the Group will be able to pay its debts as and when they become due and payable.

On behalf of the Board

G A Cubbin
Director

Sydney
13 February 2017

B R Benari
Managing Director and Chief Executive Officer

Sydney
13 February 2017

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Independent auditor's report

Independent auditor's report to the members of Challenger Limited

Report on the financial report

We have reviewed the accompanying interim financial report of Challenger Limited, which comprises the Statement of Financial Position as at 31 December 2016, the Statement of Comprehensive Income, Statement of Changes in Equity and Statement of Cash Flows for the six months ended on that date, other explanatory notes and the directors' declaration of the consolidated entity comprising the company and the entities it controlled at the period end or from time to time during the period.

Directors' responsibility for the financial report

The directors of the company are responsible for the preparation of the interim financial report that gives a true and fair view in accordance with Australian Accounting Standards and the Corporations Act 2001 and for such internal controls as the directors determine are necessary to enable the preparation of the interim financial report that is free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express a conclusion on the interim financial report based on our review. We conducted our review in accordance with Auditing Standard on Review Engagements ASRE 2410 Review of a Financial Report Performed by the Independent Auditor of the Entity, in order to state whether, on the basis of the procedures described, we have become aware of any matter that makes us believe that the financial report is not in accordance with the Corporations Act 2001 including: giving a true and fair view of the consolidated entity's financial position as at 31 December 2016 and its performance for the six months ended on that date; and complying with Accounting Standard AASB 134 Interim Financial Reporting and the Corporations Regulations 2001. As the auditor of Challenger Limited and the entities it controlled during the period, ASRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial report.

A review of an interim financial report consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Independence

In conducting our review, we have complied with the independence requirements of the Corporations Act 2001. We have given to the directors of the company a written Auditor's Independence Declaration, a copy of which is included in the Directors' Report.

Conclusion

Based on our review, which is not an audit, we have not become aware of any matter that makes us believe that the interim financial report of Challenger Limited is not in accordance with the Corporations Act 2001, including:

i. giving a true and fair view of the consolidated entity's financial position as at 31 December 2016 and of its performance for the six months ended on that date; and

ii. complying with Accounting Standard AASB 134 Interim Financial Reporting and the Corporations Regulations 2001.

Ernst & Young

S J Ferguson
Partner

Sydney
13 February 2017

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Brian Benari (Managing Director and Chief Executive Officer)

Graham Cubbin

Steven Gregg

Jonathan Grunzweig

Brenda Shanahan

JoAnne Stephenson

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Andrew Brown

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