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Challenger Limited ACN 106 842 371

2018
Interim Financial Report

Providing our customers with financial security for retirement

challenger

Contents

Key dates

27 March 2018
Interim dividend payment date

14 August 2018
Full year financial results

26 September 2018
Final dividend payment date

26 October 2018
2018 Annual General Meeting

Full listing of key dates available at

challenger.com.au/share/keydates

Dates may be subject to change

About this Interim Financial Report

The 2018 Interim Financial Report can be downloaded from Challenger's online Shareholder Centre at:

challenger.com.au/share

Overview

1 About Challenger

Challenger Limited (Challenger, CGF, the Group or the Company) is an investment manager with offices in Australia, London, New York, Stockholm and Tokyo. Challenger is listed on the Australian Securities Exchange and is regulated by the Australian Prudential Regulation Authority (APRA), the Australian banking, superannuation, general insurance and life insurance regulator. Challenger is regulated by APRA as the owner of Challenger Life Company Limited (CLC), an Australian life insurance company. Challenger's activities are also subject to supervision by other regulatory agencies both in Australia and in other markets in which it operates.

Founded in 1985, Challenger is one of Australia's fastest growing fund managers and employs 682 people managing assets of $76.5 billion with total equity of $3.5 billion as at 31 December 2017.

2 Operating segments and principal activities

For internal reporting and risk management purposes, Challenger's principal activities are divided into two operating segments, Life and Funds Management, which are serviced by one Distribution, Product and Marketing team which is responsible for ensuring the appropriate marketing and distribution of both operating segments' products. Both operating segments and the Distribution, Product and Marketing team are supported by centralised operations functions which are responsible for appropriate processes and systems and for providing the necessary resources to meet regulatory, compliance, financial reporting, legal and risk management requirements.

Life – the Life segment comprises CLC, Australia's leading provider of annuities and guaranteed retirement income products and Accurium Pty Limited, one of Australia's leading providers of self-managed superannuation fund (SMSF) actuarial certificates.

Life's products appeal to investors seeking the security and certainty of guaranteed cash flows with protection against market, inflation and longevity risks. Products are distributed via both independent financial advisers and financial advisers that are part of the major hubs. Being an independent product manufacturer, Life has distribution representation on all major Australian hubs and platforms. Life also reinsures Australian dollar annuities issued by Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary) in Japan.

Funds Management – the Funds Management (FM) segment comprises Fidante Partners and Challenger Investment Partners.

Fidante Partners encompasses a number of associate investments in boutique investment managers that each operate under their own brand. Fidante Partners provides administration and distribution services to the boutiques and shares in the profits of these businesses through equity ownership. Fidante Partners also has a presence in Europe with interests in UK-based alternative asset managers.

Challenger Investment Partners (CIP) develops and manages assets under Challenger's brand for CLC and third-party institutional investors. The investments managed by CIP are fixed income and commercial property.

There have been no significant changes in the nature of these principal activities or the state of affairs of the Company during the period.

3 Challenger's vision and strategy

Challenger's vision is to provide its customers with financial security for retirement and it seeks to do this by:

- increasing the Australian retirement savings pool allocation to secure and stable incomes;
- being recognised as the leader and partner of choice in retirement income solutions with a broad product offering;
- providing customers with relevant investment strategies exhibiting consistently superior performance; and
- delivering superior outcomes to customers and shareholders through a highly engaged, diverse and agile workforce committed to sustainable business practices and a strong risk and compliance culture.

Challenger's expectations of its workforce are encapsulated in the 'Challenger Principles' of integrity, commercial ownership, working together, compliance and creative customer solutions.

The combination of these principles and a strong risk management framework has been the key to Challenger's profitable and disciplined growth over many years.

3 Challenger's vision and strategy (continued)

1H18 strategic progress

Progress in 1H18 against strategic priorities is set out below:

Increase the Australian retirement savings pool allocation to secure and stable incomes	Annuities currently capture less than 5% of the annual transfer from the retirement savings (accumulation) to the retirement spending (retirement) phase. Challenger is focused on growing the allocation of the Australian retirement savings pool allocated to secure and stable incomes. 1H18 progress includes: **Life sales** • $3.3bn of total Life sales, up 21% on 1H17; • $2.3bn of annuity sales, up 4% on 1H17; and • $1.0bn of other Life sales, representing institutional guaranteed rate products, up 84% on 1H17. **Life sales mix and focus on long-term products** Challenger's annuity sales mix is evolving to long-term products. Long-term products include lifetime annuities and 20 year fixed rate annuities distributed via MS Primary. 1H18 long-term annuity sales represented 36% of total annuity sales, up from 31% in 1H17 and 14% in 1H16. **Tools for financial advisers** Challenger's market leading retirement illustrator was launched in FY17 in order to support advisers and the para-planning process. The retirement illustrator provides scenario modelling to demonstrate the benefits of partial annuitisation. In 1H18 Challenger's retirement illustrator was enhanced and made available to a number of superannuation funds via white label arrangements. **Superannuation reforms engagement and advocacy** The Australian Government is undertaking a range of superannuation reforms aimed at enhancing the retirement phase of superannuation. Specifically, the Government is engaging with industry on its MyRetirement reforms and new means testing rules for lifetime retirement income streams. As Australia's leading retirement income provider, Challenger is actively engaging with the Government on these reforms and is contributing to the advocacy process. These are important reforms which will take time for the Government to fully implement. The industry is moving ahead of these reforms with MyRetirement style products starting to emerge. These products recommend combining account based pensions with products that provide longevity protection, such as annuities. Challenger is playing a leading role in educating financial advisers and superannuation funds on the benefits of partial annuitisation. **Launch of Deferred Lifetime Annuities (DLAs)** On 1 July 2017 new retirement income rules were implemented, which provide a framework for product innovation, including Deferred Lifetime Annuities (DLAs). DLAs are single premium products that provide regular and reliable income commencing after a deferral period. DLAs are expected to provide a building block for MyRetirement products and will help increase Australian retirement savings allocated to secure and stable incomes. Challenger launched a DLA in September 2017 and was the first Australian life insurer to offer a DLA. Future DLA sales are expected to be supported by new means testing arrangements for lifetime retirement income streams.
Be recognised as the leader and partner of choice in retirement income solutions with a broad product offering	Challenger is the market leader in retirement incomes with 68%[1] annuity market share. As an independent provider, Challenger's strategy includes being the partner of choice for superannuation funds and wealth managers for retirement income solutions. 1H18 progress includes: **Leading adviser and consumer ratings** Amongst Australian financial advisers, Challenger continues to be the most recognised retirement income brand. The latest Marketing Pulse Adviser Study showed:

[1] Strategic Insights – September 2017.

3 Challenger's vision and strategy (continued)

1H18 strategic progress (continued)

Be recognised as the leader and partner of choice in retirement income solutions with a broad product offering (continued)	• Challenger's brand awareness amongst financial advisers increased to 89% in December 2017, up from 85% in December 2016; • Challenger continues to be recognised by financial advisers as the leader in retirement income, with 93% of financial advisers either agreeing or strongly agreeing with this statement. Challenger has maintained its leading position with a score 30 percentage points above its nearest competitor; and • Financial advisers recognise Challenger as a retirement income thought leader, with 77% of financial advisers either agreeing or strongly agreeing with this proposition. **Increased product access via investment and administration platforms** Challenger's strategic priorities include making its annuity products available on leading investment and administration platforms, allowing financial advisers and their customers easy and efficient access to Challenger annuities. In September 2017, Challenger's full range of annuity products were made available via AMP's adviser portal to their retail and corporate superannuation customers. In order to support Challenger annuities and the advice process, Challenger's retirement income tools and calculators have been made available to AMP advisers. AMP also provides retirement model portfolio guidance to its advisers. Challenger is making its annuities available on the new innovative BT Panorama platform. The launch of Challenger annuities on the BT Panorama platform is targeted for the June 2018 quarter. **Leverage MS&AD strategic relationship and expand into Japanese market** In November 2016, Challenger commenced issuing Australian dollar fixed rate annuities with a 20-year term in order to support a reinsurance agreement with MS Primary. As Australia's leader in retirement incomes, MS Primary were attracted to Challenger's ability to manage long-term assets and liabilities, Challenger's approach to risk management and product innovation experience. The MS Primary annuity relationship has contributed 17% of Challenger's 1H18 annuity sales. Challenger and MS Primary are developing a new lifetime annuity product for the Japanese market. Given the success of the annuity relationship with MS Primary, in August 2017 Challenger formed a strategic relationship with MS&AD Insurance Group Holdings Inc. (MS&AD) in order to increase access to the Japanese market and provide opportunities for both Challenger and MS&AD.
Provide customers with relevant investment strategies exhibiting consistently superior performance	Challenger is focused on providing relevant investment strategies that exhibit superior investment performance in order to help build retirement savings. 1H18 progress includes: **Maintaining superior investment performance** Fidante Partners' has a long track record of achieving superior investment performance, which is helping attract superior net flows. Over the year to 31 December 2017, 90%[1] of Fidante Partners funds outperformed their benchmark. Over five years 97%[1] of funds have outperformed their benchmark. **Adding boutiques and strategies** In February 2018, Challenger announced a new boutique partnership with Garelick Capital Partners. Garelick Captial Partners is a Boston based equities manager and will form part of Fidante Partners Europe. In 1H18 a number of new strategies for existing boutiques were launched, including: • Ardea's Real Outcome strategy for retail investors; • Avenir Capital made available to retail investors; • Lennox Capital launching a microcap strategy; and • Merlon Capital Partners Concentrated Value strategy for retail investors.

[1] Percentage of Fidante Partners' funds meeting or exceeding performance benchmarks over one and five years.

3 Challenger's vision and strategy (continued)

1H18 strategic progress (continued)

Deliver superior outcomes to customers and shareholders through a highly engaged, diverse and agile workforce committed to sustainable business practices and a strong risk and compliance culture	Challenger believes maintaining a highly engaged, diverse and agile workforce committed to sustainable business practices and a strong risk and compliance culture will provide customers and shareholders with superior outcomes. 1H18 progress includes: **Employee engagement** A highly engaged workforce helps deliver superior shareholder outcomes. Challenger's 2017 employee engagement score was five percentage points above the global high performing company norm. Challenger's next employee engagement survey is scheduled for late calendar year 2018. **Diversity** Challenger seeks to create an inclusive workforce and values the capability and experience that diversity brings to the organisation. To encourage greater representation of women at senior levels of the organisation, Challenger continues to develop initiatives targeted at improving gender equality, including setting gender diversity targets. Diversity targets were set in December 2015 and Challenger has already exceeded its mid-term targets and is on track to exceed its FY20 targets. **Maintain superior cost to income ratio** Challenger's business is highly scalable and efficient. In 1H18 Challenger's normalised cost to income ratio was 32.1%, a record low and at the mid-point of Challenger's guidance range (30% to 34%). Over the last decade Challenger's normalised cost to income ratio has fallen by 13 percentage points and is 17 percentage points below the industry average[1].

[1] Includes Australian and New Zealand Banking Corporation, AMP, Bank of Queensland, Bendigo and Adelaide Bank, BT Investment Management, Commonwealth Bank of Australia, IOOF, Macquarie Bank, Magellan Financial Group, National Australia Bank, Perpetual and Westpac Banking Corporation.

Market overview and outlook

The Australian superannuation system is underpinned by mandatory contributions, which are scheduled to increase from 9.5% of gross salaries to 12.0% by 2025. Due to the mandated nature of Australia's superannuation system, Australia has the fourth largest pension market globally[2] and is expected to grow strongly over the next 20 years. The superannuation system is forecast to grow from $2.5 trillion today to over $10 trillion by 2035[3].

Both the Life and Funds Management businesses benefit from growth in Australia's superannuation system. The Funds Management business targets the retirement savings (or accumulation) phase of superannuation by providing investment products seeking to deliver superior investment returns to help build retirement savings. The Life business targets the retirement spending (or retirement) phase of superannuation by providing investment products that convert savings into safe and secure retirement incomes.

Life outlook

The retirement spending phase of superannuation is expected to grow strongly over the next 20 years as a result of demographic changes. The number of Australians over the age of 65, which is Life's target market, is expected to increase by ~70%[3] over the next twenty years.

Reflecting the demographic changes underway, and growth in Australia's superannuation system, the annual transfer from the retirement savings phase to the retirement spending phase is estimated to be ~$60bn[4] in 2018. Annuities currently capture less than 5% of the annual transfer to the retirement phase.

There is growing recognition that retirees need to take a different approach to investing in retirement. 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 address these retiree needs.

There are a range of retirement income regulatory reforms currently underway which are designed to enhance the retirement phase of superannuation. These reforms provide a significant opportunity to increase the proportion of retirement savings invested in longevity products, including annuities.

[2] Willis Towers Watson Global Pension Study 2017.
[3] Deloitte – Dynamics of the Australian superannuation system: the next 20 years 2015-2035.
[4] Australian Taxation Office.

3 Challenger's vision and strategy (continued)

The retirement phase of superannuation is a high growth market driven by ageing demographics, rising superannuation balances from mandatory contributions, and changes in retiree risk preferences. As Australia's leading annuities provider, Challenger Life Company Limited (CLC) is expected to continue to benefit from this growth over the long-term.

CLC is diversifying its product range and expanding distribution relationships outside of Australia. In 2016, CLC commenced an annuity relationship with MS Primary, a subsidiary of MS&AD. MS Primary is a leading provider of Australian dollar denominated annuity products in Japan. This relationship provides access to Japan's Australian dollar annuities market, which is multiple times the size of Australia's.

Japan has one of the world's most rapidly ageing populations and Japan has a very low domestic interest rate environment, which is making higher returning foreign currency annuities popular. CLC is well placed to build on the MS Primary annuity relationship and is working with MS Primary to develop a new lifetime annuity product specifically for the Japanese market.

MS Primary is one of Challenger's key distributors and in recognition of the importance of the relationship, Challenger formed a strategic relationship with its parent MS&AD in August 2017. The strategic relationship will increase access to the Japanese market and broaden Challenger's existing international footprint, whilst providing opportunities for both MS&AD and Challenger. As part of the MS&AD strategic relationship, and in order to support Challenger's growth ambitions, a $500.0 million equity placement to MS&AD was completed in August 2017. The equity placement represented 6.3% of Challenger's issued capital, with MS&AD subsequently increasing their shareholding to ~10% via on market acquisitions.

Funds Management outlook

Challenger's Funds Management business has experienced significant FUM growth over the past five years, with $27 billion[1] of net inflows and FUM more than doubling in that period.

Challenger's Funds Management business is growing significantly faster than the broader Australian funds management market and is attracting superior net flows. This growth can be attributed to the strength of Challenger's retail and institutional distribution teams, a market leading Funds Management business model that focuses on investor alignment and strong investment performance.

Challenger's Fidante Partners' business model comprises interests in separately branded boutique fund managers, with Challenger providing the distribution, administration and business support, leaving managers to focus on managing investment portfolios. This strong investor alignment is driving superior long-term investment performance, with 97% of Fidante Partners' funds outperforming their benchmark[2]. This long-term performance track record is underpinning net flows, with $4 billion of net flows in 1H18, representing 6% of opening FUM.

Following the success of Challenger's Fidante Partners business model in Australia, it is being replicated in Europe, providing access to the £7 trillion United Kingdom funds management market[3], and opening up global distribution opportunities for existing investment managers. As part of its expansion, Fidante Partners is attracting new international managers.

Challenger has identified funds management opportunities in Japan, with increased access to the market via the MS&AD strategic relationship. In recognition of this, Challenger opened a Tokyo office in 2H17 and is in the process of applying for Japanese funds management licences.

Funds Management is expected to continue to benefit from Challenger's distribution capability, superior long-term investment performance, and international expansion. This provides a strong base to continue to grow the business and achieve Challenger's vision of providing customers with financial security for retirement.

Risks

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

- 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.

[1] Excluding derecognition of Kapstream following the sale in July 2015.

[2] Percentage of Fidante Partners' funds meeting or exceeding performance benchmark over five years.

[3] The Investment Association Annual Survey 2015-2016.

Operating and financial review

1 Key Performance Indicators (KPIs)

1.1 Profitability and growth

KPIs for the period ended 31 December 2017 (with the 6 months to 31 December 2016 being the prior comparative period (PCP), unless otherwise stated) include:

	31 Dec 2017	31 Dec 2016	change %
Profitability			
Statutory profit attributable to equity holders ($M)	195.4	201.5	(3.0)
Normalised NPAT ($M)	207.9	196.6	5.7
Statutory EPS (cents)	33.1	35.8	(7.5)
Normalised EPS (cents)	35.2	35.0	0.6
Interim dividend (cents)	17.5	17.0	2.9
Interim dividend franking	100%	100%	-
Normalised cost: income ratio	32.1%	32.9%	(0.8)
Statutory RoE after tax	11.9%	14.8%	(2.9)
Normalised RoE pre tax	16.8%	18.7%	(1.9)
Normalised RoE after tax	12.7%	14.5%	(1.8)
Growth			
Total Life sales ($M)	3,324.0	2,758.4	20.5
Total Life net flows ($M)	947.9	843.4	12.4
Total Life net book growth %	7.9%	7.8%	0.1
Total FM net flows ($bn)	3.9	3.2	21.9
Total AUM ($bn)	76.5	64.7	18.2

Challenger's statutory profit attributable to equity holders was 3.0% lower for the period ended 31 December 2017 than the prior comparative period primarily as a result of lower investment experience.

Normalised net profit after tax increased by 5.7% compared to the prior period, reflecting AUM growth and disciplined cost management. An interim dividend of 17.5 cents was announced, franked at 100%, up from 17.0 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 the issue of additional ordinary shares to MS&AD in the period.

Challenger's normalised cost to income ratio of 32.1% remains within the targeted range and is 80 bps lower than the ratio in the prior period. This reflects continued cost discipline throughout the business, particularly Funds Management, and it reflects the benefit of scale. Challenger's medium-term expected normalised cost to income ratio target is a range of 30-34%.

Statutory return on equity (RoE) after tax of 11.9% has decreased compared to the prior period (31 December 2016: 14.8%) as a result of higher earnings offset by lower investment experience and the issue of 38,295,689 additional ordinary shares to MS&AD. Normalised ROE after tax decreased from 14.5% in the prior period to 12.7% primarily reflecting the increased share count offset by the increased normalised net profit after tax.

1.2 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 2017	30 June 2017	change
Net assets attributable to equity holders ($M)	3,469.5	2,888.1	581.4
CLC excess capital over PCA ($M)	1,265.8	1,225.3	40.5
Group cash ($M)	121.9	83.8	38.1
CLC excess capital over PCA + Group cash ($M)	1,387.7	1,309.1	78.6
CLC PCA ratio (times)	1.49	1.57	(0.08)
CLC Tier1 ratio (times)	1.33	1.39	(0.06)

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 the Prescribed Capital Amount (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 may 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 a 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.

1 Key Performance Indicators (KPIs) (continued)

1.2 Capital management (continued)

Additional ordinary shares

On 23 August 2017, Challenger issued 38,295,689 new ordinary shares to MS&AD at a price of $13.0563 per share raising $500.0 million. The new shares were issued at a 2% premium to Challenger's 14 August 2017 30 business day volume weighted average share price of $12.9719, adjusted for the final dividend of 17.5 cents per share. The shares issued to MS&AD were not eligible for Challenger's final 2017 dividend, but remain eligible for all future dividends.

MS&AD is the parent company of Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary), a key Challenger distributor. The proceeds from the placement were used to increase CLC's Common Equity Tier 1 capital.

Subordinated debt

CLC's total regulatory capital base includes $406.8 million of admissible subordinated debt. Subordinated debt of $400.0 million was repaid during the period in accordance with its terms and replaced with a new $400.0 million issue. The new issue of subordinated debt occurred on 24 November 2017, has a call date on 24 November 2022 and is fully eligible as Tier 2 regulatory capital until 24 November 2038.

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, reporting aggregate risk exposures and intragroup transactions and exposures came 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.

Dividends and dividend reinvestment plan

Dividends	31 Dec 2017	31 Dec 2016	change	change %
Interim dividend (cents)	17.5	17.0	0.5	2.9
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 2017 was 49.7%.

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 2017 final dividend. The DRP participation rate was 4% of all issued shares and 285,232 ordinary shares were issued to satisfy the DRP requirements on 27 September 2017.

The DRP will continue in operation for the 2018 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.

No shares were bought back during the period.

1.3 Credit ratings

Challenger Limited and CLC are rated by Standard & Poor's (S&P). In November 2017, S&P reaffirmed both Challenger Limited and CLC's credit ratings and revised the outlook from stable to positive. The revised outlook reflects CLC's expanded distribution network and leadership in the Australian annuities market which is expected to strengthen the quality and resilience of underlying operating earnings.

Ratings were confirmed as:

- CLC: 'A' with a positive outlook; and
- Challenger Limited: 'BBB+' with a positive 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 significant financial flexibility.

2 Normalised profit and investment experience

Challenger has performed strongly, building on its growth momentum by delivering increased net book growth in its Life segment, substantially increased funds under management in its Funds Management segment and an overall growth in earnings.

Normalised framework (Non IFRS)

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

2 Normalised profit and investment experience (continued)

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 2017 $M	31 Dec 2016 $M	change $M	change %
Net income[1]	408.6	382.1	26.5	6.9
Comprising:				
– Life normalised COE	336.1	316.4	19.7	6.2
– FM net income	72.0	65.3	6.7	10.3
– Corporate and other net income	0.5	0.4	0.1	25.0
Operating expenses[1]	(131.1)	(125.7)	(5.4)	4.3
Normalised EBIT	**277.5**	**256.4**	**21.1**	**8.2**
Comprising:				
– Life normalised EBIT	283.0	267.0	16.0	6.0
– FM normalised EBIT	27.1	20.7	6.4	30.9
– Corporate and other normalised EBIT	(32.6)	(31.3)	(1.3)	4.2
Interest and borrowing costs	(2.9)	(2.3)	(0.6)	26.1
Tax on normalised profit	(66.7)	(57.5)	(9.2)	16.0
Normalised NPAT	**207.9**	**196.6**	**11.3**	**5.7**
Investment experience after tax	(12.5)	4.9	(17.4)	large
Statutory net profit after tax attributable to equity holders	**195.4**	**201.5**	**(6.1)**	**(3.0)**

[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 any 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 partially offset with a decreased margin being earned on those assets. Life's average assets under management (AUM) increased by 15.3% as a result of the net book growth in annuities, net flows on external unit holders' liabilities and valuation movements on those assets.

Funds Management net income increased (up $6.7 million) due to increased management and performance fee revenue offset by lower transaction fee revenue in Fidante Partners Europe. Funds Management average FUM increased by 20.0% as a result of strong inflows throughout the period together with mark-to-market gains on investments.

Operating expenses increased by $5.4 million (4.3%) for the period ended 31 December 2017 primarily to support the Company's growth ambitions. Challenger's employee numbers increased by 50 (or 7.9%) to 682 when compared to the prior period.

Normalised tax for the period was $66.7 million, reflecting a normalised effective tax rate for the period of 24.3% (22.6% at 31 December 2016).

Management analysis – investment experience

	31 Dec 2017 $M	31 Dec 2016 $M
Actual capital growth[1]		
– Cash and fixed income	52.1	52.9
– Infrastructure	(26.0)	(29.9)
– Property (net of debt)	67.0	48.0
– Equity and other investments	(8.8)	16.1
Total actual capital growth	**84.3**	**87.1**
Normalised capital growth[2]		
– Cash and fixed income	(19.4)	(16.6)
– Infrastructure	11.1	10.9
– Property (net of debt)	33.7	32.1
– Equity and other investments	34.3	24.7
Total normalised capital growth	**59.7**	**51.1**
Investment experience		
– Cash and fixed income	71.5	69.5
– Infrastructure	(37.1)	(40.8)
– Property (net of debt)	33.3	15.9
– Equity and other investments	(43.1)	(8.6)
	24.6	36.0
Annuity valuation experience[3]	(46.5)	(27.5)
Investment experience before tax	(21.9)	8.5
Tax benefit/(expense)	9.4	(3.6)
Investment experience after tax	**(12.5)**	**4.9**

[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.

2 Normalised profit and investment experience (continued)

31 December 2017 investment experience comprises a $24.6 million gain in relation to fair value movements on Life's assets together with a $46.5 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 investment experience during the period.

3 Life segment results

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

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

Life normalised results	31 Dec 2017 $M	31 Dec 2016 $M	change $M	change %
Normalised COE	336.1	316.4	19.7	6.2
– Cash earnings	276.4	265.3	11.1	4.2
– Normalised capital growth	59.7	51.1	8.6	16.8
Operating expenses	(53.1)	(49.4)	(3.7)	7.5
Normalised EBIT	**283.0**	**267.0**	**16.0**	**6.0**

Life normalised EBIT increased by $16.0 million (up 6.0%) due to higher normalised COE (up $19.7 million or 6.2%), which was partially offset with operating expenses increasing by $3.7 million (or 7.5%). The higher normalised COE was as a result of higher investment assets (Life average investment assets increased by 15.3% when compared to the prior period) offset by a lower margin earned on those assets.

Total Life sales were $3,324.0 million in the period, up $565.6 million (up 20.5%). Life annuity sales increased when compared to the prior period (up 4.3%), with increased fixed term sales (up 13.7%) offset by lower lifetime sales (down 23.8%). Other Life sales increased by $472.2 million (up 84.0%).

Life annuity sales have continued to benefit from being available on multiple platforms and strong relationships including Colonial First State, VicSuper, Local Government Super, ClearView Wealth Solutions, CareSuper, Legal Super and Suncorp. During the period, Life's previously announced relationship with AMP commenced. The relationship with AMP is to provide the full range of Life's annuity products via AMP's portal to their retail and corporate superannuation clients.

Life sales	31 Dec 2017 $M	31 Dec 2016 $M	change $M	change %
Fixed-term annuities	1,867.2	1,641.9	225.3	13.7
Lifetime annuities	422.3	554.2	(131.9)	(23.8)
Total Life annuity sales	2,289.5	2,196.1	93.4	4.3
Other Life sales	1,034.5	562.3	472.2	84.0
Total Life sales	**3,324.0**	**2,758.4**	**565.6**	**20.5**
Annuity net flows	758.2	448.9	309.3	68.9
Other Life net flows	189.7	394.5	(204.8)	(51.9)
Total Life net flows	**947.9**	**843.4**	**104.5**	**12.4**

Annuity net flows (new annuity sales less capital repayments) increased by 68.9% to $758.2 million driven by higher annuity sales and reduced maturities. Based on the opening Life annuity book for the 2017 financial year ($10,322.2 million), annuity net book growth for the period was 7.3%, which was up from 4.7% in the prior period.

Other Life sales represents Guaranteed Index Return (GIR) mandates and the Challenger Index Plus Fund. Other Life sales increased from GIR mandate rollovers and sales in the Challenger Index Plus Fund of $188.0 million.

Other Life net flows for the period were $189.7 million decreasing compared to $394.5 million in the prior period. Total Life net flows were $947.9 million representing total Life net book growth of 7.9% (31 December 2016: $843.4 million or 7.8% book growth).

4 Funds Management segment results

Challenger's Funds Management business is one of Australia's fastest growing[1], with FUM more than doubling to $73bn over the last five years.

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, UK and US based investment managers investing in equities, fixed income, infrastructure and alternatives. The Fidante Partners model is delivering superior investment performance, with 97% of funds exceeding benchmark over the last five years.

Funds Management also includes Challenger Investment Partners (CIP), a fixed income and property institutional investment manager developing and managing assets under Challenger's brand, on behalf of both CLC and third party institutional investors.

[1] Rainmaker – Consolidated FUM for Australian Fund Managers September 2017.

4 Funds Management segment results (continued)

FM normalised results	31 Dec 2017 $M	31 Dec 2016 $M	change $M	change %
Net income	72.0	65.3	6.7	10.3
– Fidante Partners	42.9	40.6	2.3	5.7
– CIP	29.1	24.7	4.4	17.8
Operating expenses	(44.9)	(44.6)	(0.3)	0.7
Normalised EBIT	**27.1**	**20.7**	**6.4**	**30.9**

Funds Management normalised EBIT increased for the period by 30.9%, with higher net income offset by marginally increased expenses. Net income benefited from increased assets under management together with performance fees being earned during the period. Expenses increased by 0.7%, reflecting continued 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 in the period increased primarily as a result of growth in FUM, as well as growth in performance fees ($6.4 million compared to the prior period of $1.1 million), offset by lower transaction fees in Fidante Partners Europe.

Challenger Investment Partners' (CIP) net income also increased (up $4.4 million) due to higher net management fees as a result of increased FUM.

Funds Management normalised return on equity (RoE) (pre-tax) for the period was 27.6%, up by 440 bps from the prior period. This increase comes as a result of the increased EBIT during the period. RoE continues to benefit from strong FUM growth and capturing the benefits of scale.

Funds Management	31 Dec 2017 $bn	31 Dec 2016 $bn	change $bn	change %
FUM				
– Fidante Partners	56.0	47.0	9.0	19.1
– CIP	17.4	15.1	2.2	14.5
Total FUM	**73.4**	**62.1**	**11.2**	**18.0**
Flows				
– Fidante Partners	2.5	1.7	0.8	47.1
– CIP	1.4	1.5	(0.1)	(6.7)
Total flows	**3.9**	**3.2**	**0.7**	**21.9**

Fidante Partners' FUM (up $9.0 billion from PCP) was driven by strong net flows (up $4.9 billion) and positive impact from investment markets (up $4.1 billion) during that period, net of distributions.

CIP FUM growth (up $2.2 billion) is primarily a result of additional fixed income flows (up $1.8 billion) and additional property flows (up $0.2 billion).

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.

Corporate and other normalised results	31 Dec 2017 $M	31 Dec 2016 $M	change $M	change %
Net income	0.5	0.4	0.1	25.0
Operating expenses	(33.1)	(31.7)	(1.4)	4.4
Normalised EBIT	**(32.6)**	**(31.3)**	**(1.3)**	**4.2**
Interest and borrowing costs	(2.9)	(2.3)	(0.6)	26.1
Normalised loss before tax	**(35.5)**	**(33.6)**	**(1.9)**	**5.7**

Normalised EBIT for the Corporate and other segment was lower (down $1.3 million) as a result of increased operating expenses.

6 Guidance for the 2018 financial year

Challenger is well positioned with strong product offerings, expanding distribution networks and highly efficient operations.

For 2018, Challenger is targeting normalised net profit before tax of between $545 million and $565 million, representing growth of between 8–12%.

The normalised cost to income ratio is also forecast to be within the range of 30–34% over the medium term.

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.

Directors' report

1 Directors

The names and details of the Directors of Challenger Limited (the Company) holding office during the six months to 31 December 2017 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
John M Green	Independent Non-Executive Director (appointed 6 December 2017)
Steven Gregg	Independent Non-Executive Director
Jonathan Grunzweig	Independent Non-Executive Director (resigned 6 December 2017)
Brenda Shanahan	Independent Non-Executive Director (resigned 26 October 2017)
JoAnne Stephenson	Independent Non-Executive Director
Melanie Willis	Independent Non-Executive Director (appointed 6 December 2017)
Leon Zwier	Independent Non-Executive Director

2 Significant events after the balance date

At the date of this financial report, no matter or circumstance has arisen that has affected, or may significantly affect, the Group's operations, the results of those operations or the Group's state of affairs in future financial years which has not already been reflected in this report.

3 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.

4 Auditor's independence declaration

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

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 2017, 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
12 February 2018

L Burns
Partner
Sydney
12 February 2018

5 Authorisation

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

G A Cubbin
Director
Sydney
12 February 2018

B R Benari
Managing Director & Chief Executive Officer
Sydney
12 February 2018

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Financial statements

Notes to the financial statements

Signed reports

Additional information

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	2017 $M	2016 $M
Revenue	1	1,128.1	940.7
Expenses	2	(763.2)	(645.2)
Finance costs		(130.0)	(45.1)
Share of profits of associates		13.2	8.6
Profit before income tax		**248.1**	**259.0**
Income tax expense	4	(52.0)	(57.4)
Profit for the period		**196.1**	**201.6**
Profit attributable to shareholders of Challenger Limited		195.4	201.5
Profit attributable to non-controlling interests		0.7	0.1
Profit for the period		**196.1**	**201.6**
Other comprehensive income			
Items that may be reclassified to profit and loss, net of tax			
Translation of foreign entities		(6.5)	(11.2)
Hedge of net investment in foreign operations		8.8	14.1
Cash flow hedges – SPV[1]		0.1	0.3
Other comprehensive income for the period		2.4	3.2
Total comprehensive income for the period		**198.5**	**204.8**
Comprehensive income attributable to shareholders of Challenger Limited		197.8	204.7
Comprehensive income attributable to non-controlling interests		0.7	0.1
Total comprehensive income for the period		**198.5**	**204.8**
Earnings per share attributable to ordinary shareholders of Challenger Limited		cents	cents
Basic	12	33.1	35.8
Diluted	12	31.9	34.1

[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 2017 $M	30 June 2017 $M	31 Dec 2016 $M
Assets				
Cash and cash equivalents		895.6	514.7	553.0
Cash and cash equivalents – SPV		98.2	122.4	148.8
Receivables		484.1	573.0	328.5
Mortgage assets – SPV		1,152.6	1,300.1	1,458.7
Derivative assets		675.8	541.4	646.1
Financial assets – fair value through profit and loss	5	16,070.1	15,479.1	14,280.4
Investment property held for sale	6	55.1	96.0	34.5
Investment and development property	6	3,711.0	3,532.9	3,512.3
Finance leases		50.6	51.3	51.9
Current tax asset		15.9	-	-
Property, plant and equipment		113.7	109.2	110.9
Investment in associates		54.2	53.5	49.1
Other assets		52.7	49.0	56.9
Goodwill		571.6	571.6	571.6
Other intangible assets		19.7	16.8	16.8
Total assets of shareholders of Challenger Limited and non-controlling interests		**24,020.9**	**23,011.0**	**21,819.5**
Liabilities				
Payables		500.3	988.0	360.7
Derivative liabilities		537.9	477.6	742.4
Interest bearing financial liabilities	10	5,278.3	5,208.6	4,947.9
Interest bearing financial liabilities – SPV		1,071.1	1,213.0	1,356.9
External unit holders' liabilities		1,909.3	1,687.8	1,633.2
Provisions		13.6	13.5	17.4
Current tax liability		-	107.6	3.0
Deferred tax liabilities		111.0	91.4	179.1
Life contract liabilities	7	11,115.8	10,322.2	9,784.9
Total liabilities of shareholders of Challenger Limited and non-controlling interests		**20,537.3**	**20,109.7**	**19,025.5**
Net assets of shareholders of Challenger Limited and non-controlling interests		**3,483.6**	**2,901.3**	**2,794.0**
Equity				
Contributed equity	9	2,071.0	1,554.5	1,560.1
Reserves		(47.5)	(16.5)	(29.9)
Retained earnings		1,446.0	1,350.1	1,250.3
Total equity of shareholders of Challenger Limited		**3,469.5**	**2,888.1**	**2,780.5**
Non-controlling interests		14.1	13.2	13.5
Total equity of shareholders of Challenger Limited and non-controlling interests		**3,483.6**	**2,901.3**	**2,794.0**

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 2016	Note	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
		Attributable to shareholders of Challenger Limited								
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	(43.8)	-	-	-	-	-	(43.8)	-	(43.8)
Vested shares released from the CPP Trust	9	41.1	-	-	-	-	-	41.1	-	41.1
CPP deferred share purchases	9	(21.3)	-	-	-	-	-	(21.3)	-	(21.3)
Settled forward purchases	9	33.3	-	-	-	-	-	33.3	-	33.3
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**
For the period ended 31 December 2017										
Balance at 1 July 2017		1,554.5	(23.2)	(0.2)	(5.2)	12.1	1,350.1	2,888.1	13.2	2,901.3
Profit for the period		-	-	-	-	-	195.4	195.4	0.7	196.1
Other comprehensive income for the period		-	-	0.1	2.3	-	-	2.4	-	2.4
Total comprehensive income for the period		**-**	**-**	**0.1**	**2.3**	**-**	**195.4**	**197.8**	**0.7**	**198.5**
Other equity movements										
Ordinary shares issued[1]	9	503.3	-	-	-	-	-	503.3	-	503.3
Shares purchased in the CPP Trust	9	(49.4)	-	-	-	-	-	(49.4)	-	(49.4)
Vested shares released from the CPP Trust	9	47.6	-	-	-	-	-	47.6	-	47.6
CPP deferred share purchases	9	(23.9)	-	-	-	-	-	(23.9)	-	(23.9)
Settled forward purchases	9	38.9	-	-	-	-	-	38.9	-	38.9
Share-based payment expense less releases		-	(33.4)	-	-	-	-	(33.4)	-	(33.4)
Dividends paid	11	-	-	-	-	-	(99.5)	(99.5)	-	(99.5)
Other movements		-	-	-	-	-	-	-	0.2	0.2
Balance at 31 December 2017		**2,071.0**	**(56.6)**	**(0.1)**	**(2.9)**	**12.1**	**1,446.0**	**3,469.5**	**14.1**	**3,483.6**

[1] On 23 August 2017, the Company issued 38,295,689 new ordinary shares to MS&AD. The Company also issued 285,232 ordinary shares on 27 September 2017 (28 September 2016: 455,140 shares) 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	2017 $M	2016 $M
Operating activities			
Receipts from customers		316.9	325.5
Annuity and premium receipts	7	2,296.8	2,218.1
Annuity and claim payments	7	(1,714.0)	(1,920.8)
Payments to reinsurer	7	(6.1)	(5.6)
Receipts from external unit holders		1,034.4	562.3
Payments to external unit holders		(865.3)	(217.3)
Payments to vendors and employees		(317.2)	(295.2)
Dividends received		54.3	36.0
Interest received		385.3	327.1
Interest paid		(66.0)	(52.2)
Income tax paid		(152.4)	(38.0)
Net cash inflows from operating activities	8	**966.7**	**939.9**
Investing activities			
Payments on net purchases of investments		(1,005.5)	(1,599.1)
Net mortgage loan repayments		116.4	251.5
Payments for net purchases of property, plant and equipment		(16.4)	(8.8)
Net cash outflows from investing activities		**(905.5)**	**(1,356.4)**
Financing activities			
Proceeds from issue of ordinary shares	9	503.3	4.1
Net (repayments)/proceeds from borrowings – interest bearing financial liabilities[1]	10	(73.5)	573.2
Payments for Treasury shares		(34.8)	(39.5)
Net dividends paid	11	(99.5)	(93.3)
Net cash inflows from financing activities		**295.5**	**444.5**
Net increase in cash and cash equivalents		**356.7**	**28.0**
Cash and cash equivalents at the beginning of the period		637.1	673.8
Cash and cash equivalents at the end of the period		**993.8**	**701.8**
Cash and cash equivalents		895.6	553.0
Cash and cash equivalents – SPV		98.2	148.8
Cash and cash equivalents at the end of the period		**993.8**	**701.8**

[1] Includes $143.4m outflow relating to SPVs in the current period and $3.0m of subordinated debt issue costs recognised in the statement of comprehensive income.

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

Basis of preparation and overarching significant accounting policies

Challenger Limited (the Company or the parent entity) is a company limited by shares, incorporated and domiciled 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 2017 was authorised for issue in accordance with a resolution of the Directors of the Company on 12 February 2018.

(i) Basis of preparation and statement of compliance

This is a general purpose interim financial report for the six months ended 31 December 2017 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 2017 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 a 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 2017.

There have been no new or revised accounting standards or interpretations which are effective from the period beginning on or after 1 July 2017 that materially impact the interim financial results.

Note 1 Revenue

	31 Dec 2017 $M	31 Dec 2016 $M
Investment revenue		
Fixed income securities and cash[1]	471.3	26.4
Investment property and property securities	272.8	231.3
Equity and infrastructure investments	7.4	17.5
Realised and unrealised gains on hedges and foreign exchange translation	43.7	135.1
Management fee revenue	102.6	104.1
Other revenue		
Life insurance contract premiums and related revenue[2]	230.3	426.3
Total revenue	**1,128.1**	**940.7**

[1] Includes fair value and realised movements in subordinated debt.
[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 2017 $M	31 Dec 2016 $M
Life contract and reinsurance expenses[1]	447.2	361.0
Investment property related expenses[2]	86.5	55.9
Fee expenses	54.2	42.6
Distribution expenses	23.5	22.0
Employee benefits expenses	92.6	89.5
Other expenses	59.2	74.2
Total expenses	**763.2**	**645.2**

[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	
	2017 $M	2016 $M	2017 $M	2016 $M	2017 $M	2016 $M	2017 $M	2016 $M	2017 $M	2016 $M
Net income	336.1	316.4	72.0	65.3	408.1	381.7	0.5	0.4	408.6	382.1
Operating expenses	(53.1)	(49.4)	(44.9)	(44.6)	(98.0)	(94.0)	(33.1)	(31.7)	(131.1)	(125.7)
Normalised EBIT	**283.0**	**267.0**	**27.1**	**20.7**	**310.1**	**287.7**	**(32.6)**	**(31.3)**	**277.5**	**256.4**
Interest and borrowing costs	-	-	-	-	-	-	(2.9)	(2.3)	(2.9)	(2.3)
Normalised net profit/(loss) before tax	**283.0**	**267.0**	**27.1**	**20.7**	**310.1**	**287.7**	**(35.5)**	**(33.6)**	**274.6**	**254.1**
Tax on normalised profit									(66.7)	(57.5)
Normalised net profit after tax									**207.9**	**196.6**
Investment experience after tax									(12.5)	4.9
Profit attributable to the shareholders of Challenger Ltd									**195.4**	**201.5**
Other statutory segment information										
Revenue from external customers	619.7	526.3	85.8	74.7	705.5	599.2	0.1	0.7	705.6	601.7
Interest revenue	421.8	338.2	-	-	421.8	326.6	0.7	0.8	422.5	339.0
Interest expense	(109.0)	(35.4)	(0.3)	(0.4)	(109.3)	(35.8)	(20.7)	(9.3)	(130.0)	(45.1)
Intersegment revenue	(20.4)	(18.1)	20.4	18.1	-	-	-	-	-	-
Depreciation and amortisation	(3.0)	(2.7)	(0.1)	(0.1)	(3.1)	(2.8)	(4.9)	(4.5)	(8.0)	(7.3)
As at 31 December										
Segment assets	17,684.2	14,996.6	260.4	284.3	17,944.6	15,280.9	6,062.2	6,525.1	24,006.8	21,806.0
Segment liabilities	(14,531.5)	(12,443.2)	(48.6)	(106.5)	(14,580.1)	(12,549.7)	(5,957.2)	(6,475.8)	(20,537.3)	(19,025.5)
Net assets attributable to shareholders	**3,152.7**	**2,553.4**	**211.8**	**177.8**	**3,364.5**	**2,731.2**	**105.0**	**49.3**	**3,469.5**	**2,780.5**

[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 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. 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

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); and
- 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).

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 period 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 2017. 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.

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 2017 $M	31 Dec 2016 $M
Reconciliation of management to statutory view of after-tax profit		
Operating segments normalised net profit before tax	310.1	287.7
Corporate and other normalised net loss before tax	(35.5)	(33.6)
Normalised net profit before tax (management view of pre-tax profit)	**274.6**	**254.1**
Tax on normalised profit	(66.7)	(57.5)
Normalised net profit after tax	**207.9**	**196.6**
Investment experience after tax	(12.5)	4.9
Profit attributable to the shareholders of Challenger Limited	**195.4**	**201.5**
Profit attributable to non-controlling interests excluded from management view	0.7	0.1
Statutory view of profit after tax	**196.1**	**201.6**
Reconciliation of management view of revenue to statutory revenue		
Operating segments	408.1	381.7
Corporate and other	0.5	0.4
Net income (management view of revenue)	**408.6**	**382.1**
Expenses and finance costs offset against revenue		
SPV expenses and finance costs offset against SPV income	14.4	18.7
Distribution expenses offset against related income	23.5	22.0
Change in life contract liabilities and reinsurance contracts recognised in expenses	447.2	361.0
Property related expenses offset against property income	60.1	50.3
Interest and loan amortisation costs	94.5	16.6
Fee expenses	54.2	42.6
Adjustment for non-controlling interests and other items	47.5	38.9
Difference between management view of investment experience and statutory recognition		
Actual capital growth	84.3	87.1
Normalised capital growth	(59.7)	(51.1)
Annuity valuation experience	(46.5)	(27.5)
Statutory revenue (refer Note 1 Revenue)	**1,128.1**	**940.7**

Note 4 Income tax

Analysis of income tax expense	31 Dec 2017 $M	31 Dec 2016 $M
Current income tax expense for the period	(35.9)	(61.3)
Current income tax benefit prior period adjustment	3.2	0.2
Deferred income tax (expense)/benefit	(19.3)	3.7
Income tax expense	**(52.0)**	**(57.4)**
Income tax benefit on translation of foreign entities	3.2	5.8
Income tax expense on hedge of net investment in foreign entities	(3.8)	(6.0)
Income tax expense from other comprehensive income	**(0.6)**	**(0.2)**
Reconciliation of income tax expense		
Profit before income tax	248.1	259.0
Prima facie income tax based on the Australian company tax rate of 30%	(74.4)	(77.7)
Tax effect of amounts not assessable/deductible in calculating taxable income:		
– non assessable and non-deductible items	14.5	17.3
– tax rate differentials	5.4	5.1
– tax adjustment in respect of non-controlling interests	0.2	-
– other items	2.3	(2.1)
Income tax expense	**(52.0)**	**(57.4)**
Underlying effective tax rate[1]	**21.0%**	**22.2%**

[1] The calculation of the underlying effective tax rate excludes the non-controlling interests' profit of $0.7 million ($0.1 million at 31 December 2016).

Unused revenue losses

Challenger tax consolidated group has no tax revenue losses. A deferred tax asset in relation to $19.9 million (30 June 2017: $21.4 million) of revenue losses (net) has been recognised in respect of non-tax consolidated group entities. A further deferred tax asset of $19.3 million (30 June 2017: $18.5 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 $228.7 million (30 June 2017: $282.9 million) of gross unused capital losses for which no deferred tax asset has been recognised. The decrease in the period is largely attributable to capital gains arising from trusts joining the tax consolidated group.

Note 5 Financial assets – fair value through profit and loss

	31 Dec 2017 $M	30 June 2017 $M	31 Dec 2016 $M
Domestic sovereign bonds and semi-government bonds	5,183.2	5,948.0	5,197.2
Floating rate notes and corporate bonds	5,649.6	5,123.1	4,843.3
Residential mortgage and asset-backed securities	2,891.2	2,538.0	2,329.2
Non-SPV mortgage assets	183.7	200.7	224.4
Fixed income securities	**13,907.7**	**13,809.8**	**12,594.1**
Shares in listed and unlisted corporations	73.3	66.7	93.8
Unit trusts, managed funds and other	914.1	664.1	617.5
Equity securities	**987.4**	**730.8**	**711.3**
Units in listed and unlisted infrastructure trusts	489.6	336.7	361.4
Other infrastructure investments	305.8	305.5	306.5
Infrastructure investments	**795.4**	**642.2**	**667.9**
Indirect property investments in listed and unlisted trusts	379.6	296.3	307.1
Property securities	**379.6**	**296.3**	**307.1**
Total financial assets – fair value through profit and loss	**16,070.1**	**15,479.1**	**14,280.4**

Note 6 Investment and development property

	31 Dec 2017 $M	30 June 2017 $M	31 Dec 2016 $M
Investment property held for sale[1]	55.1	96.0	34.5
Investment property in use	3,626.0	3,359.4	3,372.6
Investment property under development	84.7	144.1	102.6
Total investment property	**3,765.8**	**3,599.5**	**3,509.7**
Development property held for resale[2]	0.3	29.4	37.1
Total investment and development property	**3,766.1**	**3,628.9**	**3,546.8**

[1] Held for sale properties: Elder House, Gennevilliers, Parcay-Meslay and Villeneuve les Beziers (30 June 2017: 12-30 Toll, 2-10 Toll, City Century Walk, Gennevilliers, Parcay-Meslay and Villeneuve les Beziers).
[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 2017 $M	30 June 2017 $M	31 Dec 2016 $M
Life investment contract liabilities – at fair value	6,448.8	6,356.5	6,694.2
Life insurance contract liabilities – at margin on services value	4,591.3	3,885.5	3,011.6
Reinsurance contract liabilities – at margin on services value	75.7	80.2	79.1
Total life contract liabilities	**11,115.8**	**10,322.2**	**9,784.9**

	Life investment contract liabilities		Life insurance contract liabilities		Outward reinsurance contract liabilities		Total life contract liabilities	
Movement in life contract liabilities	31 Dec 2017 $M	31 Dec 2016 $M	31 Dec 2017 $M	31 Dec 2016 $M	31 Dec 2017 $M	31 Dec 2016 $M	31 Dec 2017 $M	31 Dec 2016 $M
Balance at the beginning of the period	6,356.5	6,915.3	3,885.5	2,555.3	80.2	87.9	10,322.2	9,558.5
Deposits and premium receipts	1,478.8	1,517.9	818.0	700.2	-	-	2,296.8	2,218.1
Payments and withdrawals	(1,485.4)	(1,774.0)	(228.6)	(146.8)	(6.1)	(5.6)	(1,720.1)	(1,926.4)
Revenue per Note 1	(21.5)	(77.3)	(209.2)	(344.5)	0.4	(4.5)	(230.3)	(426.3)
Expenses per Note 2	120.4	112.3	325.6	247.4	1.2	1.3	447.2	361.0
Balance at the end of the period	**6,448.8**	**6,694.2**	**4,591.3**	**3,011.6**	**75.7**	**79.1**	**11,115.8**	**9,784.9**

Recognition and measurement

The operations of the Group include the selling and administration of life contracts through Challenger Life Company Limited (CLC). These contracts are governed under the *Life Insurance Act 1995* (the Life Act) and are classified as either life insurance contracts or life investment contracts. Life insurance and life investment contract liabilities are collectively referred to as life contract liabilities or policy liabilities.

Life investment contract liabilities

Life investment contracts are contracts regulated under the 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 in the statement of comprehensive income in the period in which they occur. 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.

Note 7 Life contract liabilities (continued)

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 including individual lifetime annuities, wholesale mortality, wholesale morbidity and longevity reinsurance. 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.

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 at 30 June 2017. Discount rates applied for Australian liabilities were between 2.2-4.0% (30 June 2017: 2.2-4.2%) per annum.

Expenses

Forecasted expenses for the next year are allocated between acquisition, maintenance and investment based on the nature of the expense. Forecasted maintenance expenses then are converted to a per-contract unit cost or percentage of account balance, depending 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 1.7% for short-term inflation and 2.2% for long-term (30 June 2017: 1.4% short-term, 2.4% long-term) per annum.

Surrenders

For life investment contracts, no surrenders or voluntary discontinuances are assumed. For inwards reinsurance of Japanese business, a rate of surrenders is assumed in line with local experience in relation to similar contracts, currently 3.5% per annum.

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 LML08 and LFL08 tables, adjusted for Challenger's own recent experience. LML08 and LFL08 are mortality tables developed by the Continuous Mortality Investigation (CMI) 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 0.0-2.6% (30 June 2017: 0.0-2.3%) 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 0.0-2.6% (30 June 2017: 0.0-2.8%) per annum. Base mortality rates for retrocession of Japanese business are determined as a multiple of Japanese population mortality rates.

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.

Note 7 Life contract liabilities (continued)

Statutory fund information

The life contract operations of CLC are conducted within four separate statutory funds in accordance with 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. Funds 2 and 4 are the principal operating funds of the Group. Fund 2 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. Fund 4 contains reinsurance of fixed term business written in Japan.

Life contract liabilities for Funds 1, 2, 3 and 4 are $2.5 million, $10,193.4 million, $3.1 million and $916.8 million respectively (30 June 2017: $2.8 million, $9,746.6 million, $3.0 million and $569.8 million).

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 and retrocession of fixed term business written in Japan. 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 expectation. 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 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 Notes to statement of cash flows

Reconciliation of profit to operating cash flow	31 Dec 2017 $M	31 Dec 2016 $M
Profit for the period	**196.1**	**201.6**
Adjusted for		
Net realised and unrealised (gain)/loss on disposal of investment assets	(168.1)	117.4
Share of associates' net profit	(13.2)	(8.6)
Change in life contract liabilities[1]	216.9	(65.3)
Depreciation and amortisation expense	7.9	7.3
Impairment in other investments	4.5	23.6
Share-based payments	11.0	11.4
Dividends from associates	14.4	11.5
Change in operating assets and liabilities		
Decrease in receivables	19.0	69.0
Decrease/(increase) in other assets	3.7	(2.0)
Decrease in payables	(19.9)	(29.3)
Increase in provisions	0.1	4.9
Increase in life contract liabilities	576.7	291.7
Increase in external unit holders' liabilities	221.5	317.7
Decrease in net tax liabilities	(103.9)	(11.0)
Net cash flows from operating activities	**966.7**	**939.9**

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

Note 9 Contributed equity

	6 months to 31 Dec 2017		Year to 30 June 2017		6 months to 31 Dec 2016	
	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 and fully paid	610.6	2,145.2	572.0	1,641.9	571.7	1,638.0
CPP Trust shares treated as Treasury shares	(4.5)	(41.3)	(5.3)	(39.5)	(5.4)	(39.0)
CPP deferred share purchases treated as Treasury shares	(2.8)	(32.9)	(4.8)	(47.9)	(4.0)	(38.9)
Total contributed equity	**603.3**	**2,071.0**	**561.9**	**1,554.5**	**562.3**	**1,560.1**
Movements in contributed equity						
Ordinary shares						
Opening balance	572.0	1,641.9	571.2	1,633.9	571.2	1,633.9
Equity placement	38.3	499.8	-	-	-	-
Issued under dividend reinvestment plan	0.3	3.5	0.8	8.0	0.5	4.1
Closing balance	**610.6**	**2,145.2**	**572.0**	**1,641.9**	**571.7**	**1,638.0**
CPP Trust						
Opening balance	5.3	39.5	6.1	36.3	6.1	36.3
Shares purchased (including settled forwards)	4.8	49.4	5.3	43.8	5.3	43.8
Vested shares released to employees	(5.6)	(47.6)	(6.1)	(40.6)	(6.0)	(41.1)
Closing balance	**4.5**	**41.3**	**5.3**	**39.5**	**5.4**	**39.0**
CPP deferred share purchases						
Opening balance	4.8	47.9	6.3	50.9	6.3	50.9
CPP deferred share purchases	2.0	23.9	2.8	30.3	2.0	21.3
Settled forward purchases	(4.0)	(38.9)	(4.3)	(33.3)	(4.3)	(33.3)
Closing balance	**2.8**	**32.9**	**4.8**	**47.9**	**4.0**	**38.9**

Capital management

Equity placement

On 23 August 2017, Challenger issued 38,295,689 new ordinary shares to MS&AD at a price of $13.0563 per share raising $500.0 million and representing 6.3% of Challenger's issued capital. The new shares were issued at a 2% premium to Challenger's 14 August 2017 30 business day volume weighted average share price of $12.9719, adjusted for the final dividend of 17.5 cents per share. The shares issued to MS&AD were not eligible for Challenger's final 2017 dividend, but remain eligible for all dividends in the future. Costs associated with the transaction were $0.2 million.

Dividend Reinvestment Plan (DRP)

The Company maintained a DRP for the 2017 final dividend. On 27 September 2017, the Company issued 285,232 ordinary shares to shareholders under the DRP. The DRP issue price per share for the 2017 final dividend was $12.3095 and represents the volume weighted average share price over the ten trading days from 6 to 19 September 2017. The DRP participation rate was 4 per cent of all issued shares, resulting in proceeds of $3.5 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 relevant prudential 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 2017 was 1.49 times, down from 1.57 times at 30 June 2017, reflecting changes in asset allocation, net AUM growth, capital issuances, and changes in contributed equity and retained earnings.

Subordinated debt

CLC's total regulatory capital base includes $406.8 million of admissible subordinated debt. Subordinated debt of $400.0 million was repaid during the period in accordance with its terms and replaced with a new $400.0 million issue. The new issue of subordinated debt occurred on 24 November 2017, has a call date on 24 November 2022 and is fully eligible as Tier 2 regulatory capital until 24 November 2038.

CLC's target surplus

CLC maintains a target level of capital representing the 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 2017 $M	30 June 2017 $M	31 Dec 2016 $M
CLC's regulatory capital			
Common Equity Tier 1 regulatory capital	2,638.4	2,169.0	2,046.0
Additional Tier 1 regulatory capital	805.0	805.0	345.0
Tier 2 regulatory capital – subordinated debt[1]	406.8	395.4	386.7
CLC total regulatory capital base	**3,850.2**	**3,369.4**	**2,777.7**
Prescribed capital amount			
Asset risk charge[2]	2,502.4	2,067.1	1,933.3
Insurance risk charge	164.9	157.5	152.7
Operational risk charge	42.8	38.7	34.9
Aggregation benefit	(125.7)	(119.2)	(115.5)
CLC prescribed capital amount	**2,584.4**	**2,144.1**	**2,005.4**
CLC excess over prescribed capital amount	**1,265.8**	**1,225.3**	**772.3**
Prescribed capital adequacy ratio (times)	**1.49**	**1.57**	**1.39**

[1] Differs from $405.3 million disclosed in Note 10 Interest bearing financial liabilities due to $1.5 million (30 June 2017: $1.8 million) of accrued interest.
[2] The asset risk charge includes the combined stress test scenarios and default stress adjustments.

Note 10 Interest bearing financial liabilities

	30 June 2017 Facility $M	Opening balance $M	Cash flows Proceeds/ (repayments) $M	Non-cash movements Foreign exchange $M	Fair value changes $M	Other $M	31 Dec 2017 Closing balance $M	Facility $M
Bank loans								
Corporate	400.0	-	-	-	-	-	-	400.0
Controlled property trusts[1]	537.0	520.0	(35.2)	(7.5)	0.6	0.8	478.7	480.2
Controlled infrastructure trusts	201.1	201.1	(1.9)	-	-	-	199.2	199.2
Repurchase agreements	3,287.5	3,287.5	100.4	-	-	-	3,387.9	3,387.9
Total bank loans	**4,425.6**	**4,008.6**	**63.3**	**(7.5)**	**0.6**	**0.8**	**4,065.8**	**4,467.3**
Non-bank loans								
Subordinated debt[2]	393.6	393.6	10.6	-	1.1	-	405.3	405.3
Challenger Capital Notes	340.2	340.2	-	-	-	0.9	341.1	341.1
Challenger Capital Notes 2	449.2	449.2	-	-	-	0.9	450.1	450.1
Other finance	17.0	17.0	(1.0)	-	-	-	16.0	16.0
Total non-bank loans	**1,200.0**	**1,200.0**	**9.6**	**-**	**1.1**	**1.8**	**1,212.5**	**1,212.5**
Total interest bearing financial liabilities	**5,625.6**	**5,208.6**	**72.9**	**(7.5)**	**1.7**	**2.6**	**5,278.3**	**5,679.8**

[1] Total facility limit consists of redraw loan facilities limits totalling $101.0 million (30 June 2017: $101.0 million) and non-redraw loan facility limits totalling $379.2 million (30 June 2017: $436.0 million).
[2] $400.0 million of subordinated debt was repaid during the period in accordance with its terms and replaced with a new $400.0 million issue of subordinated debt.

Note 11 Dividends paid and proposed

	31 Dec 2017 $M	31 Dec 2016 $M
Dividend declared and paid during the period		
Final 30 June 2017 100% franked dividend: 17.5 cents (30 June 2016: 16.5 cents 100% franked)	99.5	93.3
Dividend proposed (not recognised as a liability at 31 December)		
2018 interim 100% franked dividend: 17.5 cents (2017 interim: 17.0 cents 100% franked)	105.6	96.3

A dividend reinvestment plan will be in operation for the interim 2018 dividend.

Group franking credits account	6 months to 31 Dec 2017 $M	Year to 30 June 2017 $M
Franking account balance at the beginning of the period	38.9	46.7
Franking credits from the payment of income tax during the period	145.3	71.5
Franking credits from dividends received during the period	6.1	8.1
Franking debits applied to dividend payments to shareholders	(45.8)	(82.1)
Franking debits applied to Challenger Capital Notes and Challenger Capital Notes 2	(8.0)	(5.3)
Franking credits balance	**136.5**	**38.9**

Note 12 Earnings per share

	31 Dec 2017 cents	31 Dec 2016 cents
Basic earnings per share	33.1	35.8
Diluted earnings per share	31.9	34.1

	$M	$M
Profit attributable to ordinary shareholders	195.4	201.5
Add back interest expense on Challenger Capital Notes and Challenger Capital Notes 2	16.2	6.3
Add back interest on CLC Subordinated Notes	1.1	-
Total earnings used in the calculation of dilutive earnings per share	**212.7**	**207.8**

Number of shares	Number	Number
Weighted average of ordinary shares issued	599,415,537	571,452,278
Weighted average number of Treasury shares	(8,283,329)	(9,126,635)
Weighted average ordinary shares for basic earnings per share	591,132,208	562,325,643
Adjusted for potential ordinary shares:		
Weighted average effect of Challenger Performance Plan	11,887,169	14,731,026
Weighted average effect of Challenger Capital Notes and Challenger Capital Notes 2	57,750,803	31,772,871
Weighted average effect of CLC Subordinated Notes	5,926,358	-
Weighted average ordinary shares for diluted earnings per share	**666,696,538**	**608,829,540**

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 8.3 million (31 December 2016: 9.1 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, Challenger Capital Notes 2 and CLC Subordinated 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 and Challenger Capital Notes 2 of 57.8 million shares (31 December 2016: 31.8 million), CLC Subordinated Notes of 5.9 million shares (31 December 2016: nil) and shares granted under the Challenger Performance Plan (CPP) of 11.9 million shares (31 December 2016: 14.7 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 an external price. 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.

The mortgage SPVs have total equity attributable to RIU holders at amortised cost of ($0.1 million) (30 June 2017: ($0.2 million)). The fair value of this RIU holders' asset is $83.8 million (30 June 2017: $94.9 million) and would be classified as Level 3 in the fair value hierarchy.

Challenger Capital Notes and Challenger Capital Notes 2 have carrying values of $345.0 million and $460.0 million. The fair value of these notes is $352.0 million and $489.7 million respectively and they would be classified as Level 1 in the fair value hierarchy.

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 which generally meets monthly, or more frequently if required.

All financial instruments and investment properties are measured on a recurring basis. The table on the following page 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.

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 2017				
Derivative assets	-	675.7	0.1	675.8
Fixed income securities[1]	-	11,693.3	2,214.4	13,907.7
Equity securities	46.7	700.3	240.4	987.4
Infrastructure investments	169.6	211.7	414.1	795.4
Property securities	237.9	-	141.7	379.6
Investment and development property	-	55.1	3,710.7	3,765.8
Total assets	**454.2**	**13,336.1**	**6,721.4**	**20,511.7**
Derivative liabilities	0.2	537.7	-	537.9
Interest bearing financial liabilities	-	461.1	16.0	477.1
External unit holders' liabilities	-	1,909.3	-	1,909.3
Life investment contract liabilities	-	70.4	6,378.4	6,448.8
Total liabilities	**0.2**	**2,978.5**	**6,394.4**	**9,373.1**
30 June 2017				
Derivative assets	-	541.3	0.1	541.4
Fixed income securities[1]	-	11,694.7	2,115.1	13,809.8
Equity securities	136.0	333.4	261.4	730.8
Infrastructure investments	122.4	110.6	409.2	642.2
Property securities	152.7	-	143.6	296.3
Investment and development property	-	96.0	3,503.5	3,599.5
Total assets	**411.1**	**12,776.0**	**6,432.9**	**19,620.0**
Derivative liabilities	0.5	477.1	-	477.6
Interest bearing financial liabilities	-	61.0	410.6	471.6
External unit holders' liabilities	-	1,687.8	-	1,687.8
Life investment contract liabilities	-	75.9	6,280.6	6,356.5
Total liabilities	**0.5**	**2,301.8**	**6,691.2**	**8,993.5**
31 Dec 2016				
Derivative assets	-	646.1	-	646.1
Fixed income securities[1]	-	10,582.2	2,011.9	12,594.1
Equity securities	93.9	312.9	304.4	711.2
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**	**11,682.8**	**6,432.3**	**18,436.1**
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**

[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 2017 the carrying value of asset-backed financing assets was $59.8 million (30 June 2017: $50.2 million) with no undrawn commitments (30 June 2017: none) and securitisations was $296.0 million (30 June 2017: $131.7 million) plus $63.4 million undrawn commitments (30 June 2017: $71.8 million).

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

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 2017		30 June 2017		31 Dec 2016	
	Assets $M	Liabilities $M	Assets $M	Liabilities $M	Assets $M	Liabilities $M
Balance at the beginning of the period	2,929.4	6,691.2	2,946.8	7,430.8	2,946.8	7,430.8
Fair value gains/(losses)	42.6	105.1	12.7	133.2	3.2	33.1
Acquisitions	1,062.5	1,460.2	1,698.8	2,329.7	884.8	1,464.3
Maturities and disposals	(1,023.8)	(1,862.1)	(1,782.0)	(3,202.5)	(877.7)	(1,907.2)
Transfers to other categories[1,2]	-	-	53.1	-	-	-
Balance at the end of the period[3]	**3,010.7**	**6,394.4**	**2,929.4**	**6,691.2**	**2,957.1**	**7,021.0**
Unrealised gains/(losses) included in the statement of comprehensive income for assets and liabilities held at the statement of financial position date	62.5	(91.5)	38.5	(16.1)	8.3	(25.2)

[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 2017					
Derivative assets	0.1	0.5	(0.1)	Discounted cash flow	Primarily credit spreads
Fixed income securities	2,214.4	32.7	(34.1)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(16.0)	(0.4)	-	Discounted cash flow	Primarily credit spreads
Equity, infrastructure, property assets	796.2	33.0	(34.4)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Investment contract liabilities	(6,378.4)	4.4	(4.4)	Discounted cash flow	Primarily expense assumptions
Total Level 3[4]	**(3,383.7)**	**70.2**	**(73.0)**		
30 June 2017					
Derivative assets	0.1	0.8	(0.3)	Discounted cash flow	Primarily credit spreads
Fixed income securities	2,115.1	36.1	(33.0)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(410.6)	(7.7)	7.9	Discounted cash flow	Primarily credit spreads
Equity, infrastructure, property assets	814.2	53.9	(55.3)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Investment contract liabilities	(6,280.6)	4.8	(4.8)	Discounted cash flow	Primarily expense assumptions
Total Level 3	**(3,761.8)**	**87.9**	**(85.5)**		
31 Dec 2016					
Fixed income securities	2,011.9	26.4	(31.7)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(402.6)	(8.5)	8.3	Discounted cash flow	Primarily credit spreads
Equity, infrastructure, property assets	945.2	45.4	(45.9)	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	**(4,063.9)**	**66.3**	**(72.3)**		

[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%.
[4] Does not include investment property.

Note 14 Collateral arrangements

Recognition and measurement

CLC receives collateral, where it is considered necessary, when entering into certain financial arrangements. The amount of collateral required is subject to management's credit evaluation of the counterparty which is performed on a case-by-case basis. $246.5 million (30 June 2017: $268.0 million) cash received from third parties as collateral is recorded in payables. CLC is not permitted to sell or repledge financial or non-financial assets held as collateral in the absence of default by the owner of the collateral.

CLC is required to pledge collateral, as part of the standard terms of transactions, when entering into certain financial arrangements. Cash paid to third parties as collateral is recorded in receivables. Other financial assets transferred as collateral are not derecognised from the statements of financial position as the risks and rewards of ownership remain with CLC. At the balance sheet date the fair value of cash and financial assets pledged are as follows:

Collateral pledged as security	31 Dec 2017 $M	30 Jun 2017 $M
Cash	131.8	176.3
Other financial assets[1]	4,285.0	4,375.6
Total collateral pledged	**4,416.8**	**4,551.9**

[1] Includes assets sold under repurchase agreements. Please refer Note 10 Interest bearing financial liabilities for more information.

Note 15 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 2017. 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 2017 there are potential future commitments totalling $359.6 million (30 June 2017: $311.8 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.

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 16 Subsequent events

At the date of this financial report, no matter or circumstance has arisen that has affected, or may significantly affect, the Group's operations, the results of those operations or the Group's state of affairs in future financial years which has not already been reflected in this report.

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 2017 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
12 February 2018

B R Benari
Managing Director and Chief Executive Officer

Sydney
12 February 2018

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Independent Auditor's Review Report to the Members of Challenger Limited

Report on the Half-Year Financial Report

Conclusion

We have reviewed the accompanying half-year financial report of Challenger Limited (the Company) and its subsidiaries (collectively the Group), which comprises the Statement of financial position as at 31 December 2017, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the half-year ended on that date, notes comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration.

Based on our review, which is not an audit, nothing has come to our attention that causes us to believe that the half-year financial report of the Group is not in accordance with the Corporations Act 2001, including:

a) giving a true and fair view of the consolidated financial position of the Group as at 31 December 2017 and of its consolidated financial performance for the half-year ended on that date; and

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

Directors Responsibility for the Half-Year Financial Report

The directors of the Company are responsible for the preparation of the half-year financial report that gives a true and fair view in accordance with Australian Accounting Standards and the Corporations Act 2001 and for such internal control as the directors determine is necessary to enable the preparation of the half-year 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 half-year 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, anything has come to our attention that causes us to believe that the half-year financial report is not in accordance with the Corporations Act 2001 including: giving a true and fair view of the Group's consolidated financial position as at 31 December 2017 and its consolidated financial performance for the half-year ended on that date; and complying with Accounting Standard AASB 134 Interim Financial Reporting and the Corporations Regulations 2001. As the auditor of the Group, ASRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial report.

A review of a half-year 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*.

Ernst & Young

S J Ferguson
Partner

Sydney
12 February 2018

L Burns
Partner

Sydney
12 February 2018

Additional information

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Leon Zwier

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Go electronic
Challenger can deliver all of your shareholder communications electronically, just update your details via Computershare Investor Services.

Online digital version of this report
The 2018 Interim Financial Report is available at:

challenger.com.au/share

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