IFRS17 Briefing

3 IFRS17 at Prudential: Key messages

Good afternoon from Hong Kong. My name is Ben Bulmer, and it is my pleasure to provide you with this IFRS17 briefing. This presentation will provide insights into our FY22 results following the application of IFRS17 and IFRS9, by explaining the key drivers of our financial performance.

There are a few key messages I'd like you to take-away from this briefing:

- Firstly, IFRS17 is a new accounting framework, impacting the timing of profit emergence rather than total profit. It does not change the attractive fundamentals of our business nor the exciting opportunities ahead.
- Prudential's IFRS17 opening equity position and 2022 adjusted operating profit are consistent with the guidance provided at our full-year results in March.
- In respect of the mechanics of IFRS17; profit growth is driven by growth in the contractual service margin, or CSM, which in turn is dependent on adding more from new business than is released to profit in the period. We expect the compounding effect of growth from new business CSM to support growth in adjusted operating profit over time.
- Consequently, operating profit remains one of our key IFRS performance metrics.
- And, finally, we continue to view our long-established Embedded Value reporting framework as providing a better measure of both value creation and capital generation – or in Prudential terminology – operating free surplus generation.

4: IFRS17 does not change the attractive fundamentals of our business

IFRS17 is purely an accounting change. It does not change our capital and cash generation, capital management, Embedded Value reporting, or dividend policy. And it has no effect on the attractive fundamentals of our business. These include:

- Market leading positions in our life and asset management markets of Greater China, South-east Asia, India and Africa, providing an opportunity to serve a population of four billion people across two exciting continents.
- Demand in these markets is driven by structural trends, including a rapidly growing middle-class, a vast protection gap, and significantly underserved wealth and retirement needs.
- To meet this demand, our distribution footprint is diverse, with over 100,000 active agents and the leading bancassurance platform in Asia, with over 190 partners.

Finally, as already reported, we made a strong start to 2023. In the first quarter, new business profits were up 30%, and 10 out of 13 life markets in Asia as well as Africa delivered double digit NBP growth.

5. Application of IFRS17 at Prudential

Before I describe our 2022 results, there are a number of aspects in the application of IFRS17 at Prudential which are important to understand, noting that our starting position under IFRS4 was different to our peers, and the standard is principles based.

First, upon transitioning to IFRS17 we have applied retrospective approaches for around 80% of our business in determining our opening CSM. This approach provides a comparatively consistent view of the total profitability of our business and a better degree of alignment between new business profitability and in-force profitability.

We have maintained consistency with our long-established Embedded Value framework by aligning non-economic assumptions and including similar proportions of non-market risk allowance.

Almost all of the expenses we incur in our insurance businesses are attributed to insurance contracts. As a result, our level of non-attributable insurance expenses is very small in a group context; less than $100 million. Therefore, the vast majority of our on-going insurance costs are captured in our best estimate liabilities (or the 'BEL'), as opposed to being expensed as they are incurred.

We have continued the approach to investment valuation and accounting that we have used historically. This means that IFRS9 has no material impact on us.

We continue to show investments at fair value with movements taken through P&L, rather than splitting these between P&L and OCI. This enables us to show the impacts of short-term market effects in the income statement itself.

And finally, approximately 70% of our CSM is modelled using the variable fee approach or VFA, with the balance then applying the general measurement model, or GMM. This is important to bear in mind, as the treatment of market effects differs between VFA and GMM business.

VFA business applies to contracts where policyholders and shareholders share in the returns generated by the underlying supporting investments. Market effects are first taken to CSM and then smoothed over time to operating profit. In contrast, with the GMM business, the CSM discount rate is 'locked-in' and market effects flow directly to non-operating profit.

Note that where we have contracts for products which combine protection with savings – as we do in many markets – IFRS17 applies a single approach to the combined product. This has two effects:

- Firstly, the application of a common discount rate, which when applied to the protection component of the product may be higher than if the protection element was treated separately.
- And secondly, any subsequent product upgrades are recognised as an uplift to in force CSM, rather in new business.

All this supports our approach to the implementation of IFRS17, which was to strive for internally consistent financial reporting.

6: Transition to IFRS17 consistent with guidance

Both the IFRS17 2022 opening equity and operating profit are in line with the guidance we provided in March 2023:

- IFRS17 shareholders' equity on 1 January 2022 was $18.9 billion, some $1.8 billion higher than that under IFRS 4.
- IFRS17 adjusted operating profit before tax for 2022 was $2.7bn, at the upper end of the range indicated.

As a reminder, we are not transitioning from a single accounting approach but from many different local bases.

Equity has increased, primarily because certain elements of prudence in the IFRS4 basis get released. The implication of this is that some profits that were yet to be recognized under IFRS4 have been taken directly to equity. The absolute amount of profit over the lifetime of a contract is unchanged when moving from IFRS4 to IFRS17.

The changes to equity are summarized on the slide as follows:

- Firstly, the release of prudent margins inherent in the regulatory basis which underpins our legacy IFRS 4 accounting. We saw just under a $1 billion of such margins released upon the adoption of HK RBC during 2022.
- Secondly, the recognition of the shareholders' share of the With-Profits estate, which is included in liabilities under IFRS 4. Consequently, we get an equity uplift of c.$0.4bn when transitioning to IFRS17, largely arising in Hong Kong.
- And finally, the impact from timing differences in profit recognition, both at inception and subsequent recognition, which vary by product and market.

Similarly, timing differences explain most of the difference in operating profit from IFRS4 to IFRS17, shown in the middle chart, particularly with no 'day 1' profit recognition permitted under IFRS17 that was possible under IFRS4, alongside other in-force timing effects.

The segmental comparison from IFRS4 to IFRS17, on the right hand chart, represents the combined effect of differences in product mix and differences in local accounting bases. Therefore, the impact of IFRS17 adoption differs in each country. Our IFRS17 operating profit is diversified across our reporting segments.

7: CSM & RA represent a significant stock of future profit

The construct of our IFRS balance sheet hasn't fundamentally changed, and as mentioned there is no material impact from adopting IFRS9.

As we indicated in March, our balance sheet, capital position and associated financial flexibility remain in very good shape. IFRS17 does not change any of these fundamentals.

The IFRS17 framework introduces three components in the measurement of insurance / reinsurance contracts. Firstly, there is the ‘Best estimate liabilities’ – or BEL. This represents the present value of our best estimate of future cash flows; the premiums, claims and expenses and so on, that are expected to arise, discounted on a market consistent, risk-neutral basis.

IFRS17 then applies an explicit prudence margin on top of the BEL to allow for uncertainty in calibrating non-market assumptions including mortality, morbidity and persistency. This is the Risk Adjustment. We have set this based on a 75th percentile risk level. This is released to profit as risk expires.

IFRS17 does not permit the recognition of ‘day 1’ profits at the point of sale. A further liability is raised, effectively acting as a balancing item such that no ‘day 1’ profit arises. This liability is the CSM. Over time, the CSM is a balance which will be released into earnings, acting as a source of future profit and so is similar in nature to the value of in-force in the Embedded Value framework.

In summary, the combined risk adjustment and contractual service margin represent a significant stock of future profit generation.

8 New business is the core driver of structural CSM growth

CSM development is the real engine of the IFRS17 framework.

Starting on the left of the chart, the opening CSM was $24.7 billion.

Over the course of the year, profitable new business grew the CSM by $2.1 billion.

Adding to this is the expected return, or unwind, of about $0.5 billion determined using risk neutral rates. The impact of additional real-world returns earned in the year is included within economic & other variances for VFA business.

These factors in combination added $2.6 billion, to the opening CSM balance.

The CSM balance is then updated for changes in expected future profitability, where applicable.

Short-term market effects on VFA business are captured in the CSM. 2022 was a period of significant macroeconomic volatility with materially higher interest rates and lower equity markets; the US 10 year yield increased from 1.5% to 3.9% and the MSCI Asia ex Japan index fell 24%. This drove the bulk of the $4.4 billion adverse variances. These market movements introduce some volatility into the amount of the release to P&L as well, albeit that this volatility is smoothed over the remaining life of the contracts or will reverse as market returns normalise.

The CSM release in the period of $2.2 billion represents the release of profit as insurance services are provided, and equates to a release rate of about 10%.

As I mentioned, the CSM release is calculated after all movements in the period. For example, it will reflect a degree of new business written for the period as well as any market movements relating to VFA business. The new business increment will be a function of which market, product type and the volume sold. For example, long duration Hong Kong savings products will only produce a small increment in any one year or part of the year.

This release calculation is refreshed every reporting cycle based on the latest market movements and assumptions. Effectively this means that the full year reported release does not necessarily equal the first half plus the second half release given potential revaluation effects, similar to our EV reporting.

From a structural point of view, growth in adjusted operating profit over time depends upon growing the CSM balance. To do this, new business and unwind effects need to exceed the amount being released as services are provided, absent market movements.

9 CSM release drives IFRS17 adjusted insurance operating profit

Turning to the components of the IFRS17 insurance adjusted operating profit, the contractual service margin release, reflecting services provided in the period – the $2.3 billion – is the key driver. The remaining components are:

- The release of the Risk Adjustment or 'RA' of $0.2 billion which represents the expiry of non-market risk in the financial period. This release in relation to the opening balance should be relatively stable.
- Experience variances from our non-market assumptions (covering, claims and expenses, for example) were a small component and represented a negative $0.1 billion. This is again analogous to EEV operating variances where we have a long-term track record of positive variances.
- And, the 'other insurance service result', which is largely comprised of losses relating to onerous contracts. It is worth noting that these do not necessarily mean these contracts are loss making over the life of the policy, because IFRS17 does not allow for <u>any</u> of the future real world returns we expect to earn on the assets backing these contracts, nor the expected release of the risk adjustment.
- These, with the addition of CSM release, represent the adjusted insurance service result which accounts for two thirds of adjusted operating profit.

The other key component of adjusted operating profit is the net investment result of $1.3 billion recorded on a long-term basis. This broadly reflects the expected long-term return on assets within our insurance business backing our shareholders' equity and the expected long-term spread income on assets backing GMM liabilities, and splits roughly two thirds / one third respectively.

Note that for adjusted operating profit purposes, we apply the long-term expected rates to the start-year balance. Financial investments were down about 15% over 2022 as a result of market movements, and this effect will flow into our 2023 net investment result.

Finally, we have a very moderate level of other income and expenditure of $0.1 billion, mainly related to non-attributable expenses, and $0.1 billion related to tax charges for our insurance JVs and associates.

The total adjusted operating profit for the insurance entities in 2022 was $3.3 billion.

10 Compounding effect of new business added to CSM supports growth in insurance profit over time

As I mentioned, the CSM represents a stock of unearned profit. If the contribution from new business and interest unwind exceeds the deduction for services provided, the CSM balance will increase. So, the key to sustainable growth is the addition of profitable new business cohorts, driving growth in both the CSM balance and the CSM release. I have repeated the 2022 roll-forward of the CSM balance on the left hand side to illustrate this.

The right hand chart shows how under IFRS17, insurance profit is driven by the combination of the release of the in-force CSM over time, shown in dark blue, and the compounding effect of the release of new business CSM, shown by adding additional 'layers' year-by-year, all of which is recognised as insurance services are provided.

The figures in the dark blue bar represent the pre-tax CSM release in 2022, and the expected discounted release pattern of the 2022 year-end CSM balance, based on year-end economics and assumptions. These amounts will be added to by the cumulative unwind effect on these discounted expected cash flows, and the uplift as 'real world' returns are recognised in the year they are earned. These additions are illustrated in the light-blue bars.

Looking ahead, it is reasonable to project the new business CSM in the same way you would for EEV new business profits, referencing APE as a measure of sales volume, and then considering the usual dynamics of product and channel mix, and interest rate movements.

While we had a good first quarter performance, as we explained in our Business Update, the overall effect on 2023 profits will be very muted as only a portion of the profit from new sales is recognised in the income statement. However, as new business CSM builds in 2023 and beyond, the mechanics of IFRS17 support future adjusted operating profit growth over time.

11 IFRS17: Group adjusted operating profit remains a KPI

Having run through the insurance elements, let's now turn to the Group's overall comprehensive income.

Firstly, the contribution from Eastspring is unchanged from that reported previously at $0.3 billion.

Central costs are also largely unchanged and the guidance we provided in March in terms of central costs, interest costs, and IFRS17 related costs going forwards, is also unchanged.

Overall, our IFRS17 group adjusted operating profit came to $2.7 billion. On an adjusted operating basis, our IFRS17 RoE was 12% for the 2022 year.

We then recognise adverse short-term fluctuations of $3.4 billion within the income statement. 2022 was a period of significant macroeconomic volatility with interest rates up, credit spreads widening and equities down, impacting our IFRS4, IFRS17 and EV results. It is worth remembering that IFRS17 is on an active approach, re-setting each period our economic assumptions based on the actual government bond yields and corporate bond spreads relevant to each market.

With approximately 70% of our business measured using the VFA, a considerable portion of this volatility was taken to CSM and will be smoothed into operating profit over time via the CSM release. In contrast, the non-operating income statement effect is largely the true-up between the long-term investment spreads on GMM liabilities and the long-term returns on assets backing capital and equity assumed within our operating profit result and the actual realised returns earned in the year.

We are working on producing aggregated financial market sensitivities, and will share them with you at our 2023 results.

In respect of tax, lower 2022 IFRS17 profit, mainly in markets where tax is not based on accounting profits, mechanically results in a tax charge arising on a pre-tax loss.

At an operating profit level, there is a marginally higher effective tax rate of 19 per cent.

As we apply fair value through the P&L for nearly all of our investments, investment movements largely have no impact on OCI which reflects FX movements and value movements on our residual interest in Jackson.

12 EEV vs IFRS17: Key difference economic assumptions

The key management lens that we use to measure value creation is Embedded Value.

Our Embedded Value framework is linked to our regulatory balance sheet and consequently our capital generation. So, we believe our Embedded Value framework remains important.

Under this framework, we use management expectations of real world returns in combination with risk adjusted discount rates. Our Group Embedded Value of $42.2 billion is management's best estimate of the discounted value we expect to generate from both insurance and investment activities. Of this, the value of in-force is $27.3 billion and net assets $14.9 billion.

While there are many similarities between IFRS17 accounting and Prudential's Embedded Value framework, as you can see from the chart, the main difference between the two bases is really the suite of economic assumptions:

- IFRS17 is risk-neutral and market consistent, whereas EEV reflects our ability to earn risk adjusted real-world returns.
- As a consequence, in EEV, we project cash flows based on expected returns appropriate for each asset class. This compares with an assumption that assets can only earn a risk free return plus, where applicable, a liquidity premium on an IFRS17 basis.
- In IFRS17 the liabilities are also discounted using the same risk-free rate plus liquidity premium. This premium is based on the liquidity characteristics of the liabilities, with less liquid liabilities having a higher liquidity premium and the most liquid liabilities having no liquidity premium. EEV uses a risk adjusted discount rate, which is higher.
- IFRS17 uses the full risk-free yield curve, whereas in EEV we generally apply a simpler flat yield curve other than to determine the time value of options and guarantees.

There are other small differences such as the non-attributable expenses I mentioned earlier.

Then, non-economic assumptions such as mortality, morbidity and lapses are the same between IFRS17 and EEV. In terms of the allowance for risk on these factors, our EEV allowance at FY22 is $2.8 billion, being 7 per cent of EEV equity compared with the $1.8 billion IFRS17 after tax risk adjustment, representing 5 per cent of adjusted shareholders' equity.

That takes you to the IFRS17 adjusted equity position of $35.2 billion. This comprises:

- The CSM, net of tax, and
- A $1.3 billion adjustment for reinsurance netted against the CSM that relates entirely to policyholders.

So, we remain comfortable with the Embedded Value 'real-world' economic approach as this aligns to our long-term savings product propositions and associated business.

13 History of materially positive EEV operating and economic variances

The longer-term record of operating and economic variances is an important validation of our assumptions.

In respect of operating experience and assumption changes, this represents an average net positive addition of 1.1% in relation to opening EV since 2011. This includes some volatility seen over the pandemic period. Over 2011 to 2019 the average is a net positive addition of 1.4%.

While the history of economic variance is inevitably more volatile from year to year, over the same period this comes to an average deduction of 0.9%, including the very difficult 2022 year. On a pre-pandemic view, the average is a net positive addition of 0.8%. This demonstrates that the real world returns assumed in our EV have been earned over the longer-term.

14 New business CSM vs EEV NBP: Key difference economic assumptions

Exactly the same principles explain the difference between EEV new business profit and IFRS17 new business CSM. As shown on the chart, these are

- First, different economic assumptions, and
- Secondly that IFRS17 new business CSM is presented before tax

There is also one minor scope difference. Our IFRS17 approach considers insurance contracts as a whole, which will often combine various riders with the base savings contract. Unlike EEV, any top-up to these riders is included as a variance to the base contract, rather than flowing into new business. An indication of the value of these riders has been added to make this more comparable to EEV new business.

15 Key takeaways

I trust my presentation has provided you with a reasonably accessible guide to our IFRS17 reporting.

As I said at the start; this is an accounting change – there is no change to the economics or attractive fundamentals of our business. We have:

- Market leading positions across both the life and asset management markets of Greater China, South-east Asia, India and Africa.
- The demand in these markets is driven by structural trends
- And, we have well-diversified distribution,

All of which will contribute to our ability to grow profitable new business.

Looking ahead, we expect compounding growth from new business CSM will support growth in IFRS17 adjusted operating profit over time.

And finally, our long-established embedded value framework, which is linked to the Group's regulatory position and consequently future capital generation, is more representative of shareholder value.

I look forward to seeing you on August 30th when we will present our first half 2023 result on an IFRS17 basis.

Thank you.