

## Part IV

### **Risk Factors**

A number of factors (risk factors) affect Prudential's operating results, financial condition and trading price. In common with other industry participants, the profitability of the Group's life insurance business depends primarily upon investment performance, administration and acquisition expense, mortality and morbidity trends and policy surrender rates. Risk factors include economic and market conditions, foreign currency exchange rate fluctuations, regulation, government policy and legislation, competition, credit ratings, and operational systems and processes.

The risk factors mentioned below should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. The information given is as at 15 October 2004, is not updated, and any forward-looking statements are made subject to the reservations specified on page 2 of this document.

You should carefully consider the risk factors described below before making a decision to participate in the Rights Issue. You should also refer to the other information set out in this document.

### **Prudential's businesses are inherently subject to market fluctuations and general economic conditions.**

Prudential's businesses are inherently subject to market fluctuations and general economic conditions. In the UK, this is largely because Prudential's shareholders' profit is related to bonuses for policyholders declared on its with-profits products, which are broadly based on historic and current rates of return on equity, real estate and fixed income securities, as well as Prudential's expectations of future investment returns.

In the US, fluctuations in prevailing interest rates can affect results from Jackson National Life which is predominantly a spread-based business with the majority of its assets invested in fixed income securities. In particular, fixed annuities and stable value products in Jackson National Life expose the Group to the risk that changes in interest rates which are not fully reflected in the interest rates credited to customers will reduce spread. The spread is the difference between the amounts that Jackson National Life is required to pay under the contracts, and the rate of return it is able to earn on its general account investments to support the obligations under the contract. Declines in spread from these products or other spread businesses that Jackson National Life conducts could have a material impact on its businesses or results of operations.

Similar factors can also impact on Prudential's operations in Asia.

In all markets in which Prudential operates, its businesses are susceptible to general economic conditions, which can change the level of demand for Prudential's products. Past uncertain trends in international economic and investment climates which have adversely affected Prudential's business and profitability could be repeated. This adverse effect would be felt principally through reduced investment returns and credit defaults in fixed interest corporate bonds, and may continue to affect the business unless conditions improve. In addition, falling investment returns could impair Prudential's operational capability, including its ability to write significant volumes of new business.

### **Prudential is subject to the risk of exchange rate fluctuations owing to the geographical diversity of its business.**

Due to the geographical diversity of Prudential's businesses, it is subject to the risk of exchange rate fluctuations. Prudential's international operations in the US, Asia and Europe, which represent a significant proportion of operating profit and shareholders' funds, generally write policies and invest in assets denominated in local currency. Although this practice limits the effect of exchange rate fluctuations on local operating results, it can lead to significant fluctuations in Prudential's consolidated financial statements upon translation of results into pounds sterling. The currency exposure relating to the translation of reported earnings is not separately managed. Consequently, this could impact on the Group's gearing ratios (defined as debt over debt plus shareholder funds). The impact of gains or losses on currency translations is recorded as a component of shareholders' funds within the consolidated statement of total recognised gains and losses.

**Prudential conducts its businesses subject to regulation and associated regulatory risks, including the effects of changes in the laws, regulations, policies and interpretations in the markets in which it operates.**

Changes in government policy, legislation or regulatory interpretation applying to companies in the financial services and insurance industries in any of the markets in which Prudential operates may adversely affect Prudential's product range, distribution channels, capital requirements and, consequently, reported results and financing requirements. These changes include possible changes in government pension arrangements and policies, the regulation of selling practices and solvency requirements. For instance, in the UK the FSA's proposals on reforming the UK polarisation regime and consultation paper on treating with-profits policyholders fairly and the HM Treasury report on medium and long-term retail savings could have a significant effect on types of products sold by Prudential, how its products are priced, distributed and sold and on shareholders' return on with-profits business.

Similar changes in regulation in other jurisdictions could also have an impact elsewhere in the Group.

The EU Insurance Groups Directive, which was implemented in the UK in 2001, together with the Financial Conglomerates Directive, which will be implemented by 2005, will require European financial services groups to demonstrate net aggregate surplus capital in excess of solvency requirements at the Group level in respect of shareholder-owned entities. The EU is also currently reviewing future solvency requirements (the Solvency II review). The implementation of these directives will lead to Prudential being required to maintain a somewhat higher level of capital at the Group level than necessary in respect of some of its businesses, or alternatively, to constrain the growth of those businesses, or to take other appropriate action. The FGD parent company solvency requirements will have to be complied with continuously starting 1 January 2005, with the result that Prudential will need to maintain an appropriate level of capital at the parent company to accommodate, for example, short term movements in global foreign exchange rates, interest rates, deterioration in the credit quality of the Group's bond portfolios and equity markets. In addition, an inconsistent application of these directives by regulators in different EU member states may place Prudential at a competitive disadvantage to other European financial services groups.

Various jurisdictions in which Prudential operates have created investor compensation schemes that require mandatory contributions from market participants in some instances in the event of a failure of a market participant. As a major participant in the majority of its chosen markets, circumstances could arise where Prudential, along with other companies, may be required to make such contributions.

**The resolution of several issues affecting the financial services industry, could have a negative impact on Prudential's reported results or on its relations with current and potential customers.**

Prudential is, and in the future may be, subject to legal and regulatory actions in the ordinary course of its business, both in the UK and internationally. This could be a review of business sold in the past under previously acceptable market practices at the time. Pending legal and regulatory actions include proceedings relating to aspects of Prudential's business and operations and which are typical of the business it operates such as the requirement in the UK to provide redress to certain past purchasers of pension and mortgage endowment policies and regulatory reviews on products sold and industry practices, including in the latter case businesses it has closed. Although Prudential believes it has adequately reserved in all material aspects for the costs of litigation and regulatory matters, no assurance can be provided that such reserves are sufficient. It is possible that Prudential's future performance could be affected by an unfavourable outcome in these matters.

**Prudential's businesses are conducted in highly competitive environments and Prudential's continued profitability depends on its management's ability to respond to these pressures.**

The markets for UK, US and Asian financial services are highly competitive, with several factors affecting Prudential's ability to sell its products, including price and yields offered, financial strength and ratings, range of product lines and product quality, brand strength and name recognition, investment management performance and historical bonus levels. In some of its markets Prudential faces competitors that are larger, have greater financial resources or a greater market share, offer a broader range of products or have higher bonus rates or claims-paying ratios.

Within the UK, Prudential's principal competitors in the life market include many of the major stock and mutual retail financial services companies including, in particular, Aviva, Legal & General, HBOS and Standard Life.

Jackson National Life's competitors in the United States include major stock and mutual insurance companies, mutual fund organisations, banks and other financial services companies. Jackson National Life's principal life insurance company competitors in the United States include AXA Financial, Inc., Lincoln National Corporation, Transamerica Corporation, Nationwide Financial Services, Inc., SunAmerica, Inc. and Hartford Life, Inc.

Within Asia, Prudential's main regional competitors are international financial companies, including AIG, Allianz, ING and Manulife.

Prudential believes competition will intensify across all regions in response to consumer demand, technological advances, the impact of consolidation, regulatory actions and other factors. Prudential's ability to generate an appropriate return depends significantly upon its capacity to anticipate and respond appropriately to these competitive pressures.

**Downgrades in Prudential's financial strength and credit ratings could significantly impact its competitive position and hurt its relationships with creditors or trading counterparties.**

Prudential's financial strength and credit ratings, which are intended to measure its ability to meet policyholder obligations, are an important factor affecting public confidence in most of Prudential's products, and as a result its competitiveness. Downgrades in Prudential's ratings could have an adverse effect on its ability to market products and retain current policyholders. In addition, the interest rates Prudential pays on its borrowings are affected by its debt credit ratings, which are in place to measure Prudential's ability to pay its contractual obligations. On 20 December 2002, Moody's downgraded the financial strength rating of Prudential Assurance's long-term fund from Aaa (on review for possible downgrade) to Aa1 (stable outlook). On 29 January 2003, Standard & Poor's downgraded the financial strength rating of Prudential Assurance's long-term fund from AAA (negative outlook) to AA+ (stable outlook). Prudential believes the downgrades that it, and the rest of the UK insurance industry, experienced have not to date had a discernible impact on its performance.

Prudential's long-term senior debt is rated as A2 (stable outlook) by Moody's, AA- (negative outlook) by Standard & Poor's and aa- by AM Best. Prudential's short-term debt is rated as P-1 by Moody's and A1+ by Standard & Poor's.

**Adverse experience in the operational risks inherent in Prudential's business could have a negative impact on its results of operations.**

Operational risks are present in all of Prudential's businesses, including the risk of direct or indirect loss resulting from inadequate or failed internal and external processes, systems and human error or from external events. Prudential's business is dependent on processing a large number of complex transactions across numerous and diverse products, and is subject to a number of different legal and regulatory regimes. In addition, Prudential manages several outsourced operations which include certain UK processing and IT functions. In turn, Prudential is reliant upon the operational processing performance of its outsourcing partners.

Further, because of the long-term nature of much of Prudential's business, accurate records have to be maintained for significant periods. Prudential's systems and processes are designed to ensure that the operational risks associated with its activities are appropriately controlled, but any weakness in the systems could have a negative impact on its results of operations during the effective period. Prudential has not experienced or identified any operational risks in its systems or processes during 2003, or subsequently which have caused, or are expected to cause, a significant negative impact on its results of operations.

**Changes in mortality experienced by Prudential's UK pension annuity policyholders could significantly affect Prudential's results of operations.**

Prudential is a major participant in the UK pensions annuity market. In exchange for a premium equal to the capital value of their accumulated pension fund, each pension annuity policyholder receives a guaranteed payment, usually monthly, for as long as they are alive. For a smaller monthly payment, certain annuity contracts extend the right to the payment to surviving spouses. As part of its pension annuity pricing and reserving policy Prudential assumes that current rates of mortality continuously

improve over time. Annuity mortality assumptions were revised in 2003 to assume future improvements in mortality for males and females at levels projected on the Continuous Mortality Investigations (CMI) medium cohort table as published by the Institute and Faculty of Actuaries. This corresponds to annual improvement rates at the current time of 2.6% and 3.5% respectively for 65 and 70 year olds and 2.4% and 1.9% for the same ages in 5 years time. In addition and for the purposes of prudent statutory reserves these improvement rates were for male lives subject to a minimum of 2% a year. If mortality improvement rates significantly exceed the improvement assumed, Prudential's results of operations could be adversely affected.

**As a holding company, Prudential is dependent upon its subsidiaries to cover operating expenses and dividend payments.**

Prudential's insurance and investment management operations are generally conducted through direct and indirect subsidiaries. As a holding company, Prudential's principal sources of funds are dividends from subsidiaries, shareholder backed funds, the shareholder transfer from Prudential's long-term funds and any amounts that may be raised through the issuance of debt and commercial paper.

Certain of the subsidiaries have regulatory restrictions that can limit the payment of dividends, which could limit the Group's ability to pay dividends to shareholders.