ADDITIONAL INFORMATION ON LIABILITIES, GUARANTEES AND OPTIONS, AND CAPITAL OF LIFE INSURANCE BUSINESSES

1. BACKGROUND

The Accounting Standards Board (ASB) published FRS 27 'Life Assurance' in December 2004. The implementation of FRS 27 is governed by a Memorandum of Understanding (MoU) agreed between the UK's leading life assurance companies, the Association of British Insurers, and the ASB. Under the terms of the MoU certain unaudited narrative and numerical disclosures are required to be published in the companies' Annual Reports.

The information provided in this section of the Financial Review reflects the requirements of Annex 1 of the MoU.

In summary, the requirements address the following areas:

- for large UK with-profits life assurance businesses falling within the scope of the Financial Services Authority's realistic capital regime, memorandum disclosure of liabilities to policyholders determined in accordance with that basis, together with disclosure of the excess of realistic assets over realistic liabilities, is required;
- an abridged statement of capital held within life assurance businesses with supporting disclosures; and
- information on the assumptions used in the measurement of liabilities and the terms and conditions of options and guarantees relating to life assurance contracts. For those liabilities to policyholders resulting from options and guarantees that are not measured at fair value or on a statistical basis that takes into account all possible outcomes of the option or guarantee additional information is required.

The disclosures in this section of the Financial Review do not form part of the Company's financial statements and are unaudited.

2. TECHNICAL PROVISIONS AND RESERVES

Summary of Modified Statutory Basis Technical Provisions (Net of Reinsurance) and Reserves at 31 December 2004

	£m
UK and Europe Insurance Operations	
With-profits business	
Technical provisions:	
Prudential Assurance Company (PAC) With-Profits Sub-Fund (WPSF)[1]	49,263
Prudential Annuities Limited[2]	13,623
Scottish Amicable Insurance Fund (SAIF)[3]	11,732
Total technical provisions of the PAC WPSF and SAIF[4]	74,618
Fund for Future Appropriations[5]:	
WPSF	14,465
SAIF[3]	1,836
	16,301
Total technical provisions and reserves of the PAC WPSF and SAIF	90,919
Shareholder-backed business	
Technical provisions:	
Prudential Retirement Income Limited[6]	5,978
Non-profit unit-linked business of other subsidiaries	13,587
Other	1,362
Total technical provisions of shareholder-backed business	20,927
Total UK and Europe Insurance Operations	111,846
US Operations	
Policy reserves and liabilities on non-linked business:	
Reserves for future policyholder benefits and claims payable	471
Deposits on investment contracts	17,832
Guaranteed Investment Contracts	987
Unit-linked (variable annuity) business	5,392
Total US Operations	24,682
Asian Operations	
With-profits and other non-linked business[7]	6,143
Fund for Future Appropriations of Asia subsidiaries[5]	385
Unit-linked business	1,713
Total Asian Operations	8,241
Total Group:	
Technical provisions and unit-linked liabilities	128,083
Fund for Future Appropriations	16,686
	144,769

[1] Includes inwards reassurance of all with-profits business written in the UK and Europe by other Group companies. For the purposes of this table and subsequent explanation, references to the WPSF also include, for convenience, the amounts attaching to the Defined Charges Participating Sub-Fund.

[2] Wholly-owned subsidiary of the PAC WPSF that writes annuity business.

[3] The Scottish Amicable Insurance Fund (SAIF) is a separate sub-fund within the PAC long-term business fund. This sub-fund contains all the with-profits business and all other pension business that was transferred from the Scottish Amicable Life Assurance Society to PAC in 1997. No new business is written in the sub-fund. The sub-fund is managed to ensure that all the invested assets of SAIF are distributed to SAIF policyholders over the lifetime of the SAIF policies.

[4] Excluding technical provisions of the Hong Kong branch of PAC.

[5] The Fund for Future Appropriations (FFA) represents the excess of assets over policyholder liabilities for with-profits funds and which has yet to be allocated between policyholders and shareholders. The SAIF FFA is wholly attributable to SAIF policyholders but has yet to be allocated.

[6] Wholly-owned shareholder subsidiary that writes annuity business.

[7] Including technical provisions of the Hong Kong branch of PAC.

3. UNITED KINGDOM AND EUROPE INSURANCE OPERATIONS

Prudential's long-term products in the UK consist of life insurance, pension products and pension annuities.

These products are written primarily in:

- one of three separate sub-funds of the PAC long-term fund, namely the With-Profits Sub-Fund, the Scottish Amicable Insurance Fund, and the non-profit sub-fund;
- Prudential Annuities Limited, which is owned by the PAC With-Profits Sub-Fund;
- Prudential Retirement Income Limited, a shareholder owned subsidiary; or
- other shareholder backed subsidiaries writing mainly non-profit unit-linked business.

3(a) With-Profits Products and PAC With-Profits Sub-Fund

Within the balance sheet of UK and Europe Insurance Operations there are technical provisions of £49.3bn and a Fund for Future Appropriations of £14.5bn that relate to the With-Profits Sub-Fund (WPSF). The WPSF mainly contains with-profits business but it also contains some non-profit business (unit-linked, term assurances and annuities). The WPSF's profits are apportioned 90% to its policyholders and 10% to shareholders as surplus for distribution is determined via the annual actuarial valuation.

With-profits products provide returns to policyholders through bonuses that are smoothed. There are two types of bonuses: annual and final. Annual bonuses are declared once a year, and once credited, are guaranteed in accordance with the terms of the particular product. Unlike annual bonuses, final bonuses are guaranteed only until the next bonus declaration.

When determining policy payouts, including final bonuses, Prudential considers policyholders' reasonable expectations, the need to smooth claim values and payments from year-to-year and competitive considerations, together with 'asset shares' for specimen policies. Asset shares broadly reflect the value of premiums paid plus the investment return on the assets notionally attributed to the policy, less the other items to be charged such as expenses and the cost of the life insurance cover.

For many years, UK with-profits product providers, such as Prudential, have been required by law and regulation to consider the reasonable expectations of policyholders in setting bonus levels. This concept is established by statute but is not defined. However, it is defined within the regulatory framework which also now contains an explicit requirement to treat customers fairly.

The technical provisions reported under the modified statutory basis of accounting for the WPSF are primarily for two broad types of business. These are accumulating with-profits and conventional with-profits (and other protection type policies). The provisions have been determined on a basis consistent with the detailed methodology included in regulations contained in the FSA's rules for the determination of regulatory reporting reserves. Details of the process for setting assumptions and determination of liabilities, together with the particularly sensitive assumptions are set out in note 3 to the financial statements.

The WPSF held a provision of £49m at 31 December 2004 to honour guarantees on a small amount of guaranteed annuity products. SAIF's exposure to guaranteed annuities is described below.

Beyond the generic guarantees described above there are very few explicit options or guarantees such as of minimum investment returns, surrender values or annuity at retirement and any granted have generally been at very low levels.

Valuation of the generic with-profits and other explicit guarantees of the WPSF and SAIF is required by the FSA's new realistic capital regime, which applies from 31 December 2004, as also described below.

3(b) Annuity Business

Prudential's conventional annuities include level, fixed-increase and Retail Prices Index (RPI) annuities. They are mainly written within the subsidiaries Prudential Annuities Limited and Prudential Retirement Income Limited, but there are some annuity liabilities in the WPSF and SAIF.

Prudential's fixed-increase annuities incorporate automatic increases in annuity payments by fixed amounts over the policyholder's life. The RPI annuities that Prudential offers provide for a regular annuity payment to which an additional amount is added periodically based on the increase in the UK Retail Prices Index. Prudential's with-profits annuities, which are written in the WPSF, combine the income features of annuity products with the investment smoothing features of with-profits products and enable policyholders to obtain exposure to investment return on the WPSF's equity shares, property and other investment categories over time.

Policyholders select an anticipated bonus from the specific range Prudential offers for the particular product. The amount of the annuity payment each year depends upon the relationship between the anticipated bonus rate selected by the policyholder when the product is purchased and the bonus rates Prudential subsequently declares each year during the term of the product. If the total bonus rates fall below the anticipated rate, then the annuity income falls.

The long-term business provision for these companies is based on the FSA regulatory solvency basis. The valuation is then modified for MSB reporting purposes to remove certain of the margins for prudence within the assumptions and contingency reserves, both of which are required under the solvency basis applied for regulatory purposes, but not for financial accounting.

The technical provisions are the discounted value of future claim payments, adjusted for investment expenses and future administration costs. The interest rate used for discounting claim payments is derived from the yield on the assets held with an allowance for default and mismatching risk. At 31 December 2004 the interest rates applied ranged from 1.5% to 5.0%. The mortality assumptions, which vary by age and gender, are differentiated between those applicable for group and individual business.

3(c) Scottish Amicable Insurance Fund

The Scottish Amicable Insurance Fund (SAIF) is a ring-fenced sub-fund of the PAC long-term fund and was formed following the acquisition of the mutually owned Scottish Amicable Life Assurance Society in 1997. No new business may be written in SAIF, although regular premiums are still being paid on policies in force at the time of the acquisition and incremental premiums are permitted on these policies.

The fund is solely for the benefit of policyholders of SAIF. Shareholders have no interest in the profits of this fund although they are entitled to investment management fees on this business.

The process for determining policyholder bonuses of SAIF with-profits policies, which constitute the vast majority of obligations of the funds, is similar to that for the with-profits policies of the WPSF. However, in addition, the surplus assets in SAIF are allocated to policies in an orderly and equitable distribution over time as enhancements to policyholder benefits i.e. in excess of those based on asset share.

Provision is made for the risks attaching to some SAIF unitised with-profits policies that have Market Value Reduction (MVR)-free dates and for those SAIF products which have a guaranteed minimum benefit on death or maturity of premiums accumulated at 4% per annum.

With the exception of certain guaranteed annuity products, SAIF with-profits policies do not guarantee minimum rates of return to policyholders.

The Group's main exposure to guaranteed annuities in the UK is through SAIF and a provision of £648m was held in SAIF at 31 December 2004 to honour the guarantees. As SAIF is a separate sub-fund solely for the benefit of policyholders of SAIF, this provision has no impact on the financial position of the Group's shareholders' funds.

3(d) Unit-Linked and Other Non-Profit Business

Prudential UK and Europe Insurance Operations also have an extensive book of unit-linked policies of varying types and provides a range of other non-profit business such as stakeholder, credit life and non-life long-term contracts. These contracts do not contain significant financial guarantees.

There are no guaranteed maturity values or guaranteed annuity options on unit-linked policies except for minor amounts for certain policies linked to cash units within SAIF.

3(e) Impact of FSA Realistic Capital Regime on the PAC With-Profits Fund

The amounts shown in the consolidated balance sheet for technical provisions and Fund for Future Appropriations for with-profits business of the PAC with-profits fund i.e. the WPSF and SAIF have been determined in accordance with the modified statutory basis of accounting. With the exception of minor accounting adjustments, the technical provisions reflect the UK regulatory basis of reporting that has applied for many years, and which effectively constitutes the Peak 1 basis under the new FSA regime.

The FSA's Peak 2 calculation under the new realistic regime, which comes fully into effect for the first time for 2004 regulatory reporting requires the value of liabilities to be calculated as:

- a with-profits benefits reserve (WPBR); plus
- future policy related liabilities (FPRL); plus
- the realistic current liabilities of the fund.

The WPBR is primarily based on the retrospective calculation of accumulated asset shares but is adjusted to reflect future expected policyholder benefits and other outgoings. By contrast, the Peak 1 basis addresses, at least explicitly, only declared bonuses.

The FPRL must include a market consistent valuation of costs of guarantees, options and smoothing, less any related charges, and this amount must be determined using either a stochastic approach, hedging costs or a series of deterministic projections with attributed probabilities. Under the Peak 1 basis there is an allowance on a deterministic basis for the intrinsic value of these costs.

The assumptions used in the stochastic models are calibrated to produce risk free returns on each asset class. Volatilities of, and correlations between, investment returns from different asset classes are as determined by the Group's Portfolio Management Group but are also market consistent.

The cost of guarantees, options and smoothing is very sensitive to the bonus, MVR and investment policy the Company employs and therefore the stochastic modelling incorporates a range of management actions that would help to protect the fund in adverse investment scenarios. Substantial flexibility has been included in the modelled management actions in order to reflect the discretion that the Company retains in adverse investment conditions, thereby avoiding the creation of unreasonable minimum capital requirements. The management actions assumed are consistent with our management policy for with-profits funds and our disclosures in the publicly available Principles and Practices of Financial Management.

3(f) FRS 27 Basis of Reporting the Financial Position of UK Regulated With-Profits Funds

The Peak 2 approach underpins the changed requirements of FRS 27, which the Group will adopt in 2005, as part of the implementation of International Financial Reporting Standards (IFRS) basis reporting.

Under FRS 27, the main changes that are required for UK with-profits funds are:

- de-recognition of deferred acquisition costs and related deferred tax;
- inclusion on the FSA Peak 2 basis of the value of in-force non-participating business written by the WPSF and SAIF; and
- replacement of modified statutory basis liabilities for with-profits business with adjusted realistic basis liabilities.

Adjusted realistic liabilities represent the Peak 2 realistic liabilities for with-profits business included in Form 19 of the FSA regulatory returns, but after excluding the element for shareholders' share of the future bonuses. This latter item is recognised as a liability for the purposes of regulatory returns but, for accounting purposes under FRS 27, consistent with the current basis of financial reporting, shareholder transfers are recognised only on declaration.

Applying this methodology the accounting position for the PAC with-profits fund (including the Hong Kong branch and SAIF) at 31 December 2004 is estimated to be as follows:

Realistic liabilities £69.0bn

The realistic liabilities of the WPSF and SAIF comprise:

- the estimated realistic value of with-profits liabilities for the purposes of FSA regulatory returns; less
- the estimated shareholders' share of future bonuses contained within that estimated regulatory basis liability; plus
- current liabilities.

Consistent with the regulatory basis of presentation, liabilities of non-participating business are not included.

Excess of £8.9bn of realistic assets over realistic liabilities

This excess has been determined on the accounting basis described above. For the avoidance of doubt, it has not been calculated on the same basis as the regulatory basis free assets referred to on page 21.

The principal reconciling items between the excess of £8.9bn and the £5bn referred to on page 21 are the shareholders' share of future bonuses on WPSF policies and excess assets held within SAIF.

4. US OPERATIONS

4(a) Products and Guarantees

Jackson National Life (JNL) provides long-term savings and retirement products to retail and institutional customers throughout the US. JNL offers individual fixed annuities, equity-indexed annuities, immediate annuities, variable annuities, life insurance and institutional products.

Fixed annuities

Interest sensitive annuities

In 2004, interest sensitive fixed annuities accounted for 41% of policyholder reserves of JNL. Interest sensitive fixed annuities are primarily deferred annuity products that are used for retirement planning and for providing income in retirement. They permit tax-deferred accumulation of funds and flexible payout options.

The policyholder of an interest sensitive fixed annuity pays JNL a premium, which is credited to the policyholder's account. Periodically, interest is credited to the policyholder's account and in some cases administrative charges are deducted from the policyholder's account. JNL makes benefit payments at a future date as specified in the policy based on the value of the policyholder's account at that date.

The policy provides that at JNL's discretion it may reset the interest rate, subject to a guaranteed minimum. The minimum guarantee varies from 1.5% to 5.5% depending on the date of issue, with 73% of the fund at 3% or less at 31 December 2004. The average guarantee rate is 3.3%.

Approximately 22% of the interest-sensitive fixed annuities JNL wrote in 2004 provide for a market value adjustment, that could be positive or negative, on surrenders in the surrender period of the policy. This formula based adjustment approximates the change in value that assets supporting the product would realise as interest rates move up or down. The minimum guaranteed rate is not affected by this adjustment.

Equity indexed annuities

Equity indexed annuities account for 6% of JNL's policyholder reserves at 31 December 2004. Equity indexed annuities vary in structure, but generally are deferred annuities that enable policyholders to obtain a portion of an equity linked return but provide a guaranteed minimum return. These guaranteed minimum rates are generally set at 3%.

JNL hedges the equity return risk on equity indexed products by purchasing futures and options on the relevant index. The cost of these hedges is taken into account in setting index participation rates. JNL bears the investment and surrender risk on these products.

Immediate annuities

At 31 December 2004, immediate annuities accounted for 2% of JNL's policyholder reserves. Immediate annuities guarantee a series of payments beginning within a year of purchase and continuing over either a fixed period of years and/or the life of the policyholder. If the term is for the life of the policyholder, then JNL's primary risk is mortality risk. The implicit interest rate on these products is based on the market conditions that exist at the time the policy is issued and is guaranteed for the term of the annuity.

Variable annuities

At 31 December 2004, variable annuities (VA) accounted for 26% of JNL's policyholder reserves. Variable annuities are deferred annuities that have the same tax advantages and payout options as interest-sensitive and equity-indexed fixed annuities.

The primary difference between variable annuities and interest sensitive or equity indexed fixed annuities are investment risk and return. If a policyholder chooses a variable annuity, the rate of return depends upon the performance of the selected fund portfolio. Policyholders may allocate their investment to either the fixed or variable account. Investment risk on the variable account is borne by the policyholder, while investment risk in the fixed account is borne by JNL through guaranteed minimum fixed rates of return. At 31 December 2004, approximately 26% of variable annuity funds were in fixed accounts.

JNL issues variable annuity contracts where it contractually guarantees to the contract holder either: a) return of no less than total deposits made to the contract adjusted for any partial withdrawals; b) total deposits made to the contract adjusted for any partial withdrawals plus a minimum return; or c) the highest contract value on a specified anniversary date adjusted for any withdrawals following the contract anniversary. These guarantees include benefits that are payable in the event of death (guaranteed minimum death benefit (GMDB)), annuitisation (guaranteed minimum income benefit (GMIB)), or at specified dates during the accumulation period (guaranteed minimum withdrawal benefit (GMWB)).

Life insurance

JNL's life insurance products accounted for 10% of JNL policyholder reserves at 31 December 2004. The products offered include term life insurance and interest sensitive life insurance.

Institutional products

JNL's institutional products consist of guaranteed investment contracts (GICs), funding agreements, and medium term note funding agreements. At 31 December 2004 institutional products accounted for 15% of JNL's policyholder reserves.

Under a traditional GIC, the policyholder makes a lump sum deposit. The interest rate paid is fixed and established when the contract is issued. If deposited funds are withdrawn earlier than the specified term of the contract, an adjustment is made that approximates a market value adjustment.

Under a funding agreement, the policyholder either makes a lump sum deposit or makes specified periodic deposits. JNL agree to pay a rate of interest, which may be fixed but which is usually a floating short-term interest rate linked to an external index. The average term of the funding arrangements is one to two years. Funding agreements terminable by the policyholder with less than 90 days notice account for less than 2% of JNL total policyholder reserves.

Medium term note funding agreements are generally issued to support trust instruments issued on non-US exchanges or to qualified investors (as defined by SEC rule 144A). Through the funding agreements, JNL agrees to pay a rate of interest, which may be fixed or floating, to the holders of the trust instruments.

4(b) Process for Setting Assumptions and Determining Liabilities

Under the Modified Statutory Basis of reporting, providing the requirements of the Companies Act, UK GAAP standards and the ABI SORP are met, it is permissible to reflect the local basis of provisioning. In the case of JNL, except for adjustments for certain items, the carrying values of insurance assets and liabilities are consolidated into the Group accounts based on US Generally Accepted Accounting Principles (US GAAP). The exceptions are for equity-indexed annuities, VA GMWB benefits, and VA GMIB benefits. Equity-indexed annuities include embedded derivatives that are supported by equity call options, both of which are valued at fair value under US GAAP, but are held at amortised cost under MSB. VA GMWB and reinsurance of GMIB are held at fair value under US GAAP, but are recognised as a portion of accumulated assessments related to expected excess benefits under MSB.

Under US GAAP investment contracts are accounted for by applying in the first instance a retrospective deposit method to determination of the liability for policyholder benefits. This is then augmented by potentially three additional amounts. These amounts are for:

- any amounts that have been assessed to compensate the insurer for services to be performed over future periods (i.e. deferred income);
- any amounts previously assessed against policyholders that are refundable on termination of the contract; and
- any probable future loss on the contract (i.e. premium deficiency).

Profit recognition is determined by amortisation of capitalised acquisition costs over the life of the book of contracts at a constant rate based on estimated gross profit amounts expected to be realised over this period. In determining these estimated gross profits assumptions are made as to lapse and mortality rates, expenses, investment returns and policy crediting rates.

Variable annuity contracts written by JNL may, as described above, provide for GMDB, GMIB and GMWB. In general terms liabilities for these benefits are accounted for under US GAAP by using estimates of future benefits and fees under best estimate persistency assumptions.

The GMDB liability is determined each period end by estimating the expected value of death benefits in excess of the projected account balance and recognising the excess rateably over the accumulation period based on total expected assessments. At 31 December 2004, the GMDB liability was valued using a series of deterministic investment performance scenarios, a mean investment return of 8.4% and assumptions for lapse, mortality and expense that are the same as those used in amortisation of capitalised acquisition costs.

The GMIB liability is determined each period end by estimating the expected value of the annuitisation benefits in excess of the projected account balance at the date of annuitisation and recognising the excess rateably over the accumulation period based on total expected assessments.

JNL regularly evaluates estimates used and adjusts the additional GMDB and GMIB liability balances, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. The assumptions used for calculating the GMIB liability at 31 December 2004 are consistent with those used for calculating the GMDB liability.

The GMWB liabilities are recognised currently as accumulated charges for the benefit. This benefit has been issued since 2003 and both charges to date and projected excess benefits are minimal at 31 December 2004.

With the exception of the GMDB, GMIB and GMWB features of variable annuity contracts the financial guarantee features of JNL's contracts are, in most circumstances, not explicitly valued under the standard US GAAP basis of calculation, but the impact of any interest guarantees would be reflected as they are earned in the current account value (i.e. the US GAAP liability).

For traditional life insurance contracts, reserves for future policy benefits are determined under FAS 60 using the net level premium method and assumptions as of the issue date as to mortality, interest, policy lapsation and expenses plus provisions for adverse deviation.

5. ASIAN OPERATIONS

5(a) Technical Provisions

At 31 December 2004, the aggregate UK GAAP carrying value of technical provisions (net of reinsurance) for Asian Operations was some £7.9bn as follows:

	£m
Singapore	2,967
Hong Kong	1,717
Taiwan	1,451
Japan	666
Malaysia	507
Other countries	548
Total	7,856

This amount covers a range of with-profits, unit-linked and non-participating contracts.

5(b) Products

The life insurance products offered by Prudential Corporation Asia include a range of with-profits and non-participating term, whole life, endowment and unit-linked policies. Prudential Corporation Asia also offers health, disability, critical illness and accident coverage to supplement its core life products.

The terms and conditions of the contracts written in Prudential Corporation Asia's operations, and in particular the product's options and guarantees, vary from territory to territory depending upon local market circumstances.

In general terms, Prudential Corporation Asia's participating products provide savings and protection where the basic sum assured can be enhanced by a profit share (or bonus) from the underlying fund as determined at the discretion of the insurers. Prudential Corporation Asia's non-participating term, whole life and endowment products offer savings with protection where the benefits are guaranteed or determined by a set of defined market related parameters. Unit-linked products combine savings with protection: the cash value of the policy depends on the value of the underlying unitised funds. Accident and Health (A&H) policies provide mortality or morbidity benefits and include health, disability, critical illness and accident coverage. A&H products are commonly offered as supplements to main life policies but can be sold separately.

5(c) Guarantees

Subject to local market circumstances and regulatory requirements, the guarantee features described above in respect of UK business broadly apply to similar types of participating contracts written in the PAC Hong Kong branch, Singapore and Malaysia. Participating products have both guaranteed and non-guaranteed elements.

Non-participating long-term products are the only ones where the insurer is contractually obliged to provide guarantees on all benefits. Investment linked products have the lowest level of guarantee if indeed they have any.

Product guarantees in Asia can be broadly classified into four main categories, namely: Premium Rate; Cash Value and Interest Guarantees; Policy Renewability; and Convertibility Options.

Cash value and interest rate guarantees are of three types:

- Maturity values
  Maturity values are guaranteed for non-participating products and on the guaranteed portion of participating products. Declared annual bonuses are also guaranteed once vested. Future bonus rates and cash dividends are not guaranteed in participating products;

- Surrender values
  Surrender values are guaranteed for non-participating products and on the guaranteed portion of participating products. The surrender value of declared reversionary bonuses are also guaranteed once vested; and

- Interest rate guarantees
  It is common in Asia for regulations or market driven demand and competition to provide some form of capital value protection and minimum crediting interest rate guarantees. This would be reflected within the guaranteed maturity and surrender values.

The most significant book of non-participating business in Prudential Corporation Asia is Taiwan's whole of life contracts. For these contracts there are floor levels of policyholder benefits that accrue at rates set at inception which are set by reference to minimum terms established by local regulation also at the time of inception. These rates do not vary subsequently with market conditions.

Under these contracts the cost of premiums are also fixed at inception based on a number of assumptions at that time, including long-term interest rates, mortality assumptions and expenses. The guaranteed maturity and surrender values reflect the pricing basis.

These contracts have an expected average duration of some 25 years and the UK GAAP carrying value of the liabilities is some £1.1bn.

As explained below the method for determining liabilities for UK GAAP purposes for some Asian operations is based on US GAAP principles and this method applies to these contracts with cash value and interest rate guarantees. Following standard US GAAP procedure, premium deficiency reserve calculations are performed each year to establish whether the carrying values of the liabilities are insufficient.

On the US GAAP basis the calculations are deterministic, that is to say based off a single set of projections, and expected long-term rates of return are applied.

The main variable that determines the amounts payable under the contracts is the duration of the contracts, which is determined by death or surrender.

5(d) Process for Setting Assumption and Determining MSB Liabilities

The future policyholder benefit provisions for Asian businesses in the Group's modified statutory basis accounts are determined in accordance with methods prescribed by local GAAP adjusted to comply, where necessary, with UK GAAP.

For Asian operations in countries where local GAAP is not well established and in which the business written is primarily non-participating and linked business, US GAAP is used as the most appropriate reporting basis. Of the more significant Asian operations this basis is applied in Taiwan, Japan and Vietnam. The future policyholder benefit provisions for non-linked business are determined under FAS 60 using the net level premium method, with an allowance for surrenders, maintenance and claims expenses. Rates of interest used in establishing the policyholder benefit provisions vary by operation depending on the circumstances attaching to each block of business. Additional details are shown in note 3 to the financial statements.

6. CAPITAL POSITION STATEMENT

6(a) Reconciliation of Group Modified Statutory Basis Shareholders' Funds at 31 December 2004 to Available Capital on Local Regulatory Bases in the Group's Life Assurance Businesses

	£bn
Group shareholders' funds	4.3
less: shareholders' funds of non-insurance and other operations	(0.3)
add: Fund for Future Appropriations (per published balance sheet i.e. Peak 1 basis)	16.7
add: subordinated debt of SAIF and JNL	0.2
less: adjustments to restate these amounts on to a regulatory basis (including Peak 2 basis for WPSF and SAIF)	(12.0)
Total available capital in the life assurance business on local regulatory bases to meet local regulatory requirements	8.9
Distributed as	
United Kingdom and Europe:	
PAC: available capital of with-profits funds (including Hong Kong branch and SAIF) on the Peak 2 realistic basis*	6.0
Other UK subsidiaries	0.5
	6.5
Jackson National Life	1.8
Asian Operations	0.6
Total available capital on local regulatory bases to meet local regulatory requirements	8.9

*In determining available capital for the PAC WPSF, realistic liabilities reflect the regulatory Peak 2 basis inclusive of shareholders' share of future bonuses. In addition to the WPSF and SAIF, the PAC long-term fund includes the PAC Non-Participating Sub-Fund (NPSF). The available capital of the NPSF is subsumed within the Peak 1 basis available capital of the aggregate PAC long-term fund.

6(b) Basis of Preparation and Capital Requirements

Each of the Group's long-term business operations is capitalised to a sufficiently strong level for its individual circumstances. Details by the Group's major operations are shown below.

UK and Europe Insurance Operations

PAC WPSF and SAIF

In common with other large UK regulated with-profits funds PAC is required to hold capital equivalent to the greater of their regulatory requirement (based on EU Directives) (i.e. the regulatory peak) and the new FSA basis calculation of expected liabilities (i.e. the realistic peak).

Available capital of the WPSF and SAIF of £6.0bn represents the excess of assets over liabilities on the regulatory realistic basis. Unlike the previously discussed FRS 27 basis, realistic liabilities on the regulatory basis include the shareholders' share of future bonuses.

The regulatory basis version of realistic available capital of £6.0bn is shown before deduction of the risk capital margin (RCM) which is estimated to be £1.8bn at 31 December 2004.

The FSA's basis of setting the RCM is to target at a level broadly equivalent to a Standard & Poor's credit rating of BBB and of judging this by ensuring there are sufficient assets to absorb a 1 in 200 year event. The RCM calculation achieves this by setting rules for the determination of margins to cover defined stress changes in asset values and yields for market risk credit risk and termination risk for with-profits policies.

Other UK subsidiaries

The available capital of £0.5bn reflects the excess of regulatory basis assets over liabilities, before deduction of the capital resources requirement of £0.3bn.

The capital resources requirement for these companies broadly reflects a formula which, for active funds, equates to a percentage of regulatory reserves plus a percentage of death strains.

Jackson National Life

The regulatory framework for Jackson National Life (JNL) is governed by the requirements of the US National Association of Insurance Commissioners (NAIC) approved risk based capital standards. Under the requirements, life insurance companies report on a formula based capital standard that they calculate by applying factors to various asset, premium and reserve items. The formula takes into account the risk characteristics of a company, including asset risk, insurance risk, interest rate risk and business risk.

The available capital of JNL shown above of £1.8bn reflects US regulatory basis assets less liabilities after setting aside reserves for asset valuation and interest maintenance. The asset valuation reserve is designed to provide for future credit-related losses on fixed income securities and losses on equity investments. The interest maintenance reserve is designed by state regulators to defer recognition of non-credit related realised capital gains and losses.

JNL's risk based capital ratio equates to 4.3 times the NAIC Company Action Level Risk Based Capital.

Asian Operations

The available capital shown above of £0.6bn represents the excess of regulatory basis assets over liabilities before deduction of required capital of £0.2bn. These amounts have been determined applying the local regulations in each of the operations.

At the country level, the Group's businesses in Asia are subject to comprehensive and supervisory schemes in the jurisdictions in which they operate. The Hong Kong business branch of PAC and its capital requirements are subsumed within those of the PAC long-term fund. For other material operations the details of the basis of determining regulatory capital and requirements are as follows:

Singapore

A new risk-based regulatory framework was introduced at the start of 2005 to replace the previous framework that used a net premium approach.

For participating business, a gross premium reserve, determined using prudent best estimate assumptions and which makes allowance for future bonus, is held. The amount held is subject to a minimum of the higher of the assets attributed to participating business and a gross premium reserve calculated on specified assumptions, but without allowance for future bonus, that include prescribed provisions for adverse deviations (PADs).

For non-participating business, gross premium reserves are held. For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

From 1 January 2005, capital requirements are determined using a risk-based capital approach.

Taiwan

Basic policy reserves are determined using a net premium method. Both mortality and interest rates are specified. For more recent issues, the valuation rate of interest has been linked to the prevailing market rate on 10-year government bonds.

Solvency capital is determined using a risk-based capital approach.

Japan

Mathematical reserves for traditional business are determined on a net premium basis using prescribed mortality and interest rates. Interest rates reflect the original pricing assumptions.

For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

With regard to solvency, the adjusted solvency capital assets of the company must exceed 200% of the risk related capital requirement value at risk. It is thus a risk-based capital approach.

Malaysia

Mathematical reserves for traditional business are determined on a modified net premium basis using prescribed mortality and interest rates (no higher than 4%).

For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

The capital requirement is determined as 4% of reserves plus a specified percentage of sums at risk. There is an overriding minimum capital requirement of RM100m.

Group capital requirements

In addition to the requirements at individual company level, FSA requirements under the Insurance Groups Directive for 2004 and Financial Groups Directive apply additional prudential requirements for the Group as a whole, as discussed on page 20.

6(c) Transferability of Available Capital

For PAC and all other UK long-term insurers, long-term business assets and liabilities must, by law, be maintained in funds separate from those for the assets and liabilities attributable to non-life insurance business or to shareholders. Only the 'established surplus' – the excess of assets over liabilities in the long-term fund determined through a formal valuation – may be transferred so as to be available for other purposes. Distributions from the with-profits sub-fund to shareholders reflect the shareholders' one-ninth share of the cost of declared policyholders' bonuses.

Accordingly, the excess of assets over liabilities of the PAC long-term fund is retained within that company. The retention of the capital enables the company to support with-profits and other business of the fund by, for example, providing the benefits associated with smoothing and guarantees. It also provides investment flexibility for the fund's assets, by meeting the regulatory capital requirements that demonstrate solvency, and by absorbing the costs of significant events or fundamental changes in its long-term business without affecting the bonus and investment policies.

For other UK long-term business subsidiaries the amounts retained within the companies are at levels which provide an appropriate level of capital strength in excess of the regulatory minimum.

For Jackson National Life (JNL), capital retention is maintained at a level consistent with an appropriate rating by Standard & Poor's. Currently JNL is rated AA. JNL can pay dividends on its capital stock only out of earned surplus. Dividends which exceed the greater of 10% of JNL's statutory surplus or statutory net gain from operations for the prior year require prior regulatory approval.

For Asian subsidiaries, the amounts retained within the companies are at levels which provide an appropriate level of capital strength in excess of the local regulatory minimum. For ring-fenced with-profits funds, the excess of assets over liabilities is retained with distribution tied to the shareholders' share of bonuses through declaration of actuarially determined surplus. The Group's Singapore and Malaysian businesses may remit dividends to the Group, in general, provided the statutory insurance fund meets the capital adequacy standard required under local statutory regulations.

6(d) Sensitivity to Changed Market Conditions and Capital Management Policies

Prudential manages its assets, liabilities and capital locally, in accordance with local regulatory requirements and reflecting the different types of liabilities Prudential has in each business. As a result of the diversity of products offered by Prudential and the different regulatory requirements in which it operates, Prudential employs differing methods of asset/liability and capital management, depending on the business concerned.

Stochastic modelling of assets and liabilities is undertaken in the UK, the US and Asia to assess the economic capital requirements under different confidence intervals and time horizons. In addition, reserve adequacy testing under a range of scenarios and dynamic solvency testing is carried out, including under certain scenarios mandated by the UK, the US and Asian regulators.

A stochastic approach models the inter-relationship between asset and liability movements, taking into account asset correlation, management actions and policyholder behaviour, under a large number of alternative economic scenarios. These scenarios are projected forward over a period of time, typically 25 years or longer, and the liabilities and solvency position of the fund are calculated in each scenario in each future year. The fund's policy on management actions, including bonus and investment policy continue to be set in order that they are consistent with the available capital and the targeted risk of default.

The sensitivity of liabilities and other components of total capital vary depending upon the type of business concerned and this conditions the approach to asset/liability management.

For example, for businesses that are most sensitive to interest rate changes, such as immediate annuity business, Prudential uses cash flow analysis to create a portfolio of fixed income securities whose value changes in line with the value of liabilities when interest rates change. This type of analysis helps protect profits from changing interest rates. This type of analysis is used in the UK for annuity business and by JNL for its interest-sensitive and equity-indexed fixed annuities and stable value products.

For businesses that are most sensitive to equity price changes, Prudential uses stochastic modelling and scenario testing to look at the future returns on its investments under different scenarios and best reflect the large diversity in returns that equities can produce. This allows Prudential to devise an investment and with-profits policyholder bonus strategy that, on the model assumptions, allows it to optimise returns to its policyholders and shareholders over time while maintaining appropriate financial strength. Prudential uses this methodology extensively in connection with its UK with-profits business.

6(e) Intra-Group Arrangements in Respect of SAIF

Should the assets of SAIF be inadequate to meet the guaranteed benefit obligations to the policyholders of SAIF, the PAC long-term fund would be liable to cover any such deficiency. At 31 December 2004, the excess of SAIF assets over guaranteed benefits, accounted for as the SAIF FFA on the modified statutory basis, was £1.8bn. Due to the quality and diversity of the assets in SAIF, the excess of assets stated above, and the ability of SAIF to revise guaranteed benefits in the event of an asset shortfall, the directors believe that the probability of either the PAC long-term fund, or the Group's shareholders' funds under its obligation to maintenance of the capital position of long-term funds generally, having to contribute to SAIF is remote.