Business review

Results highlights

£m unless otherwise stated	2005	2004 (at CER)	Percentage change	2005	2004 (at RER)	Percentage change
Annual premium equivalent (APE) sales	**2,146**	1,867	15%	**2,146**	1,846	16%
Net investment flows	**5,189**	3,297	57%	**5,189**	3,284	58%
NBP	**867**	752	15%	**867**	741	17%
NBP margin (% APE)	**41%**	40%	–	**41%**	40%	–
NBP margin (% PVP)	**5.2%**	5.0%	–	**5.2%**	5.0%	–
Total EEV basis operating profit*	**1,712**	1,288	33%	**1,712**	1,274	34%
Total IFRS operating profit*†	**957**	703	36%	**957**	699	37%
EEV basis shareholders' funds	**10,301**	8,998	14%	**10,301**	8,614	20%
IFRS shareholders' funds†	**5,194**	4,837	7%	**5,194**	4,740	10%

*Based on longer-term investment returns from continuing operations – excluding Jackson Federal Bank (JFB) and Egg's France business, which were discontinued in 2004.

† Comparative IFRS results are prepared on a 'pro forma' basis which reflects the estimated effect on the 2004 results as if IAS 32, IAS 39 and IFRS 4 had been applied from 1 January 2004 to the Group's insurance operations together with the discretionary change for the basis of determining longer-term investment returns, as disclosed on 2 June 2005. IFRS operating profit is stated excluding goodwill impairment, short-term fluctuations in investments returns and shareholders' share of actuarial and other gains and losses on defined benefit pension schemes.

In the business review and financial review, year-on-year comparisons of financial performance are on a CER basis, unless specifically identified as being on a Reported Exchange Rate (RER) basis.

Group results

The Group has delivered a good set of results for 2005, as illustrated by the double-digit growth of nearly all the measures shown above.

As a result of improved sales in the UK, the US and Asia, the Group delivered strong new business profits (NBP) in 2005. This, together with the significant increase in contributions from the in-force insurance business and fund management operations, drove European Embedded Value (EEV) basis operating profit up 33 per cent on 2004.

On an International Financial Reporting Standards (IFRS) basis, operating profit based on longer-term investment returns was up 36 per cent on last year driven by the growth in profits from the long-term and fund management businesses.

Earnings per share, based on EEV basis operating profit based on longer-term investment returns after tax and related minority interests were 56.6 pence, compared with a figure of 43.2 pence in 2004.

Earnings per share, based on IFRS operating profit based on longer-term investment returns after tax and minority interests were 32.2 pence compared with a figure of 22.7 pence in 2004.

Impact of currency movements

Prudential has a diverse international mix of businesses with a significant proportion of its profit generated outside the UK. In 2005, 72 per cent of NBP and 54 per cent of IFRS operating profit was delivered from overseas operations. In preparing the Group's consolidated accounts, results of overseas operations are converted at rates of exchange based on the average for the year, whilst shareholders' funds are converted at year end rates of exchange.

Changes in exchange rates from year to year have an impact on the Group's results when these are converted into pounds sterling for reporting purposes. In some cases, these exchange rate fluctuations can mask underlying business performance.

Consequently, the Board has for a number of years reviewed the Group's international performance on a Constant Exchange Rate (CER) basis. This basis eliminates the impact from conversion, the effects of which do not alter the long-term value of shareholders' interests in our non-UK businesses.

In the business review and financial review, year-on-year comparisons of financial performance are on a CER basis, unless otherwise stated.

Insurance

United Kingdom

£m unless otherwise stated	2005	2004	Percentage change
APE sales	**900**	817	10%
NBP	**243**	241	1%
NBP margin (% APE)	**27%**	30%	–
NBP margin (% PVP)	**3.2%**	3.4%	–
Total EEV basis operating profit*	**426**	486	(12)%
Total IFRS operating profit*	**400**	296	35%

*Based on longer-term investment returns.

Prudential UK delivered double-digit growth in new business sales and IFRS operating profit. EEV NBP remained in line with 2004 at a time when certain product markets have shown increased levels of competition reflected in pricing.

APE sales for Prudential UK increased 10 per cent on 2004 to £900 million, driven by strong sales of bulk annuities (up 28 per cent) and unit-linked bonds (up 31 per cent). The Phoenix Life & Pensions in-force annuity book transaction announced in June 2005 contributed £145 million to the full-year result.

APE sales of individual annuities were up two per cent on 2004 at £222 million, driven by strong sales through the Partnerships and Direct to Consumer channels which increased by 114 per cent and 14 per cent respectively. Despite APE sales of with-profits annuities through the Intermediaries channel increasing 100 per cent year-on-year, total individual annuities sales through this channel decreased 15 per cent reflecting the very competitive pricing environment throughout much of the year.

APE sales of unit-linked bonds increased 31 per cent to £64 million, reflecting Prudential's growing presence in the IFA unit-linked bond market. This offset the year-on-year decrease in with-profits bond sales which fell 31 per cent.

Prudential UK's NBP increased marginally on 2004 to £243 million. This was driven by the increase in sales volumes which was offset by a fall in the NBP margin (from 30 per cent in 2004 to 27 per cent in 2005 on an APE basis). The movement in margin reflected the shift in product mix in 2005 as Prudential continued to expand its shareholder-backed product range, however, throughout the year there continued to be competitive pressure on margins across a range of products which Prudential substantially resisted.

Total EEV basis operating profits fell 12 per cent on 2004 to £426 million primarily due to a persistency assumption change made at the half year. The charge of £148 million reflects a strengthening of persistency assumptions across all products, primarily in respect of with-profits bonds.

Increased IFRS profits arising from shareholder-backed annuities contributed to the 35 per cent increase in total IFRS operating profits, based on longer-term investment returns. In addition, the very strong investment performance of Prudential's life fund over recent years resulted in an increase in total IFRS operating profits from the with-profits business attributable to shareholders.

Prudential UK operates through four diversified distribution channels. The Intermediaries channel, which accounted for 29 per cent of APE sales in 2005, distributes a range of medium to long-term savings products primarily through financial advisers and includes sales generated through multi-ties. The Business to Business channel, which accounted for 28 per cent of 2005 APE sales, distributes corporate pensions through work-site marketing in partnership with consulting actuaries and employee benefit consultants. The Partnerships channel has responsibility for developing relationships with banks and other distributors, including other insurers and accounted for 30 per cent of APE sales in 2005, up from just six per cent in 2003. The remaining 13 per cent of APE sales were generated by the Direct to Customer channel which focuses primarily on the sale of annuities to individual pension customers.

The Partnerships channel signed a number of significant new agreements during the year. These included St. James's Place for annuities; National Australia Bank for annuities and healthcare; Wesleyan's multi-tie panel for protection; Zurich Financial Services and Openwork for annuities; and the Barclays multi-tie panel. In addition, Prudential and Royal London reached agreement for all pension annuities arising from vestings of policies written under the Scottish Life brand in the period between January 2005 and December 2010 to be reassured to Prudential as they come into payment.

Following the introduction of the new depolarisation rules, many IFA groups have used the opportunity to establish multi-tie panels. Prudential has made good progress with the new panels announced to date and is strongly positioned to take advantage of the depolarised marketplace as this develops over the next few years. Prudential achieved APE sales of £4 million through this channel in 2005 and expects that multi-ties will start to have a greater impact on sales in the future.

Prudential's Business to Business distribution channel delivers pension solutions to many of the FTSE 350 companies and is a market leader in the provision of pension schemes to the UK public sector. During 2005, Prudential continued to expand the services it offers in this area to enable advisers to address the employee benefit challenges of their clients.

PruHealth, a healthcare product that links health and fitness to the cost of medical insurance plans, celebrated its first anniversary in the third quarter of 2005. The business has made good progress with sales growing on average more than 30 per cent per month in 2005. Total premium income for the year was £9 million and PruHealth now has over 30,000 lives insured.

Prudential launched a new lifetime mortgage product, Prudential Property Release Plan, in October. This innovative product gives customers greater flexibility and control over the time of when they draw down funds, thereby reducing total interest charges over the lifetime of the loan. Performance to date has been encouraging with growing support from both advisers and customers.

Prudential transferred its UK personal lines general insurance business to Winterthur in 2002 and formed a strategic alliance with Churchill, to offer Prudential branded general insurance products. Under the terms of the agreement Prudential receives commission, the levels of which to date have been offset against payments received at the time of the original transaction, therefore no profits are recognised on this business at this time. However, under the agreement, Prudential is entitled to receive full commission payments and associated profit, from 2008 onwards.

Including these individuals with Prudential branded general insurance policies, to whom Prudential can sell long-term products, Prudential has 2.5 million marketable customers.

2006 is expected to be a year of change for the retirement savings market due to Government pensions reforms which come into force on 6 April (A-Day). Prudential believes the changes will have a positive impact and create an improved savings environment over time, although it is unclear how quickly consumers will respond to these new regulations.

Prudential has made a significant investment in its A-Day preparations including systems developments and customer communications. It currently expects pension arrangements will be compliant with the new regulations and that customers will be aware of the changes. In addition, Prudential is reviewing its product range to identify where to focus future product developments to enable customers to take better advantage of the new regime.

As a consequence of this, Prudential launched a new individual personal pension designed to offer greater transparency and flexibility. The new Pru Flexible Retirement Plan was launched in December and is available through financial advisers.

The Pensions Commission published its second report in November in which it proposed significant reform of the UK's state and private pension systems. Prudential, with its extensive experience of pensions savings, will continue to play an active role in this debate and in helping to shape the new structure.

The Prudential Assurance Company's (PAC) long-term fund remains very strong. On a realistic basis, with liabilities recorded on a market consistent basis, the free assets were valued at around £8.0 billion at 31 December 2005, before a deduction for the risk capital margin, and the fund is rated AA+ by Standard & Poor's and Aa1 by Moody's. The with-profits sub-fund delivered a pre-tax return of 20 per cent in 2005 and over the last five years, the fund has achieved a total return of 41 per cent against six per cent for the FTSE 100 total return index and 12 per cent for the FTSE All-Share total return index (figures are to 31 December 2005, before tax and charges).

Much of this excellent investment performance was achieved through the active asset allocation of the fund. As part of its asset allocation process, Prudential constantly evaluates prospects for different markets. At the end of the first quarter of 2005, based on Prudential's judgement about the relative valuations of these assets, Prudential increased its exposure to equities while decreasing its exposure to corporate bonds and direct property.

As a result of the strong investment performance achieved in 2005, Prudential UK announced in February 2006 that it will be increasing policy values for the vast majority of with-profits policies maturing in 2006.

The closer partnership of Egg with Prudential's UK life and pensions business, as announced in December, is expected to achieve revenue synergies and total annualised pre-tax cost savings across the combined business of £40 million by the end of 2007. This work to maximise the synergies between the two businesses has already started with PruHealth policies now being sold through Egg. This is an attractive opportunity for PruHealth and the first of what we believe will be a number of effective synergies between Prudential's UK businesses.

Prudential UK will continue to pursue profitable opportunities in its chosen product areas and distribution channels.

United States

Jackson National Life (JNL) operates in the largest retirement savings market in the world, with 67 per cent, or US$12.9 trillion (Source: Cerulli Associates), of the world's retirement savings assets concentrated in the US at the end of 2005. JNL provides retirement income and savings solutions in the mass and mass-affluent segments of the US market, primarily to pre- and post-retirees. It offers tools that help people plan for their retirement, and manufactures products with specialised features and guarantees to meet customer needs. By seeking to add value to both the representatives who sell JNL products, and to their customers, JNL has built a strong position in the US retirement market.

JNL delivered APE sales of £515 million during 2005, representing a 13 per cent increase on the 2004 result. This result was achieved in an individual annuity market that was down two per cent on prior year (Source: LIMRA).

JNL's NBP of £211 million were up 45 per cent on 2004, reflecting a 13 per cent increase in APE sales, and a significant improvement in new business margin to 41 per cent from 32 per cent in 2004.

The improved margin reflects a favourable business mix; an increase in the spread assumption for fixed index annuities reflecting the spread being achieved; improved average policy sizes for variable and fixed annuities; economic assumption changes, including an increase in the equity risk premium, and benefits derived from product pricing. Pricing benefits include the price increase, introduced in May 2004, on the Perspective II product. The margin on institutional business improved due to the longer average duration contracts written by JNL during 2005.

Total EEV basis operating profit, based on longer-term investment returns, of £755 million was up 104 per cent on 2004. This reflects a 45 per cent increase in NBP and an in force profit of £530 million, up 123 per cent on the prior year. This result was driven by an operating assumption change following price increases introduced on two older books of term life business (£140 million), a favourable spread variance, and an increase in the unwind of the in-force business.

Total IFRS operating profit of £362 million, based on longer-term investment returns, was up 27 per cent on 2004. The 2004 result benefited from two one-off items, a favourable legal settlement and an accounting adjustment arising from the adoption of new accounting guidance, totalling £29 million. The 17 per cent growth in long-term business operating profit primarily reflects a £119 million increase in spread income and record variable annuity fee income due to significant growth in separate account assets and the returns earned on those assets.

From 1999 to 2005, JNL has increased GAAP assets by a compound annual growth rate of 8.4 per cent from US$42 billion to US$68 billion, statutory premiums, excluding GIC deposits, from US$4.5 billion to US$7.7 billion, and has grown variable annuity reserves from US$5 billion to US$18 billion. JNL has also increased its ranking in the US annuity market from 15th to 12th since 1999, and has achieved this with a net capital inflow over the period of US$11 million from the parent company.

JNL sells variable, fixed and fixed index annuities, as well as life insurance and institutional products. All three annuity products are long-term personal retirement products, which offer tax-deferred accumulation on the funds invested until proceeds are withdrawn from the policy. Fixed annuities offer customers a guarantee of principal and a minimum guaranteed rate of return on their premiums. Fixed index annuities also offer these features, but vary from fixed annuities in that they offer potential upside from equity

United States

£m unless otherwise stated	**2005**	2004 (at CER)	Percentage change	**2005**	2004 (at RER)	Percentage change
APE sales	**515**	456	13%	**515**	453	14%
NBP	**211**	146	45%	**211**	145	46%
NBP margin (% APE)	**41%**	32%	–	**41%**	32%	–
NBP margin (%PVP)	**4.1%**	3.2%	–	**4.1%**	3.2%	–
Total EEV basis operating profit*	**755**	370	104%	**755**	368	105%
Total IFRS operating profit*	**362**	284	27%	**362**	282	28%

*Based on longer-term investment returns from continuing operations (i.e. excluding Jackson Federal Bank (JFB) which was sold in October 2004 and including broker-dealer and fund management profits.

index participation. Variable annuity products differ from the fixed annuity products in that the returns to the customer will depend upon the performance of the underlying fund portfolio. JNL's variable annuity products offer a range of protection options, such as death and withdrawal benefits which are priced separately by JNL, and which can be elected by customers according to their needs. JNL manages its exposure to equity market movements through a comprehensive derivative programme. Value movements in these derivatives are included in operating profit so as to broadly offset changes in policyholder liabilities caused by equity volatility.

During 2005, JNL again delivered record sales, with total APE sales for the year of £515 million up 13 per cent on 2004, and retail sales of £417 million, up 12 per cent. Variable annuity APE sales of £261 million were up 31 per cent on prior year, compared with market growth of 2.5 per cent during 2005 (Source: VARDS), primarily reflecting the continued success of its unbundled variable annuity contract 'Perspective II'. Utilising the flexible product design enabled by leading technology, advisors can customise the product to meet the individual needs of the consumer, including individually priced benefit options and guarantees, such that consumers only pay for what they want.

JNL improved fixed index annuity APE sales by 44 per cent to £62 million during the year, improving its market position to seventh for the year, up from ninth in 2004 (Source: LIMRA). Fixed annuity APE sales of £79 million in 2005 were down 31 per cent on 2004, reflecting the continued low interest rate environment and relatively flat yield curve in the US. JNL has continued to pursue value and hence has been unwilling to compromise entry spreads in this market. JNL was ranked the seventh largest provider of traditional individual deferred fixed annuities during 2005 (Source: LIMRA).

Institutional APE sales of £98 million were up 15 per cent on 2004. JNL took advantage of attractive issuance opportunities during 2005, and continues to participate in this market on an opportunistic basis.

Seventy per cent of retail premiums received in 2005 were for products and product features that did not exist at the beginning of 2004. In January 2005, JNL launched its 'Perspective Advisors II' variable annuity, and in March launched 'Perspective L Series' variable annuity contract, both of which included the full menu of Perspective II benefits. These two products generated combined sales of US$678 million in the year. JNL also extended its range of life products during the year with the addition of 'Ultimate Investor', a variable universal life contract. The flexibility of JNL's technology, and demonstrable competency in execution, have resulted in an ability to quickly and efficiently meet the changing needs of consumers and advisors.

JNL continued to develop its wholesale distribution capability during 2005. JNL's long-term commitment to meeting the needs of broker-dealers and their clients, through the provision of product flexibility, sales support tools, technology and customer service, continues to pay dividends. During 2005, JNL increased its share of variable annuity sales through the independent broker-dealer channel from 6.8 per cent to 9.1 per cent, and its share of the regional broker-dealer channel from 3.9 per cent to 4.9 per cent (Source: VARDS).

JNL also distributes through its independent broker-dealer, National Planning Holdings (NPH), which is a network of four independent broker-dealers that represents approximately 2,600 registered advisors. NPH employs sophisticated technology that allows representatives to operate efficiently and productively. In 2005, NPH increased total revenues by three per cent to £231 million. At June 2005, NPH was ranked the sixth largest independent broker-dealer by revenue (Source: Financial Planning Magazine).

As a result of capital conservation measures introduced in previous years and further strong earnings, JNL continued to generate significant levels of capital, improving the capital ratio from 8.5 per cent in 2004 to 9.2 per cent in 2005. JNL's statutory capital, surplus and asset valuation reserve position improved year-on-year by US$434 million, after deducting the US$150 million of capital remitted to the parent company.

Curian Capital, which offers customised separately managed accounts, continues to build a strong position with net investment flows of £298 million in the year. Curian, which can be accessed with a minimum account balance of US$25,000, offers customers access to technology that enables individual portfolio construction, and access to institutional-quality money managers. Advisors benefit from the efficiencies of on-line processing and compliance. Curian Capital now has US$1.7 billion (£973 million) of assets under management compared with US$1.1 billion (£615 million) at the start of 2005.

JNL has completed the integration of the 1.5 million Life of Georgia policies onto its own operating platform. This achievement clearly demonstrates JNL's operational effectiveness and its increasing capability in consolidating large blocks of business. This acquisition doubled the number of JNL's in-force life and annuity policies, adding scale to its operating platform and expanding its distribution capability, as well as further diversifying its income streams. This transaction enabled JNL to grow its life business at a higher return and faster rate than could be achieved organically. JNL expects to achieve the target internal rate of return after tax on this transaction of 12 per cent, and will continue to consider further US bolt-on acquisitions as opportunities arise.

With its relationship driven distribution, innovative product manufacturing capability and low cost operating model, JNL is well positioned to take advantage of the evolving opportunities in the US retirement market. As 'baby boomers' retire and shift their focus from asset accumulation to income distribution, one of JNL's main objectives will be to capture a proportion of these flows. With an emphasis on sales of low capital intensive variable annuity products, solid operating results and strong investment performance, JNL is capable of self-generating the capital necessary to support its future growth at the required returns and return a growing remittance to the parent company.

The ageing demographics of the US, with the first of the 77 million 'baby boomers' reaching 60 this year, will, over the next decade, create a very significant increase in the level of distributions from retirement savings plans. Life expectancy in the US continues to increase while at the same time the average retirement age is decreasing. This has led to a large increase in the average time individuals will spend in retirement. Consequently, there is a growing risk that individuals' finances will be insufficient to cover the costs of living through retirement. These consumers will have a growing need for independent financial advice and will increasingly seek guarantees and longevity protections from the products they purchase.

Asia

Asia's life insurance markets are very attractive with large scale and high growth rates supported by consistently strong economic growth, favourable demographics and market liberalisations. However, there are some formidable barriers to successful entry including entrenched incumbents, the pace of change and nature of regulations, mandatory partners in some markets and a shortage of experienced staff. Acquisition opportunities, particularly of scale businesses, are limited and in North Asian markets are likely to involve back books that currently experience negative spread and hence require material provisions under European regulatory capital requirements.

Since the mid 1990s, Prudential has been progressively building its Asian platform, strengthening and protecting its market-leading positions in its established markets (Singapore, Hong Kong and Malaysia), entering emerging markets (Thailand, Indonesia, Philippines, Vietnam), securing strong joint venture partners for the sizable opportunities in India and China (ICICI and CITIC respectively) and taking positions in the large North Asian markets of Taiwan, Japan and Korea. Prudential now has over seven million customers in Asia, up from 1.5 million in 2000.

In all its markets, Prudential has been focused on building proprietary distribution as the most effective way of delivering sustainable new business volumes and managing the customer proposition; typically through growing tied agency and integrated bancassurance arrangements (such as with Standard Chartered Bank in Hong Kong). Prudential also prioritises economic capital efficiency, profitability and customer centricity in its Asian product portfolio as seen, for example, with the introduction of unit-linked products across the region, an emphasis on regular premium policies (89 per cent of APE sales in 2005), life stage themed marketing and purposely limiting participation in the lowest margin and highly tactical sectors.

During 2005, the business continued to make very solid progress in a number of key areas.

In China, six new cities were added including Wuhan, the provincial capital of Hubei. CITIC-Prudential now has 10 cities operational in China and a further new provincial capital, Jinan in Shandong, was added in January 2006. The main challenge facing foreign players trying to become established in China is the need to develop local management teams to support geographic expansion. Prudential has a real advantage in being able to leverage its existing Chinese speaking operations to help incubate new teams quickly. In 2005, new business APE for China increased by 47 per cent over 2004.

Strengthening distribution continues to be a major priority. In 2005 agent numbers grew by 26 per cent to over 170,000 with geographic expansion in India and China being a key driver (up 36 per cent and 37 per cent respectively). In Indonesia, the business has excellent momentum and has increased agent numbers by 89 per cent during the year. In the established markets, improving agency productivity is a key initiative and, whilst this improved in 2005, there is still significant room for growth. Prudential's multi-channel distribution model in Korea is a real asset as, whilst volumes from direct campaigns such as a home shopping channel have waned and bank distribution has been limited by regulatory caps and industrial action, new business APE growth for 2005 of 88 per cent reflects great success in increasing the number of tied financial advisers (up 132 per cent) and extending the number of general agents (brokers).

Currently 75 per cent of Prudential's new business APE comes from its tied agency distribution and whilst this will remain the primary channel for some time, there is the potential to further expand alternate channels, particularly banks and direct marketing. Bancassurance with Standard Chartered Bank in Hong Kong continues to be especially successful and there is considerable potential particularly in Singapore, Malaysia and Taiwan over the short to medium term. The life business in Japan remains challenging and after piloting a Financial Adviser channel with little success and high running costs this was closed in January 2006; the emphasis is now on developing profitable partnership distribution opportunities.

Asia

£m unless otherwise stated	2005	2004 (at CER)	Percentage change	2005	2004 (at RER)	Percentage change
APE sales	**731**	594	23%	**731**	576	27%
NBP	**413**	365	13%	**413**	355	16%
NBP margin (% APE)	**56%**	61%	–	**56%**	62%	–
NBP margin (% PVP)	**10.2%**	10.4%	–	**10.2%**	10.4%	–
Total EEV basis operating profit*	**576**	473	22%	**576**	460	25%
Total IFRS operating profit*	**195**	119	64%	**195**	117	67%

*Based on longer-term investment returns and excluding fund management operations, development and Asia regional head office expenses.

Taiwan's macroeconomic environment remains challenging with interest rates currently at record lows leading to negative spread issues affecting the whole industry, particularly on tranches of business sold pre 2002. Prudential has a comparatively small book of this business and remains confident that any potential deficits are more than adequately supported by the profitable new business, particularly unit-linked, it has been writing for a number of years. The Taiwanese life insurance industry is currently dominated by players pursuing short-term volume whereas Prudential remains firmly focused on long-term profitability. In 2005, Prudential's new business APE mix was 73 per cent linked products compared to the industry total of 29 per cent and new business volumes were in line with 2004. NBP margins in Taiwan were 51 per cent compared to 61 per cent the previous year. The change is due to a higher proportion of capital efficient and popular new retirement-focused regular premium unit-linked savings plans that are investment-orientated.

Prudential's increasing scale is enabling it to move ahead with plans for a step change in its operating platform. A new business processing hub was launched in Kuala Lumpur, Malaysia in early 2005 under the name Prudential Services Asia. This is already successfully processing business for the Malaysian and Singaporean life operations and plans are underway for a second hub to be launched in China.

Over the last year significant progress was made with embedding a risk management and compliance framework. Prudential employs 'three lines of defence'; the operational management in each business, strong risk management related functions and an independent internal audit function. Prudential's policies are clear that any breach of regulatory standards attributable to staff malpractice is unacceptable.

In financial terms, 2005 was another strong year. Prudential's new business APE grew by 23 per cent to £731 million over 2004. The NBP margin was 56 per cent, compared to 61 per cent in 2004 representing changes in the average geographic mix (net two percentage points), economic assumption changes (net two percentage points) and product mix (net one percentage point). Looking at these changes in more detail, Korea and India now contribute 26 per cent of total APE compared to 18 per cent in 2004, average NBP margins in these countries are 37 per cent and 29 per cent respectively. The impact attributed to economic assumption changes is driven principally by increases to the risk discount rates in China and Korea. This was more than offset by a favourable shift in product mix in Korea where average margins remained slightly ahead of 2004 at 37 per cent. The other main product mix related impact was due to the lower margins on the retirement linked product in Taiwan as discussed above which led to a change in average margins from 61 per cent to 51 per cent.

With the exception of Taiwan, all markets have increased NBP over 2004.

Long-term EEV operating profits of £576 million are up 22 per cent over 2004 and are driven by NBP of £413 million and unwind of discount of £162 million with small operating assumption changes and experience variances netting out to £1 million.

IFRS operating profits based on longer-term investment returns, increased 64 per cent to £195 million from £119 million in 2004, however, 2005 does include a net £30 million from various non-recurring items including a net £44 million profit as previously disclosed at the half year and subsequently reduced by £14 million of restructuring charges in Japan. Excluding these, growth was 39 per cent reflecting the steady increase in profits from the established markets with total IFRS operating profits of £127 million, up 14 per cent, the emergence of profits on the IFRS basis from the new business being sold across the region and lower expenses in Japan.

Prudential Asia's high proportion of profitable, regular premium business combined with sound operational management means cash flows can be predicted with some certainty. As previously announced, the business is on target to fund continued strong growth internally and begin remitting surplus cash back to the Group from 2006 onwards.

In summary, Prudential has an excellent track record of building a profitable business in Asia and the scale of the opportunity for continued growth is clear.

Asset management

Prudential's three asset management businesses are aligned with their respective markets in the UK, Asia and the US. They operate under different brands and with different models, each of which is described further below.

M&G

£m unless otherwise stated	**2005**	2004	Percentage change
Gross investment flows	**7,916**	5,845	35%
Net investment flows	**3,862**	2,004	93%
Underlying profit before performance-related fees	**138**	110	25%
Total IFRS operating profit*	**163**	136	20%

*Based on longer-term investment returns.

M&G is Prudential's UK and European fund management business and has £149 billion of funds under management, of which £113 billion relates to Prudential's long-term business funds. M&G operates in markets where it has a leading position and competitive advantage, including retail fund management, institutional fixed income, pooled life and pension funds, property and private finance. M&G also manages Prudential's balance sheet for profit. M&G has scale in all key asset classes: it is one of the largest active managers in the UK stockmarket, one of the largest bond investors in the UK and one of the UK's largest property investors.

M&G's operating profit based on longer-term investment returns in 2005 including performance-related fees (PRF) was £163 million, an increase of 20 per cent on last year. Underlying profit (excluding PRF) of £138 million was 25 per cent higher than in 2004, an extremely strong result given that the previous year included £7 million of non-recurring provision releases. Adjusting for this gives a like-for-like increase in profits of 34 per cent over 2004. This continues a strong upward trend which has seen underlying profits grow from £49 million in 2002 to £138 million last year, reflecting the strengths of M&G's diversified business, disciplined cost management and the successful development of new sources of revenue.

PRF in 2005 were £24 million, including £17 million as a result of several exceptionally profitable realisations by PPM Capital that are not expected to recur. M&G received £7 million of performance fees for managing Prudential's long-term and annuity funds, which continued to beat their strategic and competitor benchmarks during the year.

M&G enjoyed a record year for sales during 2005, with gross fund inflows increasing 35 per cent to £7.9 billion. Net fund inflows also grew significantly, almost doubling to £3.9 billion and external funds under management, which represent a quarter of M&G's total funds, rose by 26 per cent to £36.2 billion.

Gross fund inflows into M&G's retail businesses were their highest ever at £3.8 billion and were nearly double the previous year. Net retail fund inflows totalled £1.3 billion, more than triple those in 2004. In the UK, M&G generated the highest ever retail sales in its 75 year history across a combination of its equity, fixed income and property funds. M&G International, which sells funds in Germany, Austria, Italy, Luxembourg and Switzerland, more than tripled its funds under management during the year. M&G's South African business saw a doubling of retail funds under management. Retail fund performance continued to be very strong, especially M&G's equity funds which saw 92 per cent of funds beating their UK sector average over three years.

M&G's institutional business saw gross fund inflows of £4.1 billion. Significant growth in the areas of private finance and property helped net fund inflows increase 59 per cent to £2.5 billion. M&G continued its successful strategy of generating new revenue streams with attractive margins using expertise developed for internal funds, especially in the area of non-correlated assets such as leveraged loans. M&G broke new ground in this asset class during the year with the launch of Europe's first pure leveraged loan fund, the M&G European Loan Fund. The success of M&G's Collateralised Debt Obligation (CDO) programme also continued during 2005 with the launch of five new CDOs. In property, the development of external vehicles managed by Prudential Property Investment Managers (PruPIM) for third party clients delivered strong fund inflows.

Asia

The Asian fund management business had £26.2 billion of funds under management as at 31 December 2005, of which £10.1 billion related to third party funds in operations in India, Taiwan, Japan, Korea, Malaysia, Singapore and Hong Kong. Prudential is a top five foreign provider of mutual funds in all countries in which it operates with the exception of Japan where significant progress has been made in a very competitive market. In 2005, the fund management business continued to expand geographically with the securing of fund management licences in China, through a joint venture with CITIC, and in Vietnam. This takes the total number of countries in which the business has a presence to nine.

Operating profit from the Asian fund management operations was £12 million for the year, the decrease from 2004 reflecting the exceptional costs of £16 million incurred due to bond fund restructuring required as a result of industry wide issues in Taiwan.

The geographic expansion of the past few years has been matched by growth in market share, with Korea, Japan, India and Malaysia being notable successes. Geographic diversification along with this growth in scale has resulted in a strong upward trend in profits with underlying profits increasing from £9 million in 2001 to £28 million in 2005.

Net inflows from third parties of £1.3 billion were driven by strong net inflows in Japan of £905 million and Korea of £926 million though these were offset by net outflows in Taiwan of £745 million due to an unsettled bond fund market.

Total reported third party funds under management of £10.1 billion was up 13 per cent on 2004. In August last year, ICICI increased its stake in Prudential's India asset management joint venture from 45 per cent to 51 per cent. As a result, Prudential no longer consolidates this business at 100 per cent and the year end numbers are reported at 49 per cent, resulting in a £1.5 billion reduction in funds under management for the year. On a comparable basis, full year 2005 funds under management grew 29 per cent on 2004.

Asia

£m unless otherwise stated	**2005**	2004 (at CER)	Percentage change	**2005**	2004 (at RER)	Percentage change
Net investment flows	**1,327**	1,293	3%	**1,327**	1,280	4%
Total IFRS operating profit*	**12**	20	(40)%	**12**	19	(37)%

* Based on longer-term investment returns. Underlying IFRS operating profit of £28 million, offset by £16 million of charges related to bond funds in Taiwan.

PPM America

£m unless otherwise stated	**2005**	2004 (at CER)	Percentage change	**2005**	2004 (at RER)	Percentage change
Funds Under Management (£bn)	**41**	40	3%	**41**	36	14%
Total IFRS operating profit*	**20**	12	67%	**20**	12	67%

* Based on longer-term investment returns.

PPM America

PPM America, based in Chicago, is Prudential's North American institutional investment manager, specialising in public and private fixed income and equity, and real estate securities, and, through its affiliate PPM Finance, Inc., commercial mortgage lending. At the end of 2005, PPM America had funds under management of £41 billion (including PPM Finance), of which 68 per cent relates primarily to JNL policyholder assets, 29 per cent to funds managed on behalf of other Prudential UK and Asian affiliates, and three per cent to funds managed for external clients, including CDOs and similar products.

In 2005, PPM America increased IFRS profits by 67 per cent, primarily due to a one-off £5 million revaluation related to investment vehicles managed by PPM America.

Banking

	2005 £m	2004** £m	Percentage change
IFRS operating profit based on longer-term investment returns, from continuing operations*:			
UK banking business	**60**	72	(17)%
Restructuring costs	**(10)**	(5)	(100)%
Transaction costs	**(7)**	(6)	(17)%
Other	**1**	0	100%
	44	61	(28)%
Highlights of UK banking business:			
Net interest income	**312**	287	9%
Non-interest income	**215**	209	3%
Cost-to-income ratio	**43%**	49%	–
Bad debts	**(241)**	(182)	(32)%

*Continuing operations – excludes Egg France and Funds Direct, which were discontinued in 2004.

**2004 comparatives are on an IFRS basis, except for adjustments for IAS 32 and IAS 39 which have been adopted from 1 January 2005, as permitted by IFRS transition rules.

Egg is an innovative financial services company primarily offering banking products and services, specifically, unsecured personal loans, credit cards, mortgages and savings accounts. Egg is now one of the world's largest on-line banks with approximately 3.7 million predominantly young and upmarket customers acquired since launch.

Operating profit from the core UK banking business was £60 million, compared with £72 million in 2004. This result represents a strong performance given a very challenging set of market conditions with sharply reducing growth in unsecured borrowings, narrowing margins following the increase in average base rates and a sharp deterioration across the industry in underlying credit quality. Regulatory changes also impacted this year's business performance. In particular, the introduction of new measures into the sales processes of payment protection insurance products in 2005 has led to a significant reduction in income from these products across the industry.

Despite this market environment, Egg managed to increase margins on credit cards via increased pricing and through focusing on the active management of its existing customer base to maximise borrowing balances. The degree of deterioration in credit quality was at a level substantially below the market.

Egg has completed the re-focus on its successful core UK banking business over the last 12 months. The exit from France was completed in the first quarter of 2005 with total costs incurred within the provision established in 2004. In October 2005, Egg completed the sale of Funds Direct, its investment wrap platform business. Total operating profit from continuing operations in 2005 includes £10 million of restructuring costs.

This reorganisation aligned Egg's cost base with its strategic focus on the UK business and contributed to a £17 million reduction in total expenses between 2005 and 2004.

Transaction costs of £7 million were incurred during 2005 in relation to Prudential's acquisition of the minority shareholdings in Egg.

The immediate benefits from the restructuring implemented in early 2005, together with Egg's effective cost management contributed to the continued downward trend in Egg's cost to income ratio. It was 43 per cent for 2005, compared to 49 per cent and 53 per cent for 2004 and 2003 respectively.

The capital position at the end of the year continued to be very strong with total capital ratio of 14.8 per cent, improving from 12.5 per cent in 2004.

The launch of Egg Money in September has further strengthened the brand awareness and reinforced the innovative values of Egg. This product concept also reflects Egg's strategy of deepening its relationship with customers which is a key differentiator and route to higher levels of cross sales and ultimately a broader range of product offerings. Egg Money won an award from *Which?* for 'Best Money Innovation' in November 2005.

On 1 December 2005, the Boards of Prudential and Egg announced a recommended Offer by Prudential for the whole of the issued and to be issued shares of Egg not already owned by the Prudential Group. This represented approximately 21.7 per cent of the existing issued share capital of Egg.

The Offer valued the existing issued share capital of Egg at approximately £973 million, a 15 per cent premium to the market capitalisation of Egg of £845 million on 30 November 2005, being the last Business Day prior to announcement of the Offer. Prudential offered 0.2237 New Prudential Shares for each Egg Share.

On 23 January 2006, Prudential announced that it had received acceptances in respect of 80.3 per cent of the issued ordinary share capital that it did not already own bringing Prudential's ownership of the Egg Group to 95.7 per cent. Prudential also announced its intention to extend the offer until further notice.

On 20 February 2006, Egg shares were delisted from the Official List.

It is anticipated that the acquisition of the minority will enable Prudential and Egg to capitalise on the product capabilities, customer relationships and brand strengths of Prudential, M&G and Egg and will also facilitate the realisation of substantial annualised pre-tax cost savings, with £40 million expected to be realised by the end of 2007, as well as opportunities for revenue synergies.