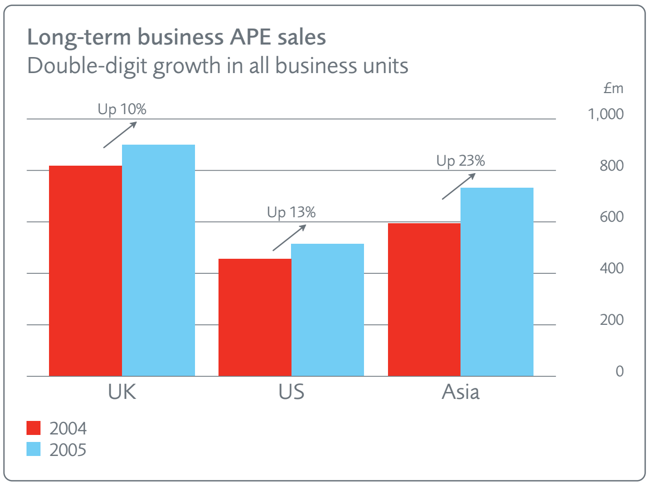
Financial review

Sales and funds under management



Prudential delivered strong sales growth during 2005 with total new insurance sales up 13 per cent to £13.8 billion at constant exchange rates (CER). This resulted in record insurance sales of £2.1 billion on the annual premium equivalent (APE) basis, an increase of 15 per cent on 2004. At reported exchange rates (RER), APE was up 16 per cent on 2004. The strong growth is reflected across all regions with APE up on 2004 by 10 per cent in the UK, 13 per cent in the US and 23 per cent in Asia at CER.

Total gross investment sales for 2005 were £26.4 billion, up six per cent on 2004 at RER. Net investment flows of £5.2 billion were up 58 per cent on last year at RER.

Total investment funds under management in 2005 increased by 24 per cent from £37.2 billion to £46.3 billion at RER, reflecting net investment flows of £5.2 billion and net market and other movements of £3.9 billion.

At 31 December 2005, total insurance and investment funds under management were £234 billion, an increase of 19 per cent up from 2004 at RER.

Present value of new business premiums in 2005 increased by 12 per cent to £16.8 billion. Present value of new business premiums is the preferred basis of disclosing margin under EEV principles, and from the half year 2006 we will provide commentary on this basis. We will continue to provide detail on the APE basis for the foreseeable future until familiarity with the new basis of reporting is developed.

Basis of preparation of results

From 1 January 2005, Prudential is required to account for its long-term insurance business on an International Financial Reporting Standards (IFRS) basis. In broad terms, IFRS profits for long-term business contracts reflect the aggregate of statutory transfers from with-profits funds and profits on a traditional accounting basis for other long-term business. Although the statutory transfers from with-profits funds are closely aligned with cash flow generation, the pattern of IFRS profits over time from shareholder-backed long-term businesses will generally differ from the cash flow pattern. Over the life of a contract, however, aggregate IFRS profits will be the same as aggregate cash flow.

As a signatory to the European CFO Forum's EEV Principles, Prudential also reports supplementary results on the European Embedded Value (EEV) basis for the Group's long-term business, including asset management operations and service companies that support the long-term businesses. These results are combined with the IFRS basis results of the Group's other businesses.

Reference to operating profit relates to profit including the expected long-term rate of return on investments, but excludes exceptional items, short-term fluctuations in investment returns and the effect of changes in economic assumptions.

International Financial Reporting Standards basis reporting

The European Union (EU) requires that all listed European groups prepare their 2005 financial statements in accordance with EU approved International Financial Reporting Standards (IFRS). The IFRS basis replaces the previous modified statutory basis (MSB) of reporting. To prepare the market for the changes the Group reported the impact of restating its 2004 results in its Economic and Financial Reporting announcement on 2 June 2005.

The announcement explained that the IFRS changes have been implemented in two stages. First, for the purposes of formal IFRS adoption from 1 January 2004 all standards other than IAS 32, 'Financial Instruments: Disclosure and Presentation', IAS 39, 'Financial Instruments: Recognition and Measurement', and IFRS 4, 'Insurance Contracts' have been applied.

Due to the complications for the retrospective application, particularly for the banking industry for financial instruments, the International Accounting Standards Board (IASB) allowed adoption of these three standards from 1 January 2005. The Group has chosen to adopt this approach. However, mindful of the impact on the Group's insurance operations, particularly Jackson National Life (JNL), the Group has prepared supplementary pro forma results that show the effect of adopting these standards if they had been applied in 2004 for those businesses. The two areas of change that are of particular relevance to Prudential's results are:

- Altered valuation bases for JNL derivatives and fixed income securities; and
- recognition of the shareholders' share of deficits on defined benefit pension schemes in shareholders' equity.

In preparing its IFRS basis results the Group has chosen to continue to provide supplementary analysis of the profit before shareholder tax so as to distinguish operating results based on longer-term investment returns, actuarial gains and losses on defined benefit pension schemes, and exceptional items. The Group has also made a discretionary change of accounting policy at the same time as the adoption of IFRS standards. The change principally affects the determination of longer-term returns for JNL that are credited to operating results. Total profit before tax is unaffected by this change.

Total profit before tax now includes value movements on derivatives that JNL uses for economic hedging together with actuarial gains and losses on the Group's defined benefit pension schemes, and is expected to be more volatile as a result. In addition, IFRS basis shareholders' funds will be more volatile from period to period because of market value movements on fixed income securities of JNL which are classified as available for sale.

The adoption of IFRS does not have a significant impact on the business or the underlying financial position.

European Embedded Value basis reporting

Life insurance products are, by their nature, long-term and the profit on this business is generated over a significant number of years. Accounting under IFRS does not, in Prudential's opinion, properly reflect the inherent value of these future profit streams.

Prudential believes that embedded value reporting provides investors with a better measure of underlying profitability of the Group's long-term businesses and is a valuable supplement to statutory accounts.

As a signatory to the European CFO Forum's EEV Principles, Prudential has adopted EEV methodology for its 2005 year end results. This replaces the achieved profits basis of reporting. The main impact of the change from the achieved profits basis on the results arises from the effects of changes to the assumed level of locked-in capital allocated to each business, the adoption of product specific risk discount rates, and an explicit valuation of the time value of options and guarantees. The EEV results also include the value of future profits from fund management and service operations that support the long-term business. In most other respects the approach that Prudential used for its achieved profits reporting already conforms to the requirements of the EEV Principles.

On the EEV basis, the shareholders' interest in the Group's long-term businesses comprises:

- The present value of future shareholder cash flows from in-force covered business (value of in-force business), less a deduction for the cost of locked-in (encumbered) capital;
- the locked-in (encumbered) capital; and
- shareholders' net worth in excess of encumbered capital.

Stochastic valuations have been undertaken to determine the value of in-force business including the cost of capital. A deterministic valuation of the in-force business is also derived using consistent assumptions, and the time value of the financial options and guarantees is derived as the difference between the two.

The Group EEV results also incorporate the effect of the discretionary change to the basis of determining longer-term investment returns included in operating profits and IFRS changes for pension scheme accounting and non-insurance operations as described below.

European Embedded Value basis operating profit

Total EEV basis operating profit from continuing operations based on longer-term investment returns was £1,712 million, up 33 per cent from 2004 at CER. At RER, the result was up 34 per cent. This result reflects a combination of strong growth in all the insurance and funds management businesses.

Prudential's insurance business achieved significant growth, both in terms of new business profits (NBP) and in-force profit, resulting in a 30 per cent increase in operating profit over 2004 at CER. In 2005, the Group has generated record NBP from insurance business of £867 million which was 15 per cent above 2004 at CER,

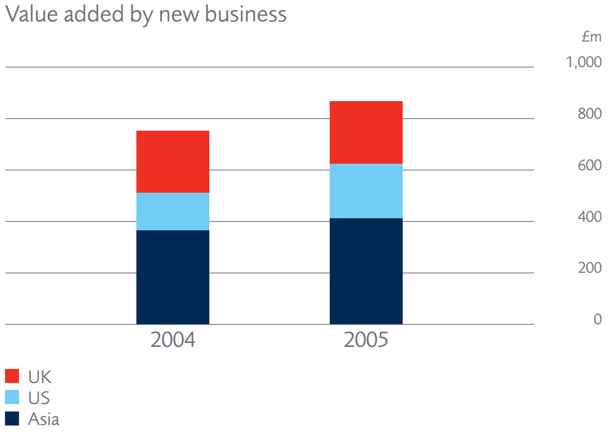
EEV basis operating profit based on longer-term investment returns	**2005 £m**	2004 (at CER) £m	Percentage change	**2005 £m**	2004 (at RER) £m	Percentage change
Insurance business:						
UK	**426**	486	(12)%	**426**	486	(12)%
US	**741**	384	93%	**741**	382	94%
Asia	**576**	473	22%	**576**	460	25%
Development expenses	**(20)**	(15)	(33)%	**(20)**	(15)	(33)%
	1,723	1,328	30%	**1,723**	1,313	31%
Fund management business:						
M&G	**163**	136	20%	**163**	136	20%
US broker-dealer and fund management	**24**	15	60%	**24**	15	60%
Curian	**(10)**	(29)	66%	**(10)**	(29)	66%
Asia fund management	**12**	20	(40)%	**12**	19	(37)%
	189	142	33%	**189**	141	34%
Banking:						
Egg (UK)	**44**	61	(28)%	**44**	61	(28)%
Other income and expenditure	**(244)**	(243)	0%	**(244)**	(241)	1%
Operating profit from continuing operations based on longer-term investment returns	**1,712**	1,288	33%	**1,712**	1,274	34%

driven by strong sales momentum across all markets. At RER, NBP was up 17 per cent. The average Group NBP margin was 41 per cent up from 40 per cent in 2004 on an APE basis and 5.2 per cent up from 5.0 per cent on a present value of premiums basis. The overall margin has been broadly maintained over the last two years, reflecting careful management of product mix within each business. In-force profit increased 48 per cent on 2004 at CER to £876 million. At RER, in-force profit was up 49 per cent. The in-force profit includes a £148 million charge in respect of a persistency assumption change in the UK and a credit in the US of £140 million reflecting an operating assumption change following price increases introduced on two blocks of in-force term life business announced at the half year. In aggregate, net assumption changes were negative £54 million, with net positive experience variances and other items of £79 million.

Results from fund management and banking business were £233 million, an increase of 15 per cent at CER on 2004. This was mainly driven by the significant contribution from M&G.

Other income and expenditure was negative £244 million compared with negative £243 million at CER in 2004. This reflected an increase in investment return on centrally held assets and other income offset by higher interest payable and head office costs.

New business profits
Value added by new business



UK insurance operations

EEV basis operating profit based on longer-term investment returns of £426 million was down 12 per cent on 2004. 62 per cent of the profit was attributable to the with-profits fund.

Prudential UK's new business profit remained in line with 2004 at £243 million. This was driven by the 10 per cent increase in APE sales volumes which was offset by a fall in the new business profit 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.

Prudential allocates shareholder capital to support new business growth across a wide range of products in the UK. The weighted average post-tax Internal Rate of Return (IRR) on the capital allocated to new business growth in the UK in 2005 was 14 per cent achieving the 2007 target set at the time of the Rights Issue two years early. This increase was achieved by broadly maintaining or improving individual product IRR's during the year coupled with a favourable product mix.

UK in-force profit of £183 million was down 25 per cent on 2004. The profits arising from the unwind of discount from the in-force book were partially offset by adverse operating assumption changes and other experience variances.

At the half year, persistency assumptions were strengthened across a number of products, primarily in respect of with-profits bonds. This resulted in a charge of £148 million for 2005 on an EEV basis. In the case of Prudence Bond, which accounts for a significant proportion of the assumption change, Prudential expected surrenders to fall after the favourable bonus declaration in February 2005. In the event, following the bonus declaration, customers continued to surrender their policies leading to a strengthening of the assumption by 40 per cent. The assumption change reflects Prudential's current experience and, post tax, represents three per cent of the overall embedded value of the UK business.

The persistency assumptions represent Prudential's current best estimate of future experience. In the case of Prudence Bond, a product with no set maturity or term and no surrender penalties after five years, future customer behaviour may differ from past experience, making it difficult to anticipate future actual surrenders with certainty.

However, the attractiveness of Prudence Bond as a long-term investment is demonstrated by investment returns that a typical customer has achieved. A Prudence Bond policy will have seen its value increase from £10,000 to £18,137 over the 10 years up to 6 April 2006. This payout represents an overall annualised return of 6.1 per cent over each of the last 10 years net of tax and charges.

Prudential continues to actively manage the conservation of its in-force book and is currently running within assumptions.

During the year, Prudential carried out a review of its mortality experience across all of its non-profit annuity business. As a result of this review, it strengthened the realistic and statutory male assumptions and weakened the realistic female assumptions to align the realistic assumptions with recent experience. The total effect of the changes was to reduce operating profit by £47 million, of which the main reduction arose from increasing the cost of capital.

New annuity business written in 2005 has been priced on the new basis for both EEV and IFRS.

Other charges of £46 million in the UK include £45 million of costs associated with complying with new regulatory requirements including Sarbanes-Oxley, product development and distribution development; a negative £19 million expense variance; and a net positive £18 million of other items. Prudential believe the announced cost savings from its UK insurance operations and Egg's collaboration, together with other initiatives will lead to a lowering of the absolute cost base going forwards.

In 2005, Prudential wrote to 440,000 of its customers contracted-out of the State Second Pension (S2P) and provided updated information and views to enable them to make an informed decision about whether to contract back into S2P or remain contracted-out, stating that Prudential believed that most people should contract back in for the 2005/6 tax year onwards. As a result of this we expect premiums from DWP rebate business to fall in 2006 and subsequent years.

US operations

In the US, EEV operating profit based on longer-term investment returns from long-term operations was £741 million, up 93 per cent at CER and up 94 per cent from prior year at RER.

Jackson National Life (JNL) new business profit of £211 million was 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. On a present value of premiums basis, the margin increased from 3.2 per cent to 4.1 per cent. 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 fee 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.

The new business margin achieved on variable annuity business in 2005 was 50 per cent compared with 36 per cent in 2004. The improved margin was driven by economic assumption changes, and a full year of benefit associated with the re-pricing mentioned above. The economic assumption changes include an increase in the equity risk premium from three per cent to four per cent which Prudential believes more accurately reflects the volatility of equities.

The fixed index annuity margin has improved from the prior year due to an increase in the long-term spread assumption from 175bps to 190bps, reflecting the spread being achieved.

For JNL, the average IRR on new business was 15 per cent which reflects JNL's strong pricing discipline.

In the US, the in-force profit of £530 million is 123 per cent up on 2004 at CER. The increase was primarily due to increased unwind of discount on the in-force business, an operating assumption change following price increases introduced on two older books of term life business (£140 million), and improved spread variance. The increase in the unwind of discount reflects the increase in risk discount rates, following an increase in the equity risk premium from three per cent to four per cent. Improved spread variance of £89 million is up from £41 million in the prior year, and reflects achieved spreads in excess of the current weighted portfolio target on the regular portfolio. The spread variance in 2005 also includes a number of non-recurring items including mortgage prepayment fees, make-whole payments and total return swap income which together represent £60 million of the spread variance.

As a discretionary change of accounting policy, implemented at the same time as the adoption of IFRS, the Group has replaced the previous basis of five year averaging of gains and losses on bonds with a method that more closely reflects longer-term returns.

On the new basis, longer-term returns on fixed income securities comprise two elements. The first element is a risk margin reserve (RMR) charge for long-term default experience of £58 million for 2005. The present value of future RMR charges is reflected in the opening embedded value. The second element is amortisation of £53 million of interest related realised gains and losses. These gains and losses are amortised to operating profit over the bonds' original maturities.

The excess or deficit of actual realised gains and losses for fixed income securities for the period over these components of longer-term returns is included in short-term fluctuations in investment returns as a separate component of total profit for the period.

Following this change of policy for JNL's EEV basis operating profit, the component for longer-term returns for fixed income securities is expected in the future to be a more stable feature than on the previous basis, which was affected by the volatility of realised gains and losses over a five year period. Total profit, including actual investment returns, is unaffected by the change. Further details of the change of policy are explained in the notes to the EEV and IFRS basis results. In 2005, JNL experienced a net realised gain of £1 million on its corporate bond portfolio. This is reflected in total EEV basis profit before tax.

Asia operations

EEV basis operating profit based on longer-term investment returns from long-term operations (excluding development and regional head office costs) was £576 million for the year, up 22 per cent at CER and 25 per cent at RER on 2004.

In Asia, NBP of £413 million was up 13 per cent at CER on 2004 with increased sales offset partially by NBP margin. During 2005, APE sales were up 23 per cent on 2004 and the NBP margins were 56 per cent on an APE basis and 10.2 per cent on a present value of premiums basis, compared with 61 per cent and 10.4 per cent respectively in 2004 at CER. The key drivers of lower margins in Asia compared to prior year were country mix (reduction of two percentage points), product mix – principally in Taiwan (reduction of one percentage point) and assumption changes (reduction of two percentage points).

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 new retirement unit-linked product in Taiwan which led to a change in average margins from 61 per cent to 51 per cent.

Asia's in-force profit (before development expenses and the Asian fund management business) increased to £163 million in 2005 from £108 million in 2004 at CER. This reflects a higher value related to the unwind of the discount rate as the in-force business builds scale.

In Asia we have target IRRs on new business at a country level of 10 percentage points over the country risk discount rate. Risk discount rates vary from five per cent to 18 per cent depending upon the risks in each country market. These target rates of return are average rates and the marginal return on capital on a particular product could be above or below the target.

We have, however, exceeded the target in each of Asia's markets in 2005 except for Thailand and Japan, which have yet to reach scale. In aggregate, IRR on new business exceeded 20 per cent on average new business risk discount rates for 2005 of 9.8 per cent.

Asset management, banking and other

M&G

M&G's operating profit was £163 million, an increase of 20 per cent on last year. This included £24 million in performance-related fees (PRF), of which £17 million was earned by PPM Capital following another year of extremely profitable realisations on behalf of its clients. These are not expected to recur.

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 profit of 34 per cent over 2004.

In the past few years, growth in income from M&G's existing businesses has been reinforced by the successful development of revenue streams from new activities. These include Prudential Finance, which manages Prudential's balance sheet for profit, private finance, including CDOs, and Prudential Property Investment Managers (PruPIM), which increasingly manages assets for external investors. In its retail businesses, sales of equity funds have risen significantly in both the UK, as a result of strong investment performance, and overseas, where M&G continues to build new distribution channels in selected European and other markets.

The benefits of this business diversification are clearly demonstrated by the strong upward trend in profits that M&G has posted – underlying profits have increased consistently from £49 million in 2002 to £138 million in 2005. Profits growth in 2005 was largely due to the impact of higher asset prices in equity and property markets, combined with the impact of positive net inflows over a period of several years. In addition, discipline continues to be exercised over costs, which have risen only slightly this year after four years in which they were held flat.

US broker-dealer and fund management businesses

The broker-dealer and fund management operations reported profits of £24 million, compared with £15 million in 2004, primarily due to a one-off £5 million revaluation related to an investment vehicle managed by PPM America.

Curian

Curian, which provides innovative fee-based separately managed accounts, recorded losses of £10 million in 2005, improved from losses of £29 million in 2004, as the business continues to build scale. At year end 2005, Curian had grown assets under management to US$1.7 billion (£973 million) from US$1.1 billion (£615 million) at year end 2004.

Asian fund management business

The fund management business in Asia has expanded into new markets in the past few years and is now in nine markets across Asia. Geographic diversification along with this growth in scale has resulted in a strong upward trend in profits.

Profit from the Asian fund management operations was £12 million for the year, down 37 per cent 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. Underlying profit from the Asian fund management operations, excluding charges of £16 million, grew by 47 per cent to £28 million, a strong result indicative of the economies of scale the business is now generating. Adjusting for the reporting of India at 49 per cent from 26 August 2005 results in an increase in profits of 55 per cent over 2004.

At the Group level, profit before tax includes £6 million in profit attributable to realising value created in India when ICICI increased its stake in Prudential's Indian asset management joint venture from 45 per cent to 51 per cent. This amount is included in short-term fluctuations but excluded from operating profit based on longer-term investment returns.

Egg

Egg's total continuing operating profit in 2005 was £44 million, compared with £61 million in 2004. This reflected the increasingly challenging market conditions and £10 million restructuring costs incurred in the first half of 2005.

Operating profit of the core UK banking business was £60 million. The reduction from £72 million for 2004 primarily reflected the fact that although Egg successfully grew income by £31 million in a difficult market and cut £17 million from its cost base, this was more than offset by an increase of £59 million in bad debts due to the changing mix in the portfolio, business growth plus a deterioration in credit quality driven by economic factors across the UK unsecured lending market.

The UK unsecured lending market only grew marginally in 2005 and, indeed, there was a net reduction in credit card balances in the second half of the year. Against this tough market environment, Egg managed to drive up the return on its credit card portfolio by focusing on growing interest bearing balances and successfully repricing the card to reflect the higher funding costs, given base rates had risen on average compared to 2004. This contributed to an increase of £32 million in net interest income.

As a result of the effective cost management, together with the benefits of reorganisation early this year, Egg's cost to income ratio continued its downward trend to 43 per cent for 2005, improving from 49 per cent and 53 per cent for 2004 and 2003 respectively.

In 2005, a sharp deterioration in credit quality has adversely affected the UK retail banking sector leading to an increase in impairment charges across the sector, including Egg, compared to expectations. The result Egg achieved, which we believe is better than average industry performance, is due to the tactical decision to tighten its lending criteria early in the credit cycle, active portfolio management and its underlying higher quality card portfolio.

Regulatory attention continues to be devoted to the creditor insurance market and we believe the introduction of new measures into the sales processes for payment protection products has led to a reduction of approximately 20 per cent on the commission revenue earned on this product across the banking sector. Egg experienced similar reductions, a solid performance for an on-line bank.

Through the acquisition of the minority interests of Egg and the closer partnership of Egg with Prudential UK life and pension businesses, Prudential expects to achieve total annualised pre-tax cost savings across the combined businesses of £40 million by the end of 2007. Costs of approximately £50 million pre-tax are estimated to be incurred from this restructuring. This will be provided for in 2006.

Other

Asia's development expenses (excluding the regional head office expenses) increased by 33 per cent at CER to £20 million, compared with £15 million in 2004. These development expenses primarily related to our newer operations and establishing our services hub in Malaysia.

Other net expenditure remained constant over 2004. This reflected other income as a result of the interest earned on the net proceeds from the 2004 Rights Issue offset by higher interest payable. Head office costs (including Asia regional head office costs of £30 million) were £100 million, up £19 million on 2004. The increase mainly reflects the substantial work being undertaken for the implementation of IFRS and EEV reporting, Sarbanes-Oxley and other regulatory costs.

Total EEV basis – result before tax for continuing operations

(Year-on-year comparisons below are based on RER.)

The result before tax and minority interests was a profit of £2,244 million up 26 per cent on 2004. This reflects an increase in operating profit from £1,274 million to £1,712 million, together with a favourable movement of £431 million in short-term fluctuations in investment returns from £570 million to £1,001 million. This is offset by negative movements, principally £223 million due to changes in economic assumptions and a goodwill impairment charge of £120 million.

The UK long-term business component of short-term fluctuations in investment returns of £995 million primarily reflects the difference between an actual investment return for the with-profits life fund of 20 per cent and the long-term assumed return of seven per cent.

The US long-term business short-term fluctuations in investment returns of £65 million include a positive £63 million in respect of the difference between actual investment returns and long-term returns included in operating profit. The primary factor was a return in excess of assumptions on limited partnership investments. It also includes a positive £4 million in relation to changed expectations of future profitability on variable annuity business in force due to the actual separate account return exceeding the long-term return reported within operating profit.

In Asia, long-term business short-term investment fluctuations were £41 million, compared to £91 million last year. This mainly reflects improving equity markets in a number of countries.

Negative economic assumption changes of £349 million in 2005 compared with negative economic assumption changes of £126 million in 2004. Economic assumption changes in 2005 comprised negative £81 million in the UK, negative £3 million in the US and negative £265 million in Asia.

In the UK, economic assumption changes of negative £81 million reflect the impact of the increase in the future investment return assumption offset by the increase in the risk discount rate. The increases arise because although interest rates have decreased over 2005, the equity risk premium assumption has increased from three per cent to four per cent.

In the US, economic assumption changes of negative £3 million primarily reflect increases in the risk discount rates following the increase in the equity risk premium from three per cent to four per cent, partially offset by an increase in the separate account return assumption.

Asia's negative economic assumption changes of £265 million primarily reflect the effect of lower bond yields in Taiwan which necessitated a reduction in the Fund Earned Rate assumptions. The economic scenarios used to calculate 2005 EEV basis results reflect the assumption of a phased progression of the bond yields from the current rates to the long-term expected rates. The projections assume that, in the average scenario, the current bond yields of around two per cent trend towards 5.5 per cent at 31 December 2012. Allowance is made for the mix of assets in the fund, our future investment strategy and the market value depreciation of the bonds as a result of the assumed yield increases. This gives rise to an average assumed Fund Earned Rate that trends from 2.3 per cent to 5.4 per cent in 2013 and falls below 2.3 per cent for seven years due to the depreciation of bond values as yields rise. Thereafter, the Fund Earned Rate fluctuates around a target of 5.9 per cent. This compares to a grading of 3.4 per cent at 31 December 2004 to 5.9 per cent by 31 December 2012 for the 2004 results. Consistent with our EEV methodology, a constant discount rate has been applied to the projected cash flows.

The effect of change in the time value of cost of options and guarantees was positive £47 million for the year, consisting of £31 million, £11 million and £5 million for the UK, the US and Asia, respectively.

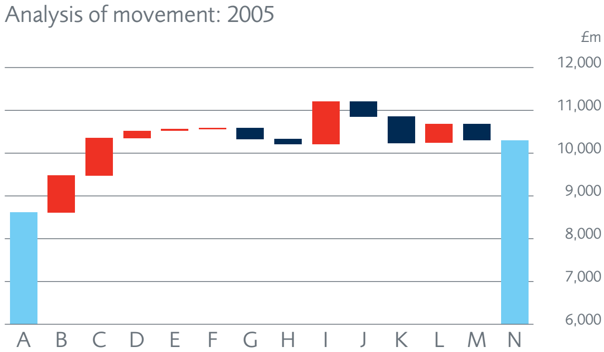
Total EEV basis – result after tax for continuing operations

The result after tax, minority interests and discontinued operations was £1,582 million. The tax charge of £653 million compares with a tax charge of £553 million in 2004. Minority interests in the Group results were £12 million.

The effective tax rate at an operating profit level was 21 per cent (2004: 27 per cent), reflecting the lower effective tax rates in the UK and certain Asian territories. The effective tax rate at a total EEV level was 29 per cent (2004: 31 per cent) on a profit of £2,244 million. The higher effective rate of tax compared with that at an operating profit level is primarily due to the effect of impairment of goodwill (which does not attract tax relief), and the impact of short-term fluctuations in investment returns and changes in economic assumptions not all of which are tax affected. The reduction in the 2005 effective tax rate arises from a number of factors, including settlement of a number of outstanding issues with HMRC and benefit taken for prior year losses incurred in France following a recent European Court of Justice decision.

EEV basis shareholders' funds

Analysis of movement: 2005



A Opening 2005 EEV basis shareholders' funds (+£8,614m)
B New business EEV profits (+£867m)
C In-force EEV profits (+£876m)
D M&G (+£163m)
E Egg (+£44m)
F Other non-life operations (+£26m)
G Other income and expenditure (incl Asia Dev exp) (-£264m)
H Goodwill impairment charge (-£120m)
I Short-term fluctuations in investment returns (+£1,001m)
J Effect of changes in economic assumptions (-£349m)
K Tax, minority interests and others (-£619m)
L FX movements (+£442m)
M External dividends (-£380m)
N Closing 2005 shareholders' funds (+£10,301m)

Return on embedded value

Prudential's return on embedded value for 2005 was 15.7 per cent, up from 13.4 per cent in 2004 reflecting the Group's continued focus on profitable growth. The return is based on post-tax EEV operating profit from continuing operations as a percentage of opening embedded value.

International Financial Reporting Standards (IFRS) results

IFRS operating profit (based on longer-term investment returns)

Reference to operating profit relates to profit including investment returns at the expected long-term rate of return but excludes short-term fluctuations in investment returns, actuarial gains and losses of defined benefit pension schemes and exceptional items.

Group operating profit before tax from continuing operations on the IFRS basis was £957 million, an increase of 36 per cent on the pro forma IFRS basis for 2004 at CER. At RER, operating profit was up 37 per cent on prior year. This reflects strong growth in insurance and funds management businesses.

In the UK, IFRS operating profit increased 35 per cent to £400 million in 2005. This reflected a nine per cent increase in profits attributable to the with-profits business, a consequence of bonus declarations announced in February 2005 and February 2006, a 44 per cent increase in profits arising from annuities business, and IFRS profits arising from the Phoenix Life and Pensions transaction completed in June 2005.

In the US, IFRS operating profit of £362 million was up 27 per cent on 2004. IFRS operating profit for long-term business was £348 million, up 17 per cent from £298 million in 2004. The US operations' results are based on US GAAP, adjusted where necessary to comply with IFRS as the Group's basis of presenting operating profit is based on longer-term investment returns. In determining the US results, longer-term returns for fixed income securities incorporate a risk margin reserve (RMR) charge for longer-term defaults and amortisation of interest-related realised gains and losses.

The growth in the US operations' long-term IFRS operating profit reflects a continued ability to deliver improved investment returns, with greater spread and fee income offset by higher amortisation of deferred acquisition costs (DAC). In 2005, spread income was £119 million higher than in 2004, and included a number of non-recurring items including mortgage prepayment fees, make-whole payments and total return swap income which together represented £60 million of spread income. JNL achieved record fee income during 2005, driven by a 42 per cent increase in separate account assets held at year end, and improved returns on these assets.

The 2004 result benefited from two one-off items, a favourable legal settlement of £28 million (£21 million after related charge to amortisation of deferred acquisition costs) and a positive £8 million adjustment arising from the adoption of new accounting guidance in SOP 03-01, 'Accounting and Reporting by Insurance Enterprises for Certain Non-traditional Long Duration Contracts and for Separate Accounts'. This adjustment relates to a change in the method of valuing certain liabilities.

The improvement in non-long-term business profits was primarily driven by reduced losses recorded by Curian, down to £10 million from £29 million in 2004, as the business continues to build scale. The result also benefited from an improvement in PPMA profits, primarily due to a one-off £5 million revaluation of an investment vehicle managed by PPMA.

Prudential Corporation Asia's operating profit for long-term business before development expenses of £20 million was £195 million, an increase of 64 per cent on 2004 at CER and included a net £44 million profit related to exceptional items reported at the half year subsequently reduced by £14 million in restructuring costs for Japan. At reported rates, operating profits were 67 per cent up on last year. The majority of this profit currently comes from the larger and more established operations of Singapore, Hong Kong and Malaysia, which represent £127 million of the total operating profit in 2005, excluding exceptional items, compared to £111 million last year. In addition, markets such as Indonesia and Vietnam are becoming larger contributors to operating profits. Five life operations made IFRS losses: China and India which are relatively new businesses rapidly building scale; Thailand and Taiwan which are marginally loss making; and Japan where the loss increased over 2004 due to restructuring costs incurred during the year.

Total IFRS profits – result before tax for continuing operations

(Year-on-year comparisons below are based on RER.)

Total IFRS profits before tax attributable to shareholders and minority interests were £998 million in 2005, compared with £985 million on the pro forma basis for 2004. The increase reflects: growth in operating profit of £258 million offset by a goodwill impairment charge of £120 million in relation to the Japanese life business; decrease in short-term fluctuations in investment return, down £82 million from 2004; and a £43 million negative movement from the prior year in actuarial gains and losses attributable to shareholder-backed operations in respect of the Group's defined benefit pension schemes.

The development of the Japanese life business has been slower than expected and, following its restructuring and the annual impairment review, Prudential concluded that the purchased goodwill associated with this business of £120 million should be written off.

The results for discontinued operations reflects the sale of Jackson Federal Bank and the discontinuation of Egg's France and Funds Direct operations.

IFRS operating profit based on longer-term investment returns	**2005 £m**	Pro forma* 2004 (at CER) £m	Percentage change	**2005 £m**	Pro forma* 2004 (at RER) £m	Percentage change
Insurance business:						
UK	**400**	296	35%	**400**	296	35%
US	**348**	298	17%	**348**	296	18%
Asia	**195**	119	64%	**195**	117	67%
Asia development expenses	**(20)**	(15)	(33)%	**(20)**	(15)	(33)%
	923	698	32%	**923**	694	33%
Fund management business:						
M&G	**163**	136	20%	**163**	136	20%
US broker-dealer and fund management	**24**	15	60%	**24**	15	60%
Curian	**(10)**	(29)	66%	**(10)**	(29)	66%
Asia fund management	**12**	20	(40)%	**12**	19	(37)%
	189	142	33%	**189**	141	34%
Banking:						
Egg (UK)	**44**	61	(28)%	**44**	61	(28)%
Other income and expenditure	**(199)**	(198)	(1)%	**(199)**	(197)	(1)%
Operating profit from continuing operations based on longer-term investment returns	**957**	703	36%	**957**	699	37%

*The comparative IFRS results shown above 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.

Total IFRS profits – result after tax for continuing operations

Profit after tax and minority interests was £748 million compared with £602 million in 2004. The effective rate of tax on operating profits, based on longer-term investment returns, was 19 per cent (2004: 30 per cent). The effective rate of tax at the total IFRS profit level for continuing operations for 2005 was 24 per cent (2004: 29 per cent). The reduction in the 2005 effective tax rate arises from a number of factors, including settlement of a number of outstanding issues with HMRC and benefit taken for prior year losses incurred in France following a recent European Court of Justice decision.

Earnings per share

Earnings per share, based on EEV basis operating profit after tax and related minority interests were 56.6 pence, compared to 43.2 pence in 2004. Earnings per share, based on IFRS operating profit after tax and related minority interests, were 32.2 pence, compared with a 2004 figure of 22.7 pence.

Basic earnings per share, based on total EEV basis profit from continuing operations for the year after minority interests, were 66.8 pence, compared with a figure of 56.8 pence in 2004. Basic earnings per share, based on IFRS profit from continuing operations for the year after minority interests, were 31.5 pence, in line with the 2004 figure.

Dividend per share

We intend to maintain our current dividend policy, with the level of dividend growth being determined after considering the opportunities to invest in those areas of our business offering attractive growth prospects, our financial flexibility and the development of our statutory profits over the medium to long term.

The Board recommends a full year dividend per share for 2005 of 16.32 pence, an increase of three per cent over the full year 2004 dividend of 15.84 pence.

Dividend cover based on reported post-tax IFRS operating profits from continuing operations is 1.9 times. Dividend cover based on reported IFRS operating profits from continuing operations and normalised tax rate of 30 per cent is 1.7 times.

Balance sheet

Explanation of balance sheet structure

The Group's capital on an IFRS basis comprises of shareholders' funds £5,194 million; subordinated long-term and perpetual debt of £2,098 million; other core structured borrowings £1,093 million and the unallocated surplus of with-profits funds of £11.4 billion.

Subordinated or hybrid debt is debt capital which has some equity like features and which would rank below other senior debt in the event of a liquidation. These features allow hybrid debt to be treated as capital for Financial Services Authority (FSA) regulatory purposes.

All of the Group's hybrid debt which qualifies in this way is held at the Group level and is therefore taken as capital into the parent solvency test under the Financial Conglomerates Directive (FCD).

The FSA has established a structure for determining how much hybrid debt can count as capital which is similar to that used for banks. It categorises capital as Tier 1 (equity and preference shares), Upper Tier 2 debt and Lower Tier 2 debt. Up to 15 per cent of Tier 1 can be in the form of hybrid debt and called 'Innovative Tier 1'. At 31 December 2005, the Group (including Egg) held £865 million of Innovative Tier 1 capital, in the form of perpetual securities, £186 million Upper Tier 2 and £1,112 million of Lower Tier 2 capital. Following the implementation of the FCD, it is advantageous to the Group from a regulatory capital standpoint to raise its long-term debt in hybrid form and it is the Group's policy to take advantage of favourable market conditions as they arise to do so.

The unallocated surplus of the with-profits funds represents assets in the Life Fund which have not yet been allocated either to policyholders or shareholders and which are not generally available to the Group other than as they emerge through the statutory transfer of the shareholders' share of the surplus as it emerges from the fund over time.

Asset and liability management

Prudential manages its assets and liabilities locally, in accordance with local regulatory requirements and reflecting the differing types of liabilities Prudential has in each business. As a result of the diversity of products Prudential offers and the different regulatory environments in which it operates, Prudential employs different methods of asset/liability management on both an in-force and new business basis. Stochastic modelling of assets and liabilities is undertaken in the UK, the US and Asia to assess economic capital requirements for different confidence intervals and time horizons. In addition, reserve adequacy testing under a range of scenarios and dynamic solvency analysis is carried out, including certain scenarios mandated by the US, the UK and Asian regulators.

Weighted average cost of capital (WACC)

Our commitment to our shareholders is to maximise the value of Prudential over time by delivering superior financial returns. Prudential's weighted average cost of capital (WACC) is circa 9.2 per cent, which is based on the net core debt and shares outstanding at the end of 2005, an equity market premium of four per cent and a market beta of 1.4. Prudential's WACC has increased since the end of 2004 largely due to an increase in the assumed equity risk premium. Prudential continues to retain a significant portion of the Rights Issue proceeds which results in a higher proportion of the Group's capital being funded by equity which, in turn, results in a temporary increase in the Group's WACC over its long-term WACC.

Shareholders' funds

On the EEV basis, which recognises the shareholders' interest in long-term businesses, shareholders' funds at 31 December 2005 were £10.3 billion, an increase of £1.7 billion from the 2004 year end level after restating for relevant IFRS changes. This 20 per cent increase primarily reflects: total EEV basis operating profit of £1,712 million; a £1,001 million favourable movement in short-term fluctuations in investment returns; and the positive impact of £442 million for foreign exchange movements. These were offset by: a £302 million negative movement due to changes in economic assumptions; a tax charge of £653 million; dividend payments of £325 million made to shareholders (net of scrip dividend); and the impairment charge of £120 million in respect of purchased goodwill associated with the Japanese life business.

At year end 2005, the embedded value for the Asian long-term business as a whole was £2.0 billion. The established markets of Hong Kong, Singapore and Malaysia contribute £1.8 billion to the embedded value generated across the region with Korea (£136 million) and Vietnam (£127 million) making further substantial contributions. Our other markets of China, India, Indonesia, Japan, Thailand and the Philippines in aggregate contribute £211 million in embedded value. Growth in embedded value for the Asian business as a whole has been partially offset by a negative embedded value in Taiwan of £311 million which includes the associated cost of economic capital, and reflects the low interest rate environment in Taiwan.

The current mix of business in Taiwan is weighted heavily towards unit-linked and protection products, representing 73 per cent and 16 per cent of new business APE in 2005, respectively. As a result, interest rates have little effect on new business profitability and a one per cent reduction in assumed interest rates would reduce new business margins in Taiwan by only two percentage points. However, the in-force book in Taiwan, predominantly made up of whole of life policies, has an embedded value that is sensitive to interest rate changes. A one per cent decrease in interest rates, along with consequential changes to assumed investment returns for all asset classes, market values of fixed interest assets and risk discount rates, would result in a £174 million decrease in Taiwan's embedded value. A similar one per cent positive shift in interest rates would increase embedded value by £106 million. Sensitivity of the embedded value to interest rate changes varies considerably across the region. In aggregate, a one per cent decrease in interest rates, along with all consequential changes noted above, would result in only a six per cent decrease to Asia's embedded value.

Statutory IFRS basis shareholders' funds at 31 December 2005 were £5.2 billion. This compares with £4.7 billion on the pro forma IFRS basis at 31 December 2004. The increase primarily reflects: profit after tax and minority interests of £748 million and positive foreign exchange movements of £268 million, offset by dividend payments to shareholders (net of scrip dividend) of £325 million.

Cash flow

The table below shows the Group holding company cash flow. Prudential believes that this format gives a clearer presentation of the use of the Group's resources than the format of the statement required by IFRS.

	2005 £m	2004 £m
Cash remitted by business units:		
UK life fund transfer*	**194**	208
UK other dividends (including special dividend)	**103**	100
JNL	**85**	62
Asia	**73**	67
M&G	**62**	84
Total cash remitted to Group	**517**	521
Net interest paid	**(115)**	(119)
Dividends paid	**(378)**	(323)
Scrip dividends and share options	**55**	119
Cash remittances after interest and dividends	**79**	198
Tax received	**107**	34
Corporate activities	**(66)**	(56)
Cash flow before investment in businesses	**120**	176
Capital invested in business units:		
UK	**(249)**	(189)
Asia	**(169)**	(158)
Total capital invested in business units	**(418)**	(347)
Decrease in cash before Rights Issue proceeds	**(298)**	(171)
Rights Issue proceeds	**0**	1,021
(Decrease) increase in cash	**(298)**	850

*In respect of prior year's bonus declarations.

The Group holding company received £517 million in cash remittances from business units in 2005 (2004: £521 million) comprising the shareholders' statutory life fund transfer of £198 million relating to the 2004 bonus declarations, of which £194 million was remitted from the UK and £4 million from Asia, together with other remittances from subsidiaries of £319 million. This includes a special dividend of £100 million from the Prudential Assurance Company (PAC) shareholders' funds in respect of profit arising from earlier business disposals and a separate payment of US$150 million from JNL. The reduced transfer from M&G is due to a higher level of reinvestment in 2005 in new activities together with a remittance of surplus cash in 2004.

After net dividends and interest paid, there was a net cash inflow of £79 million (2004: £198 million).

During 2005, the Group holding company paid £66 million in respect of corporate activities and received £107 million in respect of tax. Tax received in 2004 of £34 million was after an exceptional payment of £60 million related to the sale of equity securities backing the general insurance business. The £107 million balance in 2005 represents surrendered tax losses reimbursed by the Group. The Group invested £418 million (2004: £347 million) in its business units, comprising £249 million in its UK Operations and £169 million in Asia. During 2006, Prudential continues to expect that Asia will be a net capital provider to the Group.

In aggregate this gave rise to a decrease in cash of £298 million (2004: £850 million increase, after Rights Issue proceeds).

As a result of the bonus declarations made in February 2005 and February 2006, the shareholder transfer is expected to be £223 million in 2006.

Cash invested to support the UK business in 2006 is expected to be less than 2005, up to £230 million depending on the mix of business written and the opportunities available.

Shareholders' borrowings and financial flexibility

Net core structural borrowings at 31 December 2005 were £1,611 million compared with £1,236 million at 31 December 2004. This reflects the net cash outflow of £298 million, exchange conversion losses of £92 million and IFRS adjustments of negative £15 million.

After adjusting for holding company cash and short-term investments of £1,128 million, core structural borrowings of shareholder-financed operations (excluding Egg) at the end of 2005 totalled £2,739 million, compared with £2,797 million at the end of 2004. This decrease reflected the repayment of US$250 million bonds, the issuance of US$300 million Perpetual Subordinated Capital Securities, the repayment of £171 million of short-term borrowings, exchange conversion losses of £98 million and IFRS adjustments noted above.

Core long-term loans at the end of 2005 included £1,830 million at fixed rates of interest with maturity dates ranging from 2007 to perpetuity. £1,010 million of the core borrowings were denominated in US dollars, to hedge partially the currency exposure arising from the Group's investment in JNL.

Prudential has in place an unlimited global commercial paper programme. At 31 December 2005, commercial paper of £408 million, US$1,538 million and €228 million has been issued under this programme. Prudential also has in place a £5,000 million medium-term note (MTN) programme. At 31 December 2005, subordinated debt outstanding under this programme were £435 million and €520 million, and senior debt outstanding was US$18 million. In addition, the holding company has access to £1,500 million committed revolving credit facilities, provided by 15 major international banks and a £500 million committed securities lending liquidity facility. These facilities have not been drawn on during the year. The commercial paper programme, the MTN programme, the committed revolving credit facilities and the committed securities lending liquidity facility are available for general corporate purposes and to support the liquidity needs of the parent company.

The Group's insurance and asset management operations are funded centrally. Egg, as a separate bank, is responsible for its own financing. The Group's core debt is managed to be within a target level consistent with its current debt ratings. At 31 December 2005, the gearing ratio (debt, net of cash and short-term investments, as a proportion of EEV shareholders' funds plus debt) was 13.5 per cent compared with 12.5 per cent at 31 December 2004.

Prudential plc enjoys strong debt ratings from both Standard & Poor's and Moody's. Prudential long-term senior debt is rated AA– (negative outlook) and A2 (stable outlook) from Standard & Poor's and Moody's respectively, while short-term ratings are A1+ and P-1.

Based on EEV basis operating profit from continuing operations and interest payable on core structural borrowings (excluding Egg), interest cover was 10.8 times in 2005 compared with 9.3 times in 2004.

Treasury policy

The Group operates a central treasury function, which has overall responsibility for managing its capital funding programme as well as its central cash and liquidity positions.

The aim of Prudential's capital funding programme, which includes the £5,000 million MTN programme together with the unlimited commercial paper programme, is to maintain a strong and flexible funding capacity.

In the UK and Asia, Prudential uses derivatives to reduce equity risk, interest rate and currency exposures, and to facilitate efficient investment management. In the US, JNL uses derivatives to reduce interest rate risk, to facilitate efficient portfolio management and to match liabilities under fixed index policies.

It is Prudential's policy that all free-standing derivatives are used to hedge exposures or facilitate efficient portfolio management. Amounts at risk are covered by cash or by corresponding assets.

Due to the geographical diversity of Prudential's businesses, it is subject to the risk of exchange rate fluctuations. Prudential's international operations in the US and Asia, which represent a significant proportion of operating profit and shareholders' funds, generally write policies and invest in assets denominated in local currency. Although this practice limits the effect of exchange rate fluctuations on local operating results, it can lead to significant fluctuations in Prudential's consolidated financial statements upon conversion of results into pounds sterling. The currency exposure relating to the conversion of reported earnings is not separately managed, as it is not in the economic interests of the Group to do so. The impact of gains or losses on currency conversions is recorded as a component of shareholders' funds within the statement of recognised income and expense. The impact of exchange rate fluctuations in 2005 is discussed elsewhere in this financial review.

Unallocated surplus of with-profits funds
During 2005, the unallocated surplus, which represents the excess of assets over policyholder liabilities for the Group's with-profits funds on a statutory basis, grew from £8.3 billion at 1 January (after the effect of adoption of IFRS and the realistic reporting regime in the UK) to £11.4 billion at 31 December. This reflects an increase in the cumulative retained earnings arising on with-profits business that have yet to be allocated to policyholders or shareholders. The change in 2005 predominantly reflects the positive investment return earned by the PAC with-profits fund as a result of investment gains in the UK equity market.

Regulatory capital requirements
The FCD, which affects groups with significant cross-sector activities in insurance and banking/investment services, came into force for Prudential from 1 January 2005. Prior to this, since 1 January 2001 Prudential was required to meet the solvency requirements of the Insurance Groups Directive (IGD), as implemented by the FSA. The FSA has implemented the FCD by applying the sectoral rules of the largest sector, hence a group such as Prudential is classified as an insurance-led conglomerate and is required to focus on the capital adequacy requirements of the IGD, the Consolidated Life Directive and the Insurance Company Accounts Directive.

The FCD requires a continuous parent company solvency test which requires the aggregating of surplus capital held in the regulated subsidiaries, from which Group borrowings are deducted, other than those subordinated debt issues which qualify as capital. No credit for the benefit of diversification is allowed for under this approach. The test is passed when this aggregate number is positive, and a negative result at any point in time is a notifiable breach of UK regulatory requirements. In practice, whether Prudential is classified as a financial conglomerate or insurance group, there is very little difference in application of the rules. This is because the FSA has decided to make the test mandatory from 31 December 2006 to all insurance groups.

Due to the geographically diverse nature of Prudential's operations, the application of these requirements to Prudential are complex. In particular, for many of our Asian operations, the assets, liabilities and capital requirements have to be recalculated based on FSA regulations as if the companies were directly subject to FSA regulation.

There have been two additional FSA requirements applicable this year. Firstly, the elimination of goodwill in the valuation of non-insurance subsidiaries, for which we had already factored in the full impact in our disclosure of the 2004 IGD position, ahead of the FSA's rules coming into force. Secondly, accounting for pension fund deficits, which has had an approximate £0.1 billion impact this year to the 2005 FCD position.

The FCD position will be submitted to the FSA by 30 April 2006 but is currently estimated to be around £825 million.

The EU is continuing to develop a new prudential framework for insurance companies, 'the Solvency II project'. The main aim of this framework is to ensure the financial stability of the insurance industry and protect policyholders through establishing solvency requirements better matched to the true risks of the business. Like Basel 2, the new approach is expected to be based on the concept of three pillars – minimum capital requirements, supervisory review of firms' assessments of risk and enhanced disclosure requirements. In particular, companies will be encouraged to improve their risk management processes, including making use of internal economic capital models to enable a better understanding of the business. The emphasis on transparency and comparability would help ensure a level playing field.

Solvency II is being led by the European Commission's (EC) Internal Market Director-General, with formal 'Level 1' agreement by the European Parliament and Council on framework directive made after a full consultation process. The detailed regulatory requirements are negotiated at 'Level 2' with the EC receiving guidance from the European Insurance and Occupational Pensions Committee (EIOPC) where HM Treasury represents the UK.

The EC have directed the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), where the FSA represents the UK, to provide guidance on many technical aspects of the framework (Level 3). CEIOPS will also develop voluntary guidance for national regulators to ensure consistent interpretation of Level 2 measures. To this end, the EC and CEIOPS have jointly issued Calls for Advice in order to incorporate broader feedback from industry, for which Prudential has actively engaged in mainly through its participation in the European Chief Risk Officer (CRO) Forum.

Financial strength of insurance operations
United Kingdom
The fund is very strong with an inherited estate measured on an essentially deterministic valuation basis of around £9.0 billion compared with £6.8 billion at the end of 2004. On a realistic basis, with liabilities recorded on a market consistent basis, the free assets were valued at around £8.0 billion before a deduction for the risk capital margin.

The PAC long-term fund is rated AA+ by Standard & Poor's and Aa1 by Moody's.

The table below shows the change in the investment mix of Prudential's main with-profits fund:

	1999 %	2004 %	**2005 %**
UK equities	58	33	**40**
International equities	14	15	**19**
Property	11	18	**15**
Bonds	13	29	**21**
Cash and other asset classes	4	5	**5**
Total	100	100	**100**

For the main UK with-profits fund 83 per cent of fixed income securities are investment grade with 25 per cent rated AA or above. For Prudential Annuities Limited 95 per cent of the fixed income securities are investment grade with 48 per cent rated AA or above. For Prudential Retirement Income Limited 98 per cent of total assets are investment grade with 57 per cent rated AA or above.

With-profits contracts are long-term contracts with relatively low guaranteed amounts; this, combined with the strong financial position of the fund, enables Prudential to invest primarily in equities and property. At the end of 2005, the equity backing ratio (equity plus property) was nearly 74 per cent which reflects an approximate 10 per cent increase in the equity exposure over the year with a corresponding reduction in the bond and, to a lesser extent, the property exposure – a strategy driven by the perceived attractive pricing of equities relative to other assets in the earlier part of 2005, which led us to move back into equities. To some extent this is a retracing of the substantial (and successful) equity reduction strategy implemented towards the end of the late 90s 'bubble' period. The fund remains extremely well diversified geographically, by asset type and within the underlying stock portfolios, which we believe is an attractive feature of the Prudential with-profits proposition. It helps reduce risk or expected volatility by insulating the total fund from potential weakness in any particular market or stock. The active management of the asset mix in recent years has had a substantial beneficial impact on investment returns. The broad asset mix will continue to be reviewed as the economic environment and market valuations change.

The investment return on the Prudential main with-profits fund was 20 per cent in the year to 31 December 2005 compared with the rise in the FTSE All Share (Total Return) Index of 22 per cent over the same period. Over the last 10 years the with-profits fund has consistently generated positive fund returns with three, five and 10-year compound returns of 16.6 per cent per annum, 7.1 per cent per annum and 10.1 per cent per annum respectively, compared with corresponding increases in the FTSE All Share Index (Total Return) of 18.5 per cent, 2.2 per cent and 7.9 per cent. These returns demonstrate the benefits of the fund's strategic asset allocation and long-term outperformance.

United States

The capital adequacy position of JNL remains strong, having improved 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. JNL's financial strength is rated AA by Standard & Poor's (negative outlook) and A1 by Moody's.

JNL's invested asset mix on a US regulatory basis (including Jackson National Life of New York but excluding policy loans and reverse repo leverage) is as follows:

	2003 %	2004 %	**2005 %**
Bonds:			
Investment Grade Public	58	60	**58**
Investment Grade Private	19	19	**19**
Non-Investment Grade Public	5	4	**5**
Non-Investment Grade Private	2	2	**2**
Commercial mortgages	10	11	**11**
Private equities and real estate	4	3	**3**
Equities, cash and other assets	2	1	**2**
Total	100	100	**100**

Asia

Prudential Corporation Asia maintains solvency margins in each of its operations so that these are at or above the local regulatory requirements. Across the region less than 20 per cent of non-linked funds are invested in equities.

Both Singapore and Malaysia have discrete life funds, and in 2005 good investment returns saw their free asset ratios increase. The Hong Kong life operation is a branch of Prudential Assurance Company Limited and its solvency is covered by that business. Taiwan has Risk Based Capital regulatory solvency margins and Prudential ensures sufficient capital is retained in the business to cover these requirements.

Redress of mortgage endowment products

Prudential Assurance's main long-term business with-profits fund paid compensation of £24 million in 2005 in respect of mortgage endowment product mis-selling claims and held provisions of £63 million at 31 December 2005 to cover further claims. These compensation payments and provisions have had no impact on policyholders' asset shares. As a result, policyholders' bonuses and the shareholders' share of these bonuses are unaffected, resulting in no impact on the Group's profit before tax.

A provision of £6 million was held at 31 December 2005 by shareholders' funds to cover potential compensation in respect of mis-selling claims for Scottish Amicable mortgage endowment products sold since the acquisition of Scottish Amicable in 1997. In addition, a provision of £50 million was held at 31 December 2005 for the closed Scottish Amicable Insurance Fund (SAIF) in respect of mortgage endowment products sold prior to acquisition. This provision has no impact on shareholders. No further Scottish Amicable mortgage endowment products were sold after April 2001.

Inherited estate

The long-term fund contains the amount that the Company expects to pay out to meet its obligations to existing policyholders and an additional amount used as working capital. The amount payable over time to policyholders from the with-profits sub-fund is equal to the policyholders' accumulated asset shares plus any additional payments that may be required for smoothing or to meet guarantees. The balance of the assets of the with-profits sub-fund is called the 'inherited estate' and represents the major part of the working capital of Prudential's long-term fund which enables the Company to support with-profits business by:

- Providing the benefits associated with smoothing and guarantees;
- providing investment flexibility for the fund's assets;
- meeting the regulatory capital requirements, which demonstrate solvency; and
- absorbing the costs of significant events, or fundamental changes in its long-term business without affecting bonus and investment policies.

The size of the inherited estate fluctuates from year to year depending on the investment return and the extent to which it has been required to meet smoothing costs, guarantees and other events.

The Company believes that it would be beneficial if there were greater clarity as to the status of the inherited estate. In due course, after discussions with the FSA, the Company may therefore take steps to achieve that clarity, whether through guidance from the court or otherwise. In any event the Company expects that the entire inherited estate will need to be retained within the long-term fund for the foreseeable future to provide working capital, and so it is not considering any distribution of the inherited estate to policyholders and shareholders.

The costs associated with the mis-selling review of Prudential's with-profits personal pensions have been met from the inherited estate. Accordingly, these costs have not been charged to the asset shares used in the determination of policyholder bonus rates. Hence policyholders' pay-out values have been unaffected by personal pension mis-selling.

In 1998, Prudential stated that deducting personal pensions mis-selling costs from the inherited estate of the with-profits sub-fund would not impact the Company's bonus or investment policy. The Company gave an assurance that if this unlikely event were to occur, it would make available support to the fund from shareholder resources for as long as the situation continued, to ensure that policyholders were not disadvantaged.

The assurance was designed to protect both existing policyholders at the date it was announced, and policyholders who subsequently purchased policies while the pension mis-selling review was continuing. This review was completed on 30 June 2002 and consequently the assurance has not applied to new business issued since 1 January 2004. Therefore the maximum amount of capital support available under the terms of the assurance will reduce over time as claims are paid on the policies covered by it.

Defined benefit pension schemes

The Group operates four defined benefit schemes, three in the UK, of which the principal scheme is the Prudential Staff Pension Scheme (PSPS), and a small scheme in Taiwan. The level of surplus or deficit of assets over liabilities for defined benefit schemes is currently measured in three ways: the actuarial valuation, FRS 17 (for subsidiary accounting in the UK), and IAS 19 for the Group financial statements. FRS 17 and IAS 19 are very similar. As at 31 December 2005 the shareholders' share of the deficit of these schemes amounted to £153 million net of related tax relief.

Defined benefit schemes in the UK are generally required to be subject to full actuarial valuation every three years to assess the appropriate level of funding for schemes having regard to their commitments. These valuations include assessments of the likely rate of return on the assets held within the separate trustee administered funds. PSPS was last actuarially valued as at 5 April 2002 and this valuation demonstrated the Scheme to be 110 per cent funded, with an excess of actuarially determined assets over liabilities of 10 per cent, representing a fund surplus of £376 million. As a result, no change in employers' contributions from the current 12.5 per cent of salaries has been required until now.

The PSPS valuation as at 5 April 2005 is currently being finalised and is expected to show a small deficit on the actuarial basis. The Company expects that for 2006 and future years the employers' contributions for ongoing service of current employees will approximately double whilst, in addition, deficit funding amounts designed to eliminate the actuarial deficit over a 10-year period will be made. Total contributions to the Scheme for these two components are expected to be of the order of £70-75 million per annum over a 10-year period. This compares with contributions in 2005 of £19 million.

Under IAS 19 the basis of valuation differs markedly from the full triennial valuation basis. In particular, it would require assets of the Scheme to be valued at their market value at the year end, while pension liabilities would be required to be discounted at a rate consistent with the current rate of return on a high quality corporate bond. As a result, the difference between IAS 19 basis assets and liabilities can be volatile. For those schemes such as PSPS, which hold a significant proportion of their assets in equity investments, the volatility can be particularly significant. Under IAS 19, for 2005, a £22 million pre-tax shareholder charge to operating results based on longer-term returns arises, outside the operating result, but included in total profits is a pre-tax shareholder charge of a further £51 million. This is comprised of two components. First, £31 million of net actuarial gains arises on the movement in the shareholders' share of the scheme deficits. The second component is a charge of £20 million which arises from the need under UK GAAP (when applied to the Group's insurance contracts under IFRS) to set aside amounts for future expenses on certain contracts. The £20 million charge reflects the increase relating to the increased future contributions for ongoing service.

Surpluses and deficits on the Group's defined benefit schemes are apportioned to the PAC life fund and shareholders' funds based on estimates of employees' service between them. Previously, for the purposes of memorandum FRS 17 disclosure, the deficit on the PSPS Scheme has been apportioned in the ratio 80/20 between the life fund and shareholder-backed operations. During the year, additional analysis has been undertaken and the ratio reassessed as 70/30. At 31 December 2005, the total share of the deficits on PSPS and the much smaller Scottish Amicable scheme attributable to the PAC life fund amounted to £296 million net of related tax relief.

Risk management

A significant part of the Group's business involves the acceptance and management of risk. The Group's risk management model requires the primary responsibility for risk management at an operational level to rest with business unit chief executives. The second line of defence of risk comprises oversight functions reporting to the Group Chief Executive, Group Chief Risk Officer and Group Risk function together with business unit risk functions and risk management committees. The third line of defence comprises independent assurance from Internal Audit reporting to business unit and Group audit committees.

The Group operates a comprehensive planning process. Executive management and the Board receive regular reports on the financial position of the Group, actual performance against plan, together with updated forecasts. The insurance operations of the Group all prepare a financial condition report, which is reported on to the Board.

The Group's risk management procedures are further described in the Corporate Governance Report. Further discussion on key risk factors of the Group is included on pages 201 to 203.

Internal rate of return

The internal rate of return (IRR) is equivalent to the discount rate at which the present value of the post-tax cash flows expected to be earned over the life time of the business written in shareholder-backed life funds is equal to the total invested capital to support the writing of the business. The capital included in the calculation of the IRR is the initial capital in excess of the premiums received required to pay acquisition costs and set up the statutory capital requirement. The time value of options and guarantees are included in the calculation.

Products and drivers of insurance operations' profit

United Kingdom

In common with other UK long-term insurance companies, Prudential's products are structured as either with-profits (or participating) products, or non-participating products including annuities in payment and unit-linked products. Depending upon the structure, the level of shareholders' interest in the value of policies and the related profit or loss varies.

With-profits policies are supported by a with-profits sub-fund and can be single premium (for example, Prudence Bond) or regular premium (for example, certain corporate pension products). Prudential's primary with-profits sub-fund is part of PAC's long-term fund. The return to shareholders on virtually all with-profits products is in the form of a statutory transfer to PAC shareholders' funds which is analogous to a dividend from PAC's long-term fund and is dependent upon the bonuses credited or declared on policies in that year. Prudential's with-profits policyholders currently receive 90 per cent of the distribution from the main with-profits sub-fund as bonus additions to their policies and shareholders receive 10 per cent as a statutory transfer.

The profits from almost all of Prudential's new non-participating business accrue solely to shareholders. Such business is written in the non-profit sub-fund within PAC's long-term fund, or in various shareholder-owned direct or indirect subsidiaries, the most significant of which is Prudential Retirement Income Limited (PRIL), which also writes all new immediate annuities arising from vesting deferred annuity policies in the with-profits sub-fund of PAC. There is a substantial volume of in-force non-participating business in PAC's with-profits sub-fund and that fund's wholly owned subsidiary Prudential Annuities Limited (PAL) which is closed to new business; profits from this business accrue to the with-profits sub-fund.

United States

JNL's principal retail savings products are sold as single premium fixed, variable or fixed index deferred annuities.

Interest-sensitive fixed annuities are products which allow for tax-deferred accumulation of funds, with flexible payout options. They are used for retirement planning and for providing income in retirement. The policyholder pays JNL a premium, which is credited to the policyholder's account. Periodically, interest is credited to the policyholder's account and administrative charges are deducted, as appropriate. JNL may reset the interest rate on each policy anniversary, subject to a guaranteed minimum, in line with state regulations. When the annuity matures, JNL either pays the policyholder the amount in the policyholder account or begins making payments to the policyholder in the form of an immediate annuity product. This latter product is similar to a UK annuity in payment. Fixed annuity policies provide for early surrender charges for the first six to nine years of the policy. In addition, the policy may be subject to a market value adjustment at the time of early surrender. JNL's profits on fixed annuities arise primarily from the spread between the return it earns on investments and the interest credited to the policyholder's account (net of any surrender charges or market value adjustment) less expenses.

Fixed index annuities (formerly referred to as equity-indexed annuities) are deferred annuities that enable policyholders to obtain a portion of an equity-linked return but provide a guaranteed minimum return. JNL guarantees an annual minimum interest rate, although actual earnings may be higher and are based on a participation in an equity index over its indexed option period. JNL's profit arises from the investment income earned and the fees charged on the policy, less the expenses incurred, which include the costs of the guarantees, and the return credited to the policy. Fixed index annuities contain provision for early surrender.

Variable annuities are tax advantaged deferred annuities where the rate of return depends upon the performance of the underlying portfolio, similar in principle to UK unit-linked products. They are used for retirement planning and to provide income in retirement. The policyholder's premiums are held apart from JNL's general account assets, in a 'separate' account, which is analogous to a unit-linked fund. The policyholder can allocate the premiums between a variety of variable sub-accounts with a choice of fund managers and/or guaranteed fixed-rate options. The value of the portion of the separate account allocated to variable sub-accounts fluctuates with the underlying investment. Variable annuity policies provide for early surrender charges.

JNL offers a choice of guarantee benefit options within its variable annuity product range which customers can elect and pay for. These include the guaranteed minimum death benefit (GMDB), which guarantees on death the policyholder receives a minimum value regardless of past market performance. These guaranteed death benefits might be expressed as the return of original premium, the highest past anniversary value of the policy, or as the original premium accumulated at a fixed rate of interest. In addition, there are two other types of guarantee, guaranteed minimum withdrawal benefits (GMWB) and guaranteed minimum income benefits (GMIB). GMWBs provide a guaranteed return of the principal invested by allowing for periodic withdrawals which are limited to a maximum percentage of the initial premium. GMIBs provide for a minimum level of benefits upon annuitisation regardless of the value of the investments underlying the contract at the time of annuitisation. The GMIB is reinsured.

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

Prudential's business in Asia is focused on regular premium products that provide both savings and protection benefits. In 2005, the new business profit mix was 63 per cent unit-linked, 25 per cent non-linked and 12 per cent Accident and Health (A&H) products.

Unit-linked products combine savings with protection and the cash value of the policy depends on the value of the underlying unitised funds. Participating products provide savings with 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 insurer. Non-participating products offer savings with protection where the benefits are guaranteed or determined by a set of defined market related parameters. A&H products provide mortality or morbidity benefits and include health, disablement, critical illness and accident covers. A&H products are commonly offered as supplements to main life policies but can also be sold separately.

The profits from participating policies are shared between the policyholder and insurer (typically in a 90:10 ratio) in the same way as with-profits business in the UK. Under unit-linked products the profits that arise from managing the policy, its investments and the insurance risk accrue entirely to shareholders, with investment gains accruing to the policyholder within the underlying unitised fund. The profits from A&H and non-participating products consist of any surplus remaining after paying policy benefits.

Unit-linked products tend to have higher profits on the EEV basis of reporting than traditional non-linked products as expenses and charges are better matched and solvency capital requirements are lower. At the end of 2005 Prudential Corporation Asia offered unit-linked products in 10 of the 12 countries in Asia in which it operates.

In addition to the life products described above, Prudential offers mutual fund investment products in India, Taiwan, Japan, Singapore, Malaysia, Hong Kong, Korea and Vietnam, allowing customers to participate in debt, equity and money market investments. The Company earns a fee based on assets under management.

Description of EEV basis reporting
Prudential's results are prepared on two bases of accounting, the supplementary EEV basis and the IFRS basis for the financial statements. Over the life of any given product, the total profit recognised will be the same under either the IFRS or the EEV basis. However, the two methods recognise the emergence of that profit differently, with profits emerging earlier under the EEV basis than under IFRS. This section explains how the two bases operate and why they are used.

Prudential's primary financial statements are prepared in accordance with the IFRS basis of reporting of long-term business. In broad terms, IFRS profits for long-term business reflect the aggregate of statutory transfers from with-profits funds and profit on a traditional accounting basis for other long-term business.

However, the products sold by the life insurance industry are by their nature long-term, as it commits to service the products for many years into the future. In many cases policies require customers to continue to pay further premiums in the future. The profit on these insurance sales is generated over a significant number of years and IFRS basis profits do not, in Prudential's opinion, properly reflect the inherent value of these future profit streams.

From 1997, Prudential and other major UK quoted financial groups adopted the achieved profits basis, a form of embedded value reporting, as a supplementary accounting measure in order to give a better reflection of the value attaching to long-term insurance business. Achieved profits basis financial statements were prepared under guidance issued by the ABI in December 2001.

In May 2004 the CFO Forum representing the Chief Financial Officers of 19 European Insurers, published the European Embedded Value (EEV) Principles which are designed to improve the transparency and consistency of embedded value reporting. Member companies, of which Prudential is one, agreed to adopt the principles for supplementary reporting no later than the financial year end commencing 1 January 2005. Prudential has fully adopted the Principles for the first time in respect of full year 2005 results.

For Prudential, EEV reporting represents an evolution from the achieved profits basis previously used for supplementary reporting and we welcome the improved clarity and consistency of information that it will provide to investors. We reiterate our view that embedded value information provides investors with a more realistic reflection of the current performance of life insurance business. In summary, the principal changes from current achieved profits reporting are in respect of three areas:

- Inclusion of an explicit allowance for the impact of options and guarantees. This will typically require stochastic calculations, under which a large number of simulations are performed that provide a representation of the future behaviour of financial markets;
- more active allowance for the combined impact of risk profile, encumbered capital and explicit valuation of options and guarantees in the selection of discount rates. This will ensure that the risks to the emergence of shareholder cash flows are properly accounted for; and
- enhanced disclosure that will enable informed investors to more fully understand the key risks within the business together with management's approach to them, and the basis of preparation of results.

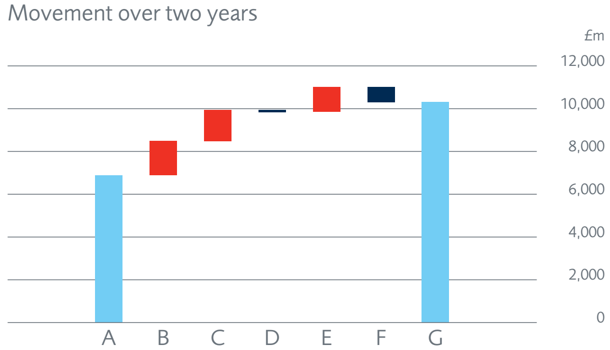
In other respects we expect that the EEV basis of reporting to be similar to the achieved profits basis.

The EEV basis not only provided a good indicator of the value being added by management in a given accounting period but it also demonstrates whether shareholder capital is being deployed to best effect. Indeed insurance companies in many countries use comparable bases of accounting for management purposes. Prudential believes that the EEV basis provides useful information for shareholders. In contrast, for many types of contract, the IFRS result does not reflect the long-term benefit that will arise in the future from current management initiatives and capital expenditure in the year under review, as it focuses instead on the amounts accruing to shareholders in the current year only from business already in force.

The EEV basis is a value based method of reporting in that it reflects the change in value of the business over the accounting period. This value is called the shareholders' funds on the EEV basis which, at a given point in time, is the value of future cash flows expected to arise from the current book of long-term insurance business plus the net worth of the Company. In determining these expected cash earnings, Prudential makes full allowance for the risks attached to their emergence and associated cost of capital and takes into account recent experience in assessing likely future persistency, mortality and expenses. Economic assumptions as to future investment returns and inflation are based on market data.

The change in value is typically analysed as shown in the EEV basis shareholders' funds chart into the following components: the value added from new business sold during the year; the change in value from existing business already in place at the start of the year; short-term fluctuations in investment returns; change in the time value of cost of options and guarantees and economic assumption changes; other items (for example, profit from other Group operations, tax, foreign exchange, exceptional items); and dividends.

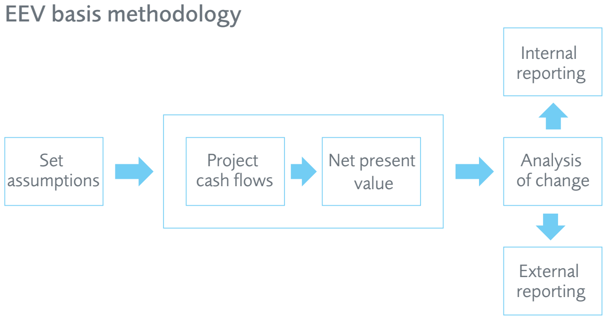
EEV basis shareholders' funds
Movement over two years



A Opening 2004 EEV basis shareholders' funds
B New business EEV profits
C In-force EEV profits
D Other
E Short-term fluctuations in investment returns, change in cost of guarantees, effect of changes in economic assumptions and shareholders' share of actuarial and other gains and losses of defined benefit pension schemes
F Dividends
G Closing 2005 EEV basis shareholders' funds

The value added from new business (being the present value of the future cash flows arising from new business written in the year) is a key metric used in the management of the business. The change in value of business in force at the start of the year demonstrates how the existing book is being managed. Together they provide management and shareholders with valuable information about the underlying development of the business and the success or otherwise of management actions.

EEV basis methodology



As indicated above, EEV basis results are prepared by first of all making assumptions about all relevant factors including levels of future investment return, expenses, surrender levels and mortality. These best estimate assumptions are used to project future cash flows. The present value of the future cash flows is then calculated using a discount rate which reflects both the time value of money and the risks associated with the cash flows. The risk discount rate is determined using the actual yield on long-term government bonds plus a risk margin. The projected future cash flows are prepared on a set of assumptions specific to product group, and the actual outcome may be different from that projected. Where the actual outcome is different, this will be reflected in the experience variances for that year.

The total profit that emerges over the lifetime of an individual contract as calculated using the EEV basis is the same as that calculated under the IFRS basis. However, since the EEV basis reflects discounted future cash flows under this methodology the profit emergence is advanced, thus more closely aligning the timing of the recognition of benefits with the efforts and risks of current management actions, particularly with regard to business sold during the year.

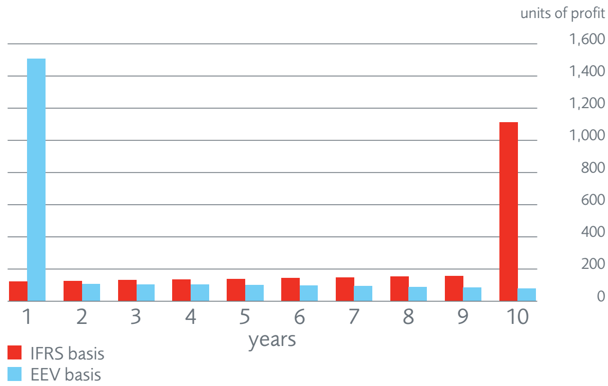
The assumptions used for the EEV basis of accounting are set out on pages 212 to 214 in the notes that accompany the supplementary EEV basis information. An indication of the sensitivity of the results to changes in the key assumptions of interest rate and investment return is provided on pages 226 to 228.

The EEV basis can be illustrated by considering a theoretical individual contract. Using assumptions for the drivers of future income and expenditure (including levels of future investment return, expenses, surrender levels and mortality) a profile of future cash flows can be estimated. These cash flows are then discounted back to the point of sale to give a new business profit.

The EEV basis profits emerging in each subsequent accounting period will comprise the unwinding of the discount (which arises from discounting future cash flows for one fewer period) and the profit or loss arising from any difference between the actual cash flow and the cash flow which had been assumed in the accounting period under review, together with the effect of any changes of assumption where the directors believe a revision is required to the original estimates of future experience.

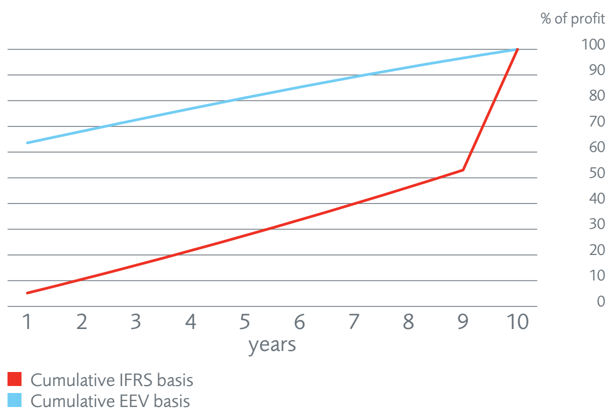
Set out below is an illustrative profit profile for a typical with-profits product. The pattern of actual profit emergence will vary by product.

Illustration of IFRS basis and EEV basis profit profiles for a typical with-profits product



The different timing of profit recognition under the two bases is demonstrated in the next chart, which shows the cumulative level of profit recognition for the yearly profits shown in the previous chart. It illustrates that under the EEV basis profits emerge earlier, but the eventual total profit is the same under both bases.

Illustration of IFRS basis and EEV basis cumulative profit profiles for a typical with-profits product



Philip Broadley
Group Finance Director