Other corporate information

Explanation of balance sheet structure

The Group's capital on an IFRS basis comprises of shareholders' funds of £5,488 million, subordinated long-term and perpetual debt of £1,989 million, other core structural borrowings of £1,074 million and the unallocated surplus of with-profits funds of £13.6 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 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 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 and Lower Tier 2. Up to 15 per cent of Tier 1 can be in the form of hybrid debt and called 'Innovative Tier 1'. At 31 December 2006, the Group held £763 million of Innovative Tier 1 capital, in the form of perpetual securities, £250 million of Upper Tier 2 and £1,103 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. They 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.

Weighted average cost of capital (WACC)

Prudential's commitment to its 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 9.6 per cent, which is based on the net core debt and shares outstanding at the end of 2006, an equity market premium of four per cent and a market beta of 1.4. Prudential's WACC has increased since the end of 2005 largely due to an increase in interest rates and to equity forming a greater proportion of capital.

Financial instruments

The Group is exposed to financial risk through its financial assets, financial liabilities, and policyholder liabilities. The financial risk factors affecting the Group include market risk, foreign exchange risk, credit risk and liquidity risk. Information on the financial risk management objectives and policies of the Group and the exposure of the Group to the financial risk factors is given in Section C on pages 136 to 138.

Further information on the use of derivatives and hedge accounting by the Group is also provided in notes D3 and G3 on pages 155 and 156 and 195 to 197 respectively.

Shareholders' borrowings and financial flexibility

Net core structural borrowings at 31 December 2006 were £1,493 million compared with £1,611 million at 31 December 2005. This reflects the net cash outflow of £104 million, exchange conversion gains of £240 million and other adjustments of £18 million.

After adjusting for holding company cash and short-term investments of £1,119 million, core structural borrowings of shareholder-financed operations (excluding Egg) at the end of 2006 totalled £2,612 million, compared with £2,739 million at the end of 2005. This decrease reflected exchange conversion gains of £135 million and other adjustments of £8 million.

Core long-term loans at the end of 2006 included £1,626 million at fixed rates of interest with maturity dates ranging from 2007 to perpetuity. Core borrowings of £890 million were denominated in US dollars, to hedge partially the currency exposure arising from the Group's investment in Jackson.

Prudential has in place an unlimited global commercial paper programme. At 31 December 2006, commercial paper of £198 million, US$3,449 million and €85 million has been issued under this programme. Prudential also has in place a £5,000 million medium-term note (MTN) programme. At 31 December 2006, subordinated debt outstanding under this programme was £435 million and €520 million, and senior debt outstanding was US$18 million and £5 million. In addition, the holding company has access to £1,600 million committed revolving credit facilities, provided by 16 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 2006, the gearing ratio (debt, net of cash and short-term investments, as a proportion of EEV shareholders' funds plus debt) was 11.2 per cent compared with 13.5 per cent at 31 December 2005.

Prudential plc enjoys strong debt ratings from both Standard & Poor's and Moody's. Prudential long-term senior debt is rated A+ (stable outlook), A2 (stable outlook) and AA- from Standard & Poor's, Moody's and Fitch respectively, while short-term ratings are A1, P-1 and F1+.

Based on EEV basis operating profit from continuing operations and interest payable on core structural borrowings (excluding Egg), interest cover was 12.2 times in 2006 compared with 10.8 times in 2005.

Other corporate information continued

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.

Prudential UK and Prudential Corporation Asia use derivatives to reduce equity risk, interest rate and currency exposures, and to facilitate efficient investment management. In the US, Jackson 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 2006 is discussed elsewhere in this OFR.

Unallocated surplus of with-profits

During 2006, 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 £11.3 billion at 1 January to £13.6 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 2006 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 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.

Due to the geographically diverse nature of Prudential's operations, the application of these requirements to Prudential is 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.

The FCD position will be submitted to the FSA by 30 April 2007 but is currently estimated to be around £1.0 billion. A further gain of £0.3 billion is expected to arise in 2007 from the sale of Egg. The sale of Egg implies that Prudential may again be designated an 'insurance group' rather than its current treatment as a financial conglomerate, and thus will be required to meet the requirements of the IGD. This should not have a significant impact on the Group, as the FSA's prudential requirements pertaining to insurance groups are very similar to those applying to insurance conglomerates, in particular because the FSA has decided to make the continuous parent solvency test mandatory from 31 December 2006 for all insurance groups.

The European Commission is continuing to develop a new prudential framework for insurance companies, 'the Solvency II project' that will update the existing life, non-life and insurance groups directives. 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. However, the scope is wider than Basel 2 and will cover valuations, the treatment of insurance groups, the definition of capital and the overall level of capital requirements.

A key aspect of Solvency II is the focus on risks and, for example, capital requirements will be calibrated to a one year Value at Risk with a 99.5 per cent confidence level. Companies will be encouraged to improve their risk management processes and will be allowed to make use of internal economic capital models to enable a better understanding of risks. The emphasis on transparency and comparability would ensure a level playing field but not delivering this remains one of the key risks for the project.

Prudential is actively engaged in policy discussions mainly through its participation in the Chief Risk Officer (CRO) Forum of major European insurance firms. Prudential has been emphasising the importance of level playing fields, in particular in connection with the treatment of operations outside the EU.

The Commission intends to adopt proposals for a framework directive in mid-2007 which will contain high-level principles. These principles will be supplemented by implementing measures that will be adopted by the Commission and EU member states. Solvency II is then intended to be implemented around 2010. It is important that the EU policy makers keep up the progress to enable implementation by the suggested date.

During 2006, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) invited EU insurance industry to participate in the second quantitative impact study, which provided useful input for supervisors and industry alike. The EU insurance industry will be participating in another quantitative impact study during the first half of 2007 with a view to provide quantitative input into the calibration of the capital requirements. Participation in these exercises involves a substantive commitment and is expected to yield benefits by providing evidence leading to a truly risk-based capital requirement.

Financial strength of insurance operations

United Kingdom

The PAC's long-term fund remains very strong. On a realistic valuation basis, with liabilities recorded on a market consistent basis, the free assets are valued at approximately £8.7 billion at 31 December 2006, before a deduction for the risk capital margin. The fund is rated AA+ by Standard & Poor's, Aa1 by Moody's and AA+ by Fitch Ratings.

The with-profits sub-fund delivered a pre-tax return of 12.4 per cent in 2006, and over the last five years the fund has achieved a total return of 63.8 per cent against 41.1 per cent for the FTSE 100 total return and 50.2 per cent for the FTSE All-Share (Total Return) index (figures are to 31 December 2006, before tax and charges). Much of this excellent investment performance was achieved through the active asset allocation of the fund. As part of its asset allocation process, Prudential UK constantly evaluates prospects for different markets and asset classes. During the year, Prudential UK decreased its exposure to equities while increasing its exposure to corporate bonds and alternative assets, reflecting Prudential UK's view that increased diversification in the assets of the with-profits sub-fund was appropriate.

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

	2006 %	2005 %	2004 %
UK equities	**36**	40	33
International equities	**17**	19	15
Property	**15**	15	18
Bonds	**25**	21	29
Cash and other assets classes	**7**	5	5
Total	**100**	100	100

United States

The capital adequacy position of Jackson remains strong, having improved the capital ratio from 9.2 per cent in 2005 to 9.8 per cent in 2006. Jackson's statutory capital, surplus and asset valuation reserve position improved year-on-year by US$193 million, after deducting the US$200 million of capital remitted to the parent company. Jackson's financial strength is rated AA by Standard & Poor's and A1 by Moody's.

Jackson's invested asset mix on a US regulatory basis (excludes policy loans and reverse repo leverage) is as follows:

	2006 %	2005 %	2004 %
Bonds:			
Investment Grade Public	**60**	58	60
Investment Grade Private	**18**	19	19
Non-Investment Grade Public	**4**	5	4
Non-Investment Grade Private	**1**	2	2
Commercial mortgages	**12**	11	11
Private equities and real estate	**3**	3	3
Equities, cash and other assets	**2**	2	1
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 40 per cent of non-linked funds are invested in equities. Both Singapore and Malaysia have discrete life funds, and have strong free asset ratios. 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

PAC's main long-term business with-profits fund paid compensation of £11 million in 2006 in respect of mortgage endowment product mis-selling claims and held a provision of £60 million at 31 December 2006 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.

Other corporate information continued

A provision of £5 million was held at 31 December 2006 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 £45 million was held at 31 December 2006 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.

In May 2006, the Group introduced a deadline for both Prudential and Scottish Amicable mortgage endowment complaints. Impacted customers have three years to lodge a mis-selling complaint in line with the time limit prescribed by the FSA and the ABI.

Inherited estate of Prudential Assurance

The assets of the main with-profits fund within the long-term insurance fund of PAC comprise the amounts that it 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 fund is equal to the policyholders' accumulated asset shares plus any additional payments that may be required by way of smoothing or to meet guarantees. The balance of the assets of the with-profits fund is called the 'inherited estate' and has accumulated over many years from various sources.

The inherited estate represents the major part of the working capital of PAC's long-term insurance fund. This enables PAC to support with-profits business by providing the benefits associated with smoothing and guarantees, by providing investment flexibility for the fund's assets, by meeting the regulatory capital requirements that demonstrate solvency and by absorbing the costs of significant events or fundamental changes in its long-term business without affecting the bonus and investment policies. 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.

PAC believes that it would be beneficial if there were greater clarity as to the status of the Inherited Estate. As a result, PAC has announced that it has begun a process to determine whether it can achieve that clarity through a reattribution of the inherited estate. As part of this process, a Policyholder Advocate has been nominated to represent policyholders' interests. This nomination does not mean that a reattribution will occur.

Given the size of the Group's with-profits business any proposal is likely to be time consuming and complex to implement and is likely to involve a payment to policyholders from shareholders' funds. If a reattribution is completed the inherited estate will continue to provide working capital for the long-term insurance fund.

Defined benefit pension schemes

The Group operates four defined benefit schemes, three in Prudential 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 2006, the shareholders' share of the £65 million surplus for PSPS and the deficits of the other schemes amounted to an £8 million deficit net of related tax relief.

Defined benefit schemes in Prudential 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 2005 and this valuation demonstrated the Scheme to be 94 per cent funded, with a shortfall of actuarially determined assets to liabilities of six per cent, representing a deficit of £243 million.

The finalisation of the valuation as at 5 April 2005 was accompanied by changes to the basis of funding for the Scheme. For 2006 and future years, deficit funding amounts designed to eliminate the actuarial deficit over a 10-year period have been and are being made. Total contributions to the Scheme for deficit funding and employer's contributions for ongoing service for current employees are expected to be of the order of £70-75 million per annum over a 10-year period. However, in 2006, total contributions, including amounts in arrears for the scheme year to 5 April 2006, were £137 million.

Under IAS 19 the basis of valuation differs markedly from the full triennial valuation basis. In particular, it requires assets of the Scheme to be valued at their market value at the year end, while pension liabilities are 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 substantial proportion of their assets in equity investments, the volatility can be particularly significant. For 2006, a £28 million pre-tax shareholder charge to operating results based on longer-term returns arises. In addition, outside the operating result, but included in total profits is a pre-tax shareholder credit of £167 for net actuarial gains. These gains primarily represent the difference between actual and expected investment returns for the schemes and the reduction in liabilities caused by an increase in the discount rate caused by increases in corporate bond returns.

In 2006, the PSPS asset allocation was altered away from equity investments such that at 31 December 2006 the market value of equities for the Group's defined benefit schemes represented 31 per cent (2005: 52 per cent) of the total asset value, whilst the bond portfolio accounted for 43 per cent (2005: 34 per cent).

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. At 31 December 2005, the deficit on the PSPS Scheme was apportioned in the ratio 70/30 between the life fund and shareholder-backed operations. This ratio was determined following extensive analysis of the source of the cumulative funding for the scheme to that date. This basis has been applied for 2006 to the assets and liability movements relating to the start position and also to the deficit funding paid in the year. However, the IAS 19 service cost for the year and employer contributions for ongoing service of current employees have been apportioned in the ratio relevant to current activity. At 31 December 2006, the total share of the surplus on PSPS and the deficit on the much smaller Scottish Amicable scheme attributable to the PAC life fund amounted to a net surplus of £66 million net of related tax relief.

Products and drivers of insurance operations' profits

United Kingdom

In common with other UK long-term insurance companies, Prudential UK'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 UK 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. There are two types of bonuses 'annual' and 'final'. Annual bonuses are declared once a year, and once credited, are guaranteed in accordance with the terms of the particular product and are determined as a prudent proportion of the long-term expected future investment return on the underlying assets. 'Final' bonuses are only guaranteed until the next bonus declaration and are primarily determined on the actual smoothed investment return achieved over the life of the policy. Prudential's UK 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 defined charge participating sub-fund (DCPSF) forms part of the PAC long-term fund and comprises the accumulated investment content of premiums paid in respect of the defined charge participating with-profits business issued in France, and the defined charge participating with-profits business reassured into PAC from Prudential International Assurance plc and Canada Life (Europe) Assurance Ltd. All profits in this fund accrue to policyholders in the DCPSF.

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

Jackson'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 asset accumulation in retirement planning and for providing income in retirement. The contractholder pays Jackson a premium, which is credited to the contractholder's account. Periodically, interest is credited to the contractholder's account and administrative charges are deducted, as appropriate. Jackson may reset the interest rate on each contract anniversary, subject to a guaranteed minimum, in line with state regulations. When the annuity matures, Jackson either pays the contractholder the amount in the contractholder account or begins making payments to the contractholder in the form of an immediate annuity product. This latter product is similar to a UK annuity in payment. Fixed annuity policies are subject to early surrender charges for the first six to nine years of the contract. In addition, the contract may be subject to a market value adjustment at the time of early surrender. During the surrender charge period, the contractholder may cancel the contract for the surrender value. Jackson's profits on fixed annuities arise primarily from the spread between the return it earns on investments and the interest credited to the contractholder'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 allow for tax-deferred accumulation of funds, with flexible payout options. They are used for asset accumulation in retirement planning and for providing income in retirement. The contractholder pays Jackson a premium, which is credited to the contractholder's account. Periodically, interest is credited to the contractholder's account and administrative charges are deducted, as appropriate. Jackson guarantees an annual minimum interest rate, although actual interest credited may be higher and is linked to an equity index over its indexed option period. Jackson's profit arises from the investment income earned and the fees charged on the contract, less the expenses incurred, which include the costs of the guarantees, and the interest credited to the contract. Fixed index annuities are subject to early surrender charges for the first five to 12 years of the contract. During the surrender charge period, the contractholder may cancel the contract for the surrender value.

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 also used for asset accumulation in retirement planning and to provide income in retirement. The contractholder's premiums are held apart from Jackson's general account assets, in a separate account, which is analogous to a unit-linked fund. The contractholder 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

Other corporate information continued

the underlying investments. Variable annuity policies are subject to early surrender charges for the first three to six years of the contract. During the surrender charge period, the contractholder may cancel the contract for the surrender value. Jackson offers one variable annuity that has no early surrender charges.

Jackson offers a choice of guaranteed benefit options within its variable annuity product portfolio which customers can elect and pay for. These include the guaranteed minimum death benefit (GMDB), which guarantees on death the contractholder 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 contract, 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. One version of the GMWBs provides for a minimum annual withdrawal amount that is guaranteed for the contractholder's life without annuitisation. 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.

As the investment return on the separate account assets is attributed directly to the contractholders, Jackson's profit arises from the fees charged on the contracts, less the expenses incurred, which include the costs of guarantees.

Jackson also sells several types of life insurance including term life, universal life, survivorship universal life, and variable universal life. Term life provides protection for a defined period of time and a benefit that is payable to a designated beneficiary upon death of the insured. Universal life provides permanent individual life insurance for the life of the insured and includes a savings element. Survivorship universal life is a form of permanent life insurance that insures two people and pays the policy benefits after the death of the last surviving insured. Variable universal life is a life insurance policy that combines death benefit protection and the important tax advantages of life insurance with the long-term growth potential of professionally managed investments.

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 2006, the new business profit mix was 60 per cent unit-linked, 18 per cent non-linked and 22 per cent 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 2006, 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, Vietnam and China, allowing customers to participate in debt, equity and money market investments. It is also licensed in UAE. Prudential Corporation Asia 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 EEV differs from IFRS and why it is used.

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. The IFRS result, however, does not reflect the long-term benefits that 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 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. 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 the long-term insurance business and the current performance.

In May 2004, the CFO Forum, representing the Chief Financial Officers of 19 European insurers, published the European Embedded Value Principles (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 fully adopted the Principles for the first time in respect of full-year 2005 results.

For Prudential, EEV reporting represents an evolution from achieved profits reporting and it welcomes the improved clarity and consistency of information that it provides to investors although there is still some way to go before achieving full consistency.

Compared to achieved profits, the principal differences are in respect of three areas:

- inclusion of an explicit allowance for the impact of options and guarantees. This typically requires 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 and encumbered capital in the selection of discount rates. This ensures that the risks to the emergence of shareholder cash flows are properly accounted for; and
- enhanced disclosure that enables informed investors to understand better the key risks within the business and the basis of preparation of the results.

The EEV basis not only provides 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.

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 the 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 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; the effect of changes in economic assumptions, the time value of the cost of options and guarantees and other short-term volatilities caused through market movements; other items (for example, profit from other Group operations, tax, and the effect of exchange movements); and dividends.

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 results are prepared by first of all setting best estimate assumptions, by product, for all relevant factors including levels of future investment returns, expenses, surrender levels and mortality.

These 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 by adding a risk margin to the appropriate risk free rate of return. The actual outcome may be different from that projected in which case the effect will be reflected in the experience variances for that year.

The assumptions used for the EEV basis of accounting are set out on pages 260 to 264 in the notes that accompany the supplementary EEV basis information. An indication of the sensitivity of the results to changes in key assumptions is provided on pages 278 to 280.

The EEV basis can be illustrated by considering a theoretical individual contract. Using assumptions for the drivers of future income and expenditure, 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 and expected experience, together with the effect of any changes of assumption where the directors believe a revision is required to the original estimates of future experience.

Post-balance sheet events

Important events affecting the Company after the end of the financial year are detailed in note I8 on page 239.

Payment policy

It is the policy of the Group to agree terms of payment when orders for goods and services are placed and to pay in accordance with those terms. Trade creditor days, based on the ratio of amounts which were owed to trade creditors at the year end to the aggregate of the amounts invoiced by trade creditors during the year, were 22 days.