Risk management

Principles

As a provider of financial services, including insurance, the Group's business is the managed acceptance of risk. Prudential believes that effective risk management capabilities are a key competitive advantage and a strategic risk, capital and value management framework and risk management culture has been developed to enhance the Group's embedded and franchise value.

Risk is defined as the uncertainty that Prudential faces in successfully implementing its strategies and objectives. This includes all internal or external events, acts or omissions that have the potential to threaten the success and survival of Prudential. Risk is not only regarded as harmful, but is also considered in relation to achieving profitable returns through controlled risk taking.

The control procedures and systems the Group has established are designed to manage, rather than eliminate, the risk of failure to meet business objectives and can only provide reasonable and not absolute assurance against material mis-statement or loss, and focus on aligning the levels of risk taking with the achievement of business objectives.

The Group's policy is to proactively identify, evaluate, and manage risk. This forms an essential element of delivering the Group's performance ambition. In so doing, material risks will only be retained where this is consistent with Prudential's risk appetite framework, i.e.:

- the retention of the risk contributes to value creation;
- the Group is able to withstand the impact of an adverse outcome; and
- the Group has the necessary capabilities, expertise, processes and controls to manage the risk.

A common risk language is used across the Group which allows meaningful comparisons to be made between different business units. Risks are broadly categorised as shown in Table 1.

Risk governance

Governance structure

Prudential's risk governance framework requires that all of the Group's businesses and functions establish processes for identifying, evaluating and managing the key risks faced by the Group. The risk governance framework is based on the concept of 'three lines of defence': Risk Management, Risk Oversight and Independent Assurance (see diagram opposite).

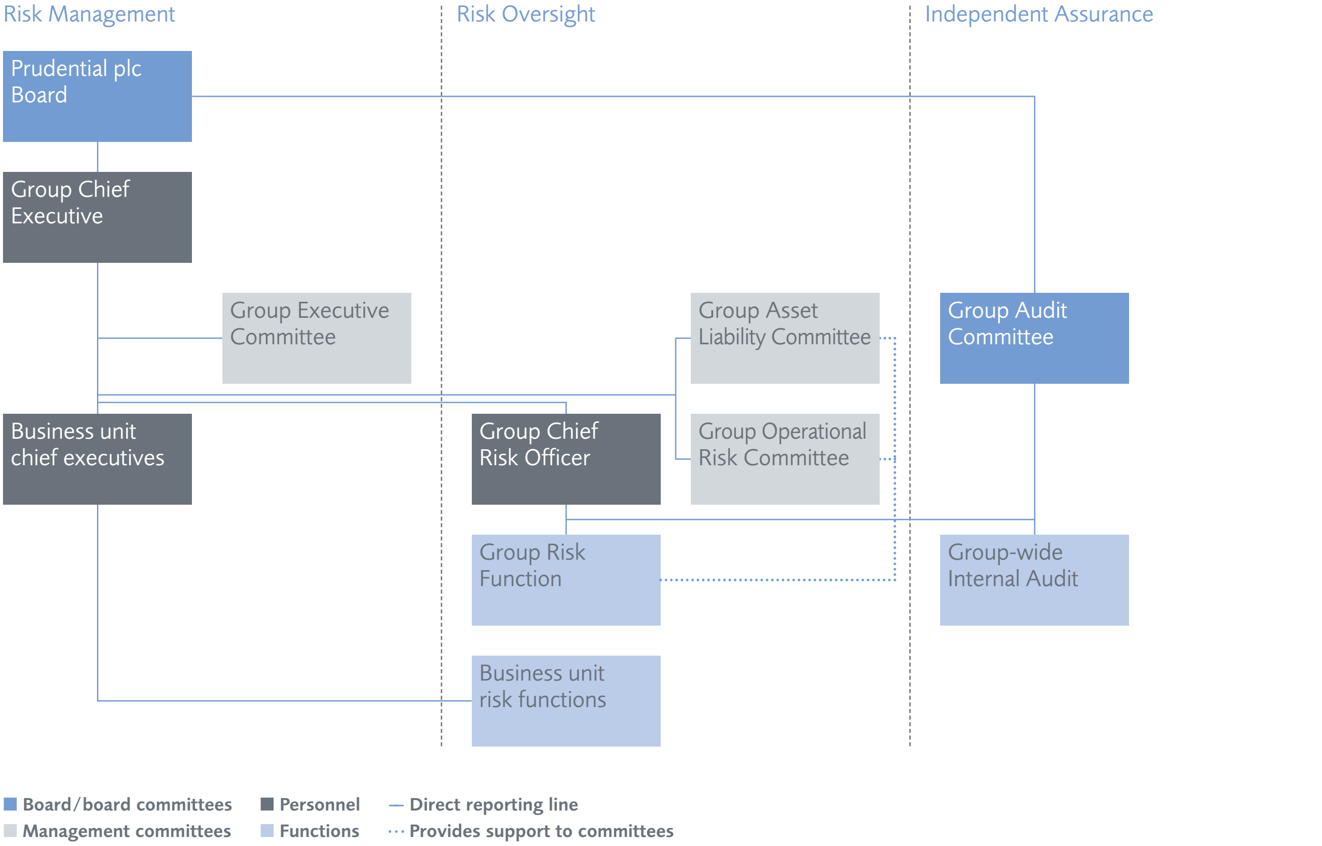
1. Risk management: primarily responsible for strategy, performance management and risk control lies with the Board, the Group Chief Executive Officer and the chief executives of each business unit.
2. Risk oversight: risk management oversight is provided by Group-level risk committees, Group Chief Risk Officer (Group CRO) and Group Risk Function working with counterparts in the business units in addition to other functions, including Group Compliance and Group Security.
3. Independent assurance: independent assurance on the effectiveness of the Group's and business unit control and risk management systems is provided by Internal Audit reporting to the Group and business unit audit committees.

The risk management roles and responsibilities of the various management bodies and committees are described below:

Risk categorisation

Category	Risk type	Definition
Financial risks	Market risk	The risk that arises from adverse changes in the value of, or income from, assets and changes in interest rates or exchange rates.
	Credit risk	The risk of loss if another party fails to perform its obligations, or fails to perform them in a timely fashion.
	Insurance risk	The inherent uncertainty as to the occurrence, amount and timing of insurance liabilities. This includes adverse mortality, morbidity and persistency experience.
	Liquidity risk	The risk that a business, though solvent, either does not have the financial resources to meet its obligations as they fall due or can secure the resources only at excessive cost.
Non-financial risks	Operational risk	The risk of direct or indirect loss resulting from inadequate or failed internal processes, people or systems, or from external events.
	Business environment risk	Exposure to forces in the external environment that could significantly change the fundamentals that drive the business's overall objectives and strategy.
	Strategic risk	Ineffective, inefficient or inadequate senior management processes for the development and implementation of business strategy in relation to the business environment and the Group's capabilities.
	Regulatory compliance risk	The risk caused by changes in the compliance/regulatory environments for financial services products or failure to understand or effectively apply and comply with compliance/regulatory standards, principles and practices.

Risk Governance Framework



Board
The Board has overall responsibility for the system of internal control and risk management. In order to fulfil this responsibility, the Board:

- determines (on advice from the Group Chief Executive) the amount and type of risk that the Group is prepared to accept, ensures the formulation of adequate risk management strategies and approves the overall framework for managing the risks faced by the Group;
- seeks regular assurance, supported by the Group Audit Committee (GAC), that the system of controls is functioning effectively, and that the Group's system of internal control is managing risk in the manner that it has approved; and
- delegates authority (where necessary), via the Group Chief Executive, to the Group Executive Committee (GEC) and Group-level risk committees, as well as to senior management within the Group and business units.

Group level management
Group executive management (Group Chief Executive and GEC): the Group Chief Executive has overall responsibility for the risks facing the Group. The Group Chief Executive recommends to the Board the amount and type of risk that the Group is prepared to accept, and recommends risk management strategies as well as an overall framework for managing the risks faced by the Group (with support from the GEC, Group CRO and Group level risk committees). The Group Chief Executive provides regular updates to the Board on the risk position and risk policy.

Group Chief Risk Officer: the Group CRO is responsible for providing risk management oversight for the Group. The Group CRO oversees Group Risk, Group Compliance, Group Security and, for management purposes only, the Group-wide Internal Audit function. The Group CRO is a member of the GEC and chairs the Group-level risk committees.

Group level risk committees
Group Asset Liability Committee (Group ALCO): responsible for oversight of financial risks (market, credit, liquidity and insurance risks) across the Group. It is chaired by the Group CRO and its membership includes senior business unit and Group executives (chief actuaries, principal ALM officers and chief investment officers) who are involved in the management of the aforementioned risks. The Group ALCO is supported by Group Risk.

Group Operational Risk Committee (GORC): responsible for the oversight of non-financial risks (operational, business environment, regulatory compliance and strategic risks) across the Group. Responsibilities include monitoring operational risk and related policies and processes as they are applied throughout the Group. It is chaired by the Group CRO and its membership includes senior representatives of the business unit and Group Risk functions. The GORC is supported by Group Risk.

Risk management continued

Group Risk function

The Group Risk function is a Group Head Office (GHO) oversight function that is structured independently of the business units. The purpose of the Group Risk department is to establish and embed a strategic risk, capital and value management framework and risk management culture consistent with Prudential's risk appetite that protects and enhances the Group's embedded and franchise value. Group Risk, under the guidance of the Group CRO, is also responsible for the continued development and expansion of the Risk Management Framework.

Group Risk is responsible for establishing and maintaining the risk management agenda across the Group by:

1. Risk framework:
Establishing structures and capabilities through designing, implementing and maintaining a consistent and harmonised risk management framework and policies spanning Economic, Regulatory and Rating Agency Capital, Risk Appetite and Risk-adjusted Profitability.

2. Risk monitoring:
Establishing a 'no surprises' risk management culture accomplished by identifying the risk landscape, assessing and monitoring risk exposures and understanding change drivers.

3. Risk controlling:
Implementing risk mitigation strategies and remedial actions where exposures are deemed inappropriate and managing the response to extreme events.

4. Risk communication:
Communicating the Group risk, capital and profitability position to internal and external stakeholders and other commentators.

5. Risk culture:
Fostering a risk management culture, providing quality assurance and facilitating the sharing of best practice risk measurement and management across the Group and industry.

Group Risk acts as secretariat and adviser to the Group ALCO and GORC. In addition to the above primary responsibilities, Group Risk is also responsible for:

- Group Insurance Risk Management (GIRM): procures and manages Group-wide insurance programmes;
- Regulatory Developments: leads the Group's response to regulatory and industry developments such as Solvency II; and
- Actuarial Support: Group Risk provides actuarial support and oversight to the business unit and Group functions for regulatory and accounting measures (EEV, IFRS and US GAAP).

Business unit management

The business unit chief executives are accountable for the implementation and operation of an appropriate business unit risk framework and for ensuring compliance with the policy and minimum standards set by the Group. As the first line of defence, business units are responsible for identifying and managing business unit risks and providing regular risk reporting to the Group.

Business units undertake risk self-assessments in accordance with the Group Risk Framework, with dedicated risk functions, risk committees (comprising business unit asset-liability committees and operational risk committees) and named individuals responsible for the operation of the Group Risk Framework in each business unit. Business unit risk functions report directly to the respective business unit chief executives who in turn are members of the GEC and report to the Group Chief Executive.

Internal audit

Group Audit Committee: the GAC provides independent assurance to the Board on the effectiveness of the Group's system of internal controls and risk management. The GAC reviews the Group's risk management framework, and regular risk reports. The GAC is supported by Group-wide Internal Audit.

Group-wide Internal Audit (GwIA): the GwIA function independently assures the effective operation of the Group's risk management framework across the Group. This involves the validation of methodology application, policy compliance and control adequacy. The GwIA Director reports all audit related matters to the GAC and reports for management purposes (but not audit related matters) to the Group CRO.

Risk reporting

The Group Risk function develops and maintains a process for the regular, systematic identification, measurement, monitoring and management of business unit and GHO risk exposures.

The Group's risk reporting framework forms an important part of the Group's business planning process. As part of the annual preparation of its business plan, all of the Group's businesses and functions are required to carry out a review of risks. This involves an assessment of the impact and likelihood of key risks and of the effectiveness of controls in place to manage them, and is reviewed regularly throughout the year. In addition, business units review opportunities and risks to business objectives regularly with the Group Chief Executive, the Group Finance Director and the Group CRO.

Quarterly risk reports from the business units and Group are reported to Group Risk and the Group-level risk committees covering risks of Group significance. Regular reports are also made to Group and business unit audit committees by management, internal audit, compliance and legal functions.

The Board is provided with regular updates on the Group's economic capital position, risk appetite position and risk-adjusted profitability as part of the overall risk framework. This provides a top down overview of the Group's risk profile measured on a consistent and economic basis.

The insurance operations of the Group all prepare an annual financial condition report, which is reported on to the Board. The financial condition reports include an assessment of key risks affecting the business unit.

The impact of large transactions or divergences from business plan is investigated by Group Risk as and when they are proposed, by considering the potential impacts on relevant risk reporting metrics (e.g. risk appetite position). New risk management initiatives such as new control frameworks and mitigation strategies are reported to the GEC while they are being developed.

Policies and procedures

The Group's internal control processes, including risk management, are detailed in the Group Governance Manual. Detailed policies and procedures exist (at both the Group and business unit levels) covering risk, finance, legal, compliance, security, technology, audit, human resources and communications. The policy framework includes the following items (amongst others) of particular relevance to risk management:

- the Group-wide policy on risk management (covering financial and non-financial risks) is detailed in the Group Risk Framework, which is maintained by Group Risk;
- investment management policies for each business unit mandate are set out in Investment Management Agreements between the relevant business units and fund managers;
- financial control policies (including financial reporting and business planning) are set out in business unit Financial Procedures Manuals; and
- policies for all aspects of actuarial management (including regulatory reporting and asset liability management) are set out in business unit Actuarial Procedures Manuals.

Group Security maintains detailed procedures to mitigate certain operational risks, including: fraud, money laundering, bribery, business continuity, information security and operational security.

The Group prepares an annual business plan with three-year projections. Executive management and the Board receive monthly reports on the financial position of the Group and actual performance against plan, together with updated forecasts.

All senior management committees within the Group and business units have clearly documented terms of references.

Risk management

Risk limits

Group Risk Appetite

The Group Risk Appetite framework sets out the Group's tolerance to risk exposures, approach to risk/return optimisation and management of risk. The Board and GEC have set up Group-level risk appetite statements concerning the key risk exposures faced by the Group. The Group Risk Appetite statements set out the Group's risk tolerance, or risk appetite, to 'shocks' to the key financial risk exposures (market, credit and insurance risk). In order to determine its risk appetite position, each business unit calculates the impacts (on earnings 'flow' and capital 'stock' measures) of a shock to market, credit and insurance risk exposures. The market and credit risk shocks include: parallel movements in interest rates, falls in equities, falls in property, changes in credit spreads and increases in credit losses. The insurance risk shocks include changes in assumptions for longevity, mortality, persistency and expenses.

The Group Risk Appetite statements are defined in terms of earnings volatility and capital requirements, as follows:

- Earnings volatility: The objectives of the limits are to ensure that (a) the volatility of earnings is consistent with stakeholder expectations, (b) the Group has adequate earnings (and cash flows) to service debt and expected dividends and (c) that earnings (and cash flows) are managed properly across geographies and are consistent with the Group's funding strategies. The risk appetite statements for earnings volatility are defined in terms of two measures: EEV operating profit and IFRS operating profit; and

Group Risk Appetite Framework

	Earnings measures (flow)		Capital measures (stock)		
	EEV	**IFRS**	**Economic**	**Regulatory (local/FCD)**	
Business as usual	Maintain target EEV operating profit	Maintain target IFRS operating profit	Maintain target level of capitalisation Individual tail events should not significantly reduce financial resources	Maintain suitable margin above Group solvency requirement over planning horizon	Business as usual
Earnings stress	No large unexpected falls in EEV operating profit	No large unexpected falls in IFRS operating profit	Remain above minimum capitalisation	Meet Group solvency requirement and hold sufficient resources to pay dividends and fund new business	Capital stress

Risk management continued

- Capital requirements: The objectives of the limits are to ensure that (a) the Group is economically solvent, (b) the Group achieves its desired target rating to meet its business objectives, (c) supervisory intervention is avoided, (d) any potential capital strains are identified, and (e) accessible capital is available to meet business objectives. The risk appetite statements for capital are defined in terms of two measures: EU Financial Conglomerates Directive (FCD) capital requirements and Economic capital requirements.

Risk appetite is part of the annual business planning cycle and the risk profile of the Group is monitored against the agreed limits throughout the year by Group Risk. Using submissions from business units, Group Risk calculates the Group's position (allowing for diversification effects between business units) relative to the limits implied by the statements.

A two-tier approach is used to apply the limits at business unit level. Firstly, indicative business unit risk limits are calculated; these ensure that, if each business unit keeps within its limits, the Group risk position would be within the Group limits. Secondly, the impact on the Group Risk Appetite position is considered as part of Group Risk's scrutiny of large transactions or departures from plan proposed by individual business units.

Any potential breaches of the Group Risk Appetite limits implied by a business unit plan will necessitate a dialogue process between GHO and the business units. Group-wide limits may not be breached if, for example, limits in other business units are not fully utilised, or the diversification effect at Group level of a particular risk with other business units means that the Group limit is not breached. Ultimately, authorisation to breach Group limits would require GEC approval.

Group counterparty exposure limits

In addition to business unit operational limits on credit risk, counterparty risk limits are also set at the Group level. Limits on total Group-wide exposures to a single counterparty are specified for different credit rating 'buckets'. Actual exposures are monitored against these limits on a quarterly basis.

Risk mitigation

Prudential employs a range of risk mitigation strategies aimed at reducing the impact of a variety of risks. Key mitigation strategies include: adjustment of asset portfolios to reduce investment risks (such as duration mismatches or overweight counterparty exposures), use of derivatives to hedge market risks, reinsurance programmes to limit insurance risk, and corporate insurance programmes to limit impact of operational risks. Revisions to business plans (such as reassessment of bonus rates on participating business and scaling back of target new business volumes) may be also be used as a mitigating strategy.

Primary responsibility for identifying and implementing controls and mitigation strategies rests with the business units. Group Risk provides oversight and advice to the mitigation process. The quarterly risk reporting by business units to Group Risk includes details of the controls and mitigating actions being employed for each key risk (along with an assessment of the effectiveness of each control). Any mitigation strategies involving large transactions (e.g. a material derivative transaction) would be subject to scrutiny at Group level before implementation.

Contingency plans are in place for a range of operational risk scenarios, including incident management and business continuity plans. As a contingency plan for liquidity risk, the Group has arranged access to committed revolving credit facilities and committed securities lending facilities.

Asset liability management

Prudential manages its assets and liabilities locally, in accordance with local regulatory requirements and reflecting the different types of liabilities of each business unit. Stochastic asset/liability modelling is carried out locally in the UK, the US and Asia to perform dynamic solvency testing and assess economic capital requirements. Reserve adequacy testing under a range of scenarios is also carried out, including scenarios prescribed by local regulatory bodies.

The investment strategy for assets held to back liabilities is set locally by business units, taking into account the nature, term and currency of the liabilities, and any local regulatory requirements. The main principles are as follows:

- for liabilities that are sensitive to interest rate movements (in particular, UK non-profit annuities and Jackson fixed annuities), cash flow analysis is used to construct a portfolio of fixed income securities whose value changes in line with the value of liabilities when interest rates change;
- for participating business (in particular, the UK with-profits fund), stochastic asset-liability modelling is used to derive a strategic asset allocation and policyholder bonus strategy that (based on the model assumptions) will optimise policyholder and shareholder returns, while maintaining financial strength. The bonus strategy on participating business is an integral part of the asset-liability management approach for participating business; and
- for unit-linked business, the assets held to cover policyholder unit accounts are invested as per the stated investment strategy or benchmark index given in the product marketing literature. Assets in respect of non-unit reserves (e.g. sterling reserves) are invested in fixed income securities (using a cash flow matching analysis).

Derivative hedging strategies are also used on a controlled basis across the Group to manage exposure to market risks.

Surplus assets held centrally are predominantly invested in short-term fixed income securities. The Group's central treasury function, which is run by Prudential Finance, actively manages the surplus assets to maximise returns, subject to maintaining an acceptable degree of liquidity.

Economic capital

Overview

Economic capital provides a realistic and consistent view of Prudential's capital requirements across the Group, allowing for diversification benefits. Economic capital provides valuable insights into the risk profile of the Group and is an integral part of the Group's risk management framework.

The Group distinguishes between two distinct types of 'economic capital' approaches. These are:

- Group Economic Capital: Prudential's Group economic capital is calculated using an integrated model of Group-wide risk, capturing dependencies and diversification benefits between different business units and risk categories. The capital requirement is determined based on a multi-year projection, thus taking into account the long-term nature of Prudential's liabilities; and
- 1-year Value at Risk Capital (1yr VaR Capital): 1yr VaR Capital is defined as the capital required to withstand a maximum loss over a time period of one year consistent with a confidence level of 99.5 per cent. This measure was developed internally as part of Prudential's Risk-adjusted Profitability (RAP) approach to risk/return optimisation within the Group Risk Appetite framework. This measure captures the risk arising from individual risk types, and generally allows for diversification by using a correlation matrix approach. The methodology is continually being developed and improved. In addition to its risk management applications, the 1yr VaR Capital framework is used for Individual Capital Assessments (ICAS) in the UK and anticipated to form the basis of Prudential's capital modelling for future regulatory reporting developments, such as Solvency II.

These measures provide a consistent basis for comparing the risk profiles and capital requirements of different business units. The Group economic capital position and risk profile is reported to the Board annually, with more frequent updates on an ad hoc basis.

Group Risk is responsible for developing and maintaining the economic capital models, and for calculating the Group economic capital position.

Group economic capital methodology

Prudential's internal Group economic capital requirement is defined as the minimum amount of capital that the Group needs to hold in order to remain economically solvent over a 25-year horizon, given a target probability of insolvency appropriate for AA-rated debt. The target confidence level is based on historic default rates for AA-rated debt, and varies over the time horizon of the projection. The economic capital requirement is calculated in respect of existing contractual and discretionary liabilities only.

For the purposes of calculating Group economic capital, Group 'economic solvency' is defined as the position where both: (a) the capital balance of the parent company is positive, and (b) all business units are solvent on the applicable local regulatory basis. This definition of solvency allows the Group's capital position to be assessed on an economic basis while taking into account the actual regulatory constraints at the business unit level.

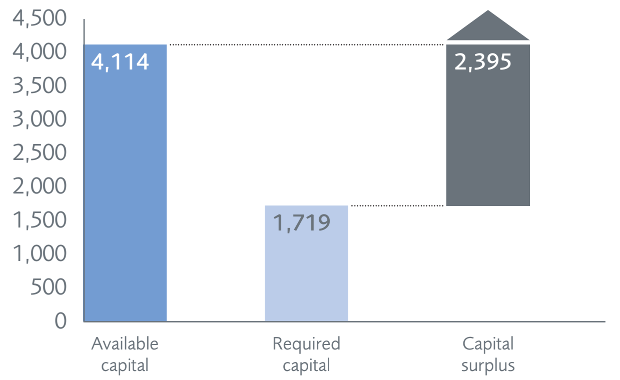
The Group economic capital position is calculated using the Group Solvency Model (GSM) – an integrated stochastic asset/liability model of the Group economic solvency position. Projected economic scenarios in the GSM are generated using a stochastic economic scenario generator that captures all the correlations between different asset classes and geographies.

Group economic capital results

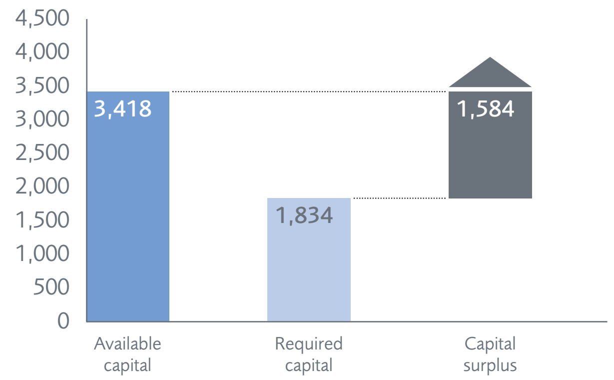
As at 31 December 2005, the Group economic capital requirement was £1.7 billion, compared to available capital resources of £4.1 billion. The Group economic capital requirement quoted is after allowance for diversification benefits between risk types and business units, and inclusive of the local regulatory capital requirements at the business unit level. The economic capital requirement is calculated for in-force liabilities only, excluding the impact of future new business and dividend distributions.

Group Economic Capital Position £m

Group Capital Position at year end 2005 AA basis



Group Capital Position at year end 2004 AA basis



Risk management continued

Note that the economic capital surplus of £2.4 billion quoted above excludes any surplus in respect of the Group's participating with-profits funds. For Group economic capital, it is assumed that any free assets in participating funds are ring-fenced to support the relevant fund (and excluded from the Group's economic surplus). Any capital injections required by participating funds (on top of the ring-fenced free assets) are captured in the Group economic capital requirement calculation. For year end 2005, none of the Group's participating funds required additional economic capital on top of the ring-fenced free assets.

The allocation of economic capital (diversified) by risk type is shown below. The largest risk exposure is credit risk, which reflects the relative size of the exposure in Jackson, Prudential UK and Egg. The ALM risk exposure mainly reflects interest rate risk in Jackson and Taiwan. An increasingly significant component of the underwriting risk is attributable to longevity risk, which has increased due to the growth in annuity business being written in the UK shareholder fund.

The standalone economic capital for Operational Risk has been relatively stable. The reason for the proportional increase shown above is that the other risk capital requirements have decreased in absolute terms, rather than a significant increase in Operational Risk from the 2004 year-end level.

Scenario testing

The impact of a range of deterministic 'shock' scenarios is tested using the Group economic capital model. The purpose is to assess the resilience of the Group's economic solvency position to a range of key threat scenarios. For the year-end 2005, economic capital scenarios relating to stable, falling and rising interest rates were tested. In addition, scenarios proposed by the 2006 Financial Risk Outlook, as published by the FSA, were tested. The scenarios related to high oil prices, lower consumption and US dollar depreciation, and were considered individually and in combination. Finally, the potential expected effect of a pandemic on the Group was analysed.

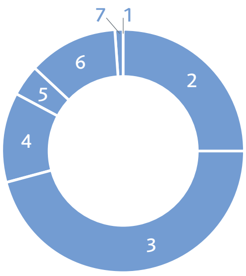
The impact of each scenario was tested by analysing the projected Group cash flow balances over 25 years. The results of the analysis showed that the projected net cash flow balance to the Group remains positive in all future years under each scenario tested.

Business unit local economic capital assessments

In addition to Group-level economic capital framework described above, business units also monitor their own economic capital requirements locally on a 'stand alone' basis (without allowance for diversification effects with the rest of the Group). The business unit economic capital assessments are reported regularly and included in the business unit financial condition reports. The business unit economic capital assessments allow management to put the local regulatory capital requirements into an economic context.

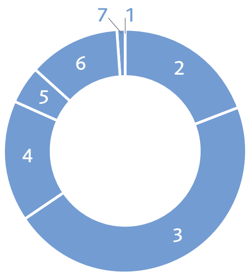
Economic Capital Requirement split by business unit

Risk exposure at year end 2005 AA basis



1 UK with-profits 0%
2 UK shareholder 25%
3 Jackson 46%
4 Prudential Corporation Asia 12%
5 M&G 4%
6 Egg 12%
7 GHO 1%

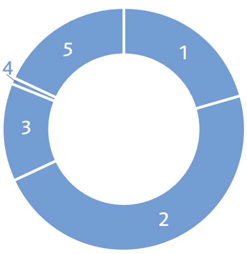
Risk exposure at year end 2004 AA basis



1 UK with-profits 0%
2 UK shareholder 19%
3 Jackson 46%
4 Prudential Corporation Asia 16%
5 M&G 5%
6 Egg 12%
7 GHO 1%

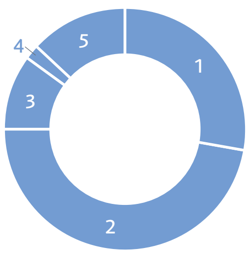
Economic Capital Requirement split by risk type

Risk exposure at year end 2005 AA basis



1 ALM 21%
2 Credit 48%
3 Underwriting 13%
4 Persistency 1%
5 Operational 18%

Risk exposure at year end 2004 AA basis



1 ALM 28%
2 Credit 47%
3 Underwriting 10%
4 Persistency 2%
5 Operational 13%

Market risk

Market risk is the risk of adverse financial impact due to changes in fair values of financial instruments from fluctuations in asset prices, foreign currency exchange rates and interest rates. Market risk arises in business units due to fluctuations in the value of liabilities and the value of investments held. Prudential's businesses are inherently subject to market fluctuations and general economic conditions.

In the UK, this is because a significant part of Prudential's shareholders' profit is related to bonuses for policyholders declared on its with-profits products, which are broadly based on historic and current rates of return on equity, real estate and fixed income securities, as well as Prudential's expectations of future investment returns.

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

For some non-linked investment products, in particular those written in some of the Group's Asian operations, it may not be possible to hold assets which will provide cash flows to exactly match those relating to policyholder liabilities. This is particularly true in those countries where bond markets are not developed and in certain markets, such as Taiwan, where regulated surrender values are set with reference to the interest rate environment prevailing at time of policy issue. This is due to the duration and uncertainty of the liability cash flows and the lack of sufficient assets of a suitable duration. This results in a residual asset-liability mismatch risk which can be managed but not eliminated. Where interest rates in these markets remain lower than those implied by surrender values over a sustained period this could have an adverse impact on the Group's reported profit.

The management of market risk is undertaken at both business unit and Group level. Business units manage market risks locally using their local ALM frameworks and business unit ALCOs, and within local regulatory constraints. Business units may also be constrained by the requirement to meet policyholders' reasonable expectations and to minimise or avoid market risk in a number of areas. At Group level, market risk is the responsibility of the Group ALCO, which has a remit to manage a number of investment related risks, in particular those faced by the shareholder funds throughout the Group.

For each of the major components of market risk, described in more detail below, Prudential has put in place policies and procedures to set out how each risk should be managed and monitored, and the approach to setting an appropriate risk appetite.

Currency risk

Prudential currently operates in the UK, the US, 12 countries in Asia (including Taiwan, South Korea, Japan, Taiwan and China) and Europe. 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 translation of results into pounds sterling. The currency exposure relating to the translation of reported earnings is not separately managed. Consequently, this could impact on the Group's gearing ratios (defined as debt over debt plus shareholders' funds). The impact of gains or losses on currency translations is recorded as a component of shareholders' funds within the statement of changes in equity.

Prudential does not generally seek to hedge foreign currency revenues, as these are substantially retained locally to support the growth of the Group's business and meet local regulatory and market requirements. However, where foreign surplus is deemed to be supporting UK capital or shareholders' interests this exposure is hedged if it is deemed optimal from an economic perspective. Currency borrowings and derivatives are used to manage exposures within the limits that have been set.

Interest rate risk

Interest rate risk arises primarily from Prudential's investments in long-term debt and fixed income securities. Interest rate risk also exists in policies that carry investment guarantees on early surrender or at maturity, where claim values can become higher than the value of backing assets when interest rates rise or fall.

The Group manages this risk by adopting close asset-liability matching criteria, to minimise the impact of mismatches between the value of assets and liabilities from interest rate movements. Interest rate risk is also controlled through the use of a variety of derivative instruments, including futures, options and swaps, in order to hedge against unfavourable market movements in interest rates inherent in the underlying assets and liabilities. The impact of exposure to sustained low interest rates is regularly monitored.

Equity risk

The Group is subject to equity price risk due to daily changes in the market values of its equity securities portfolio. The Group's shareholders are exposed to both direct equity shareholdings in its shareholder assets, and indirectly to the impact arising from changes in the value of equities held in policyholders funds from which management charges or a share of performance are taken, as well as from its interest in the free estate of long-term funds.

At business unit level, equity price risk is actively managed through the use of derivative instruments, including futures and options, in order to mitigate anticipated unfavourable market movements where this lies outside the risk appetite of the fund concerned. Business units actively model the performance of equities through the use of stochastic models, in particular to understand the impact of equity performance on guarantees, options and bonus rates.

Risk management continued

In particular, Jackson actively hedges its exposure to the guarantees arising from its variable annuity business. Where possible, Jackson will seek to find offsetting exposures across its asset and liability portfolios and to conduct its hedging activities on a macro basis, and relies on option-based strategies to address tail risks. Although the macro approach and the hedging of tail events are not consistent with the way certain accounting methods test for effectiveness, our view is that the efficiency of execution and the need to hedge on an economic basis outweighs the need to avoid any short-term accounting volatility.

The Group does not have material holdings of unquoted equity securities. In addition, local asset admissibility regulations require that business units hold diversified portfolios of assets thereby reducing exposure to individual equities.

Credit risk

Credit risk is the risk of loss in the value of financial assets due to counterparties failing to meet all or part of their obligations. Credit risk is Prudential's most significant financial risk, and it is actively monitored by business units via business unit investment committees and ALCOs.

In addition to business unit operational limits on credit risk (requiring business units to implement local credit risk policies), Prudential's management of credit risk includes monitoring exposures at Group level. Large individual counterparty exposures are aggregated and monitored on a quarterly basis against centrally-set red zone, amber zone and green zone limits. This active monitoring of counterparty exposures, on a consolidated Group level, is undertaken by the Group ALCO.

Financial assets are graded according to current credit ratings issued by the rating agencies. Financial assets are classified within the range of AAA to D ratings, with AAA being the highest possible rating. Typically, around 95 per cent of the Groups assets are rated within the investment grade category (BBB- and higher). The level of financial assets which fall outside the range of the ratings is also monitored on an ongoing basis, and this tends to be less than one per cent of shareholder assets at any given point in time.

Insurance risk

Prudential needs to make assumptions about a number of factors in determining the pricing of its products and for reporting the results of its long-term business operations. In common with other industry participants, the profitability of the Group's businesses depends on a mix of factors including mortality and morbidity trends, voluntary discontinuance rates, investment performance, unit cost of administration and new business acquisition expense.

For example, the assumption that Prudential makes about future expected levels of mortality is particularly relevant for its UK annuity business where in exchange for their accumulated pension fund, pension annuity policyholders receive a guaranteed payment, for as long as they are alive. Prudential conducts rigorous research into longevity risk using data from its substantial annuitant portfolio. As part of its pension annuity pricing and reserving policy, Prudential UK assumes that current rates of mortality continuously improve over time at levels based on adjusted data from the Continuous Mortality Investigations (CMI) medium cohort table projections as published by the Institute and Faculty of Actuaries.

Prudential's voluntary discontinuance (persistency) assumptions reflect recent past experience for each relevant line of business, and any expectations of future persistency. Where appropriate, allowance is also made for the relationship, which is either assumed or historically observed, between persistency and investment returns and the resulting additional risk is allowed for.

Liquidity risk

Liquidity risk is the risk that a business, though solvent, either does not have the financial resources to meet its obligations as they fall due or can secure the resources only at excessive cost.

Business units have their own liquidity policies, which also depend on the maturity of the business, and the available assets in the markets. For Prudential UK, liquidity risk is managed through holding assets at the greater of a specified percentage of total funds managed or a specified multiple of the average peak daily cash flow over the last 12 months. For Jackson, modelling is performed on how quickly their different liabilities could be called, and how quickly they could also liquidate their assets, ensuring that at 30, 90 days and one year the cash available exceeds potential obligations.

For Prudential Group, there is a committed corporate credit facility for liquidity.

Non-financial risk

Prudential's Group Risk Framework also covers non-financial risks – operational risk, business environment risk, strategic risk and regulatory compliance risk. Prudential processes a large number of complex transactions across numerous and diverse products, and is subject to a number of different legal and regulatory regimes. Prudential outsources several operations, including certain UK processing and IT functions and is thus reliant upon the operational processing performance of its outsourcing partners.

Business units are responsible for the management of the non-financial risks associated with their business. They conduct a formal self-assessment of material operational risks and assess their impact and likelihood. Business units also identify control available to mitigate the impact or likelihood or both of the identified risk. There is also an assessment of the control which considers the quality of the control's design.

Quantitative analysis is carried out for operational risks with material and potential direct losses (i.e. excluding opportunity costs and lost revenue). For each risk, the analysis describes the possible manifestations of the risk and the controls against it in each business unit and, on this basis, frequency and severity parameters are assigned to each risk. The effect of operational risk on the Group as a whole is analysed by aggregating the individual risks using a Group operational risk capital model, allowing for the correlations and diversification effects between different risk types and business units.

Financial strength and capital management

Prudential's financial strength and credit ratings, which are intended to measure its ability to meet policyholder obligations, are an important factor affecting public confidence in most of Prudential's products and, as a result, its competitiveness. Changes in methodologies and criteria used by rating agencies could result in downgrades that do not reflect changes in the general economic conditions or Prudential's financial condition. Downgrades in Prudential's ratings could have an adverse effect on its ability to market products and retain current policyholders. In addition, the interest rates Prudential pays on its borrowings are affected by its debt credit ratings, which are in place to measure Prudential's ability to meet its contractual obligations. Prudential believes the credit rating downgrades it experienced in 2002 and 2003, together with the rest of the UK insurance industry, and in 2006 by Standard & Poor's to bring it into line with the standard rating agency notching between operating subsidiary financial strength rating and the credit rating for other European insurance holding companies have not to date had a discernible impact on the performance of its business.

Prudential's long-term senior debt is rated as A2 (stable outlook) by Moody's, A+ (stable outlook) by Standard & Poor's and AA– (stable outlook) by Fitch.

Prudential's short-term debt is rated as P-1 by Moody's, A-1 by Standard & Poor's and F1+ by Fitch.

The PAC long-term fund is rated Aa1 (stable outlook) by Moody's, AA+ (stable outlook) by Standard & Poor's and AA+ (stable outlook) by Fitch.

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

Certain of the subsidiaries are regulated and therefore have restrictions that can limit the payment of dividends, which in some circumstances could limit the Group's ability to pay dividends to shareholders.

Summary of risk factors

The International Organisation of Securities Commissions (IOSCO) has recommended that annual reports of publicly held companies include a section on risk factors which discusses inherent risks in the business and trading environment. The US Securities and Exchange Commission (SEC) requires listed companies to disclose prominently risk factors that are specific to the companies or their industries in their annual reports on Form 20-F filed with the SEC. The Accounting Standards Board's Reporting Statement: Operating and Financial Review (OFR), recommends as best practice, that the OFR has a description of the principal risks and uncertainties facing the business. The European Union (EU) Prospectus Directive also requires disclosure of risk factors.

A number of factors (risk factors) affect Prudential's operating results, financial condition and trading price. The risk factors mentioned below should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. The information given is as of the date of this report, is not updated, and any forward-looking statements are made subject to the reservations specified on the inside back cover of the Annual Report.

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

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

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

For some non-unit-linked investment products, in particular those written in some of the Group's Asian operations, it may not be possible to hold assets which will provide cash flows to exactly match those relating to policyholder liabilities. This is particularly true in those countries where bond markets are not developed and in certain markets such as Taiwan where regulated surrender values are set by regulators with reference to the interest rate environment prevailing at time of policy issue. This results in a mismatch due to the duration and uncertainty of the liability cash

Risk management continued

flows and the lack of sufficient assets of a suitable duration. This residual asset/liability mismatch risk can be managed but not eliminated. Where interest rates in these markets remain lower than surrender values over a sustained period this could have an adverse impact on the Group's reported profit.

In all markets in which Prudential operates, its businesses are susceptible to general economic conditions and changes in investment returns, which can change the level of demand for Prudential's products. Past uncertain trends in international economic and investment climates which have adversely affected Prudential's business and profitability could be repeated. This adverse effect would be felt principally through reduced investment returns and credit defaults. In addition, falling investment returns could impair Prudential's operational capability, including its ability to write significant volumes of new business. Prudential in the normal course of business enters into a variety of transactions, including derivative transactions with counterparties. Failure of any of these counterparties, particularly in conditions of major market disruption, to discharge their obligations, or where adequate collateral is not in place, could have an adverse impact on Prudential's results.

Prudential is subject to the risk of exchange rate fluctuations owing to the geographical diversity of its businesses.
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 translation of results into pounds sterling. The currency exposure relating to the translation of reported earnings is not separately managed. Consequently, this could impact on the Group's gearing ratios (defined as debt over debt plus shareholders' funds). The impact of gains or losses on currency translations is recorded as a component of shareholders' funds within the statement of changes in equity.

Prudential conducts its businesses subject to regulation and associated regulatory risks, including the effects of changes in the laws, regulations, policies and interpretations and any accounting standards in the markets in which it operates.
Changes in government policy, legislation or regulatory interpretation applying to companies in the financial services and insurance industries in any of the markets in which Prudential operates, which in some circumstances may be applied retrospectively, may adversely affect Prudential's product range, distribution channels, capital requirements and, consequently, reported results and financing requirements. For instance, regulators in jurisdictions in which Prudential operates may change the level of capital required to be held by individual businesses. Also these changes could include possible changes in the regulatory framework for pension arrangements and policies, the regulation of selling practices and solvency requirements. In the UK several proposed and potential regulatory changes could have significant effect on the types of products Prudential provides to its customers and intermediaries and how those products are priced, distributed and sold. These include the FSA's move towards principles-based regulation, the FSA's Treating Customers Fairly initiative, the FSA's review of retail distribution, the proposed regulatory change affecting the UK pensions market and the implementation of the Markets in Financial Instruments Directive (MiFID) and the Solvency II directive.

Current EU directives require European financial services groups to demonstrate net aggregate surplus capital in excess of solvency requirements at the Group level in respect of shareholder-owned entities. The test is a continuous requirement, so that Prudential needs to maintain a somewhat higher amount of regulatory capital at the Group level than otherwise necessary in respect of some of its individual businesses to accommodate, for example, short-term movements in global foreign exchange rates, interest rates, deterioration in credit quality and equity markets. In addition, changes in the local regulatory regimes of designated territories could affect the calculation of the Group's solvency position under FCD. Given the recently announced sale of Egg, and pending discussions with the FSA, Prudential may again become an insurance group rather than its current classification as a financial conglomerate. This would imply that Prudential would have to meet the requirements of the EU Insurance Groups Directive (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 financial conglomerates. The EU is also currently reviewing future solvency requirements (Solvency II) with a draft directive expected in mid 2007 for implementation by member states not earlier than 2010. Inconsistent application of these directives by regulators in different EU member states may place Prudential at a competitive disadvantage to other European financial services groups.

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

Any further changes or modification of the recently introduced IFRS accounting policies and EEV guidance may require a change in the reporting basis of future results or a restatement of reported results.

The resolution of several issues affecting the financial services industry could have a negative impact on Prudential's reported results or on its reputation or on its relations with current and potential customers.
Prudential is, and in the future may be, subject to legal and regulatory actions in the ordinary course of its business, both in the UK and internationally. This could be a review of business sold in the past under previously acceptable market practices at the time such as the requirement in the UK to provide redress to certain past purchasers of pension and mortgage endowment policies and regulatory reviews on products sold and industry practices, including in the latter case businesses it has closed.

Regulators particularly, but not exclusively, in the US and the UK are increasingly interested in the approach that product providers use to select third-party distributors and to monitor sales made by them.

In the US, federal and state regulators have focused on, and continue to devote substantial attention to, the mutual fund, variable annuity and insurance product industries. This includes new regulations in respect of the suitability of broker-dealers' sales of certain products. As a result of publicity relating to widespread perceptions of industry abuses, there have been numerous regulatory inquiries and proposals for legislative and regulatory reforms.

In Asia, regulatory regimes are developing at different speeds, driven by a combination of global factors and local considerations. There is a risk that new requirements are introduced that are retrospectively applied to sales made prior to their introduction.

Litigation and disputes may adversely affect Prudential's profitability and financial condition.

Prudential is, and may be in the future, subject to legal actions and disputes in the ordinary course of its insurance, investment management and other business operations. These legal actions and disputes may relate to aspects of Prudential's businesses and operations that are specific to Prudential, or that are common to companies that operate in Prudential's markets. Legal actions and disputes may arise under contracts, regulations or from a course of conduct taken by Prudential, and may be class actions. Although Prudential believes that it has adequately reserved in all material aspects for the costs of litigation and regulatory matters, no assurance can be provided that such reserves are sufficient. Given the large or indeterminate amounts of damages sometimes sought, and the inherent unpredictability of litigation and disputes, it is possible that an adverse outcome could, from time to time, have an adverse effect on Prudential's results of operation or cash flows.

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

The markets for the UK, the US and Asian financial services are highly competitive, with several factors affecting Prudential's ability to sell its products and its continued profitability, including price and yields offered, financial strength and ratings, range of product lines and product quality, brand strength and name recognition, investment management performance, historical bonus levels, developing demographic trends and customer appetite for certain savings products. In some of its markets Prudential faces competitors that are larger, have greater financial resources or a greater market share, offer a broader range of products or have higher bonus rates or claims-paying ratios. Further, heightened competition for talented and skilled employees with local experience, particularly in Asia, may limit the Group's potential to grow its business as quickly as planned.

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

Jackson's competitors in the US include major stock and mutual insurance companies, mutual fund organisations, banks and other financial services companies such as AXA Financial Inc, Hartford Life Inc., Lincoln National, MetLife, Prudential Financial and TIAA-CREF.

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

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

Prudential's financial strength and credit ratings, which are intended to measure its ability to meet policyholder obligations, are an important factor affecting public confidence in most of Prudential's products and, as a result, its competitiveness. Changes in methodologies and criteria used by rating agencies could result in downgrades that do not reflect changes in the general economic conditions or Prudential's financial condition. Downgrades in Prudential's ratings could have an adverse effect on its ability to market products and retain current policyholders. In addition, the interest rates Prudential pays on its borrowings are affected by its debt credit ratings, which are in place to measure Prudential's ability to meet its contractual obligations. Prudential believes the credit rating downgrades it experienced in 2002 and 2003, together with the rest of the UK insurance industry, and in 2006 by Standard & Poor's to bring Prudential into line with the standard rating agency notching between operating subsidiary financial strength rating and the credit rating for other European insurance holding companies, have not to date had a discernible impact on the performance of its business.

Prudential's long-term senior debt is rated as A2 (stable outlook) by Moody's, A+ (stable outlook) by Standard & Poor's and AA– (stable outlook) by Fitch.

Prudential's short-term debt is rated as P-1 by Moody's, A-1 by Standard & Poor's and F1+ by Fitch.

The PAC long-term fund is rated Aa1 (stable outlook) by Moody's, AA+ (stable outlook) by Standard & Poor's and AA+ (stable outlook) by Fitch.

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

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

Risk management continued

Further, because of the long-term nature of much of Prudential's business, accurate records have to be maintained for significant periods. Prudential's systems and processes incorporate controls which are designed to manage and mitigate the operational risks associated with its activities. For example, any weakness in the administration systems or actuarial reserving processes could have an impact on its results of operations during the effective period. Prudential has not experienced or identified any operational risks in its systems or processes during 2006, or which have subsequently caused, or are expected to cause, a significant negative impact on its results of operations.

Adverse experience against the assumptions used in pricing products and reporting business results could significantly affect Prudential's results of operations.

Prudential needs to make assumptions about a number of factors in determining the pricing of its products and for reporting the results of its long-term business operations. For example, the assumption that Prudential makes about future expected levels of mortality is particularly relevant for its UK annuity business. In exchange for a premium equal to the capital value of their accumulated pension fund, pension annuity policyholders receive a guaranteed payment, usually monthly, for as long as they are alive. Prudential conducts rigorous research into longevity risk, using data from its substantial annuitant portfolio. As part of its pension annuity pricing and reserving policy, Prudential UK assume that current rates of mortality continuously improve over time, at levels based on adjusted data from the Continuous Mortality Investigations (CMI) medium cohort table projections (as published by the Institute and Faculty of Actuaries). If mortality improvement rates significantly exceed the improvement assumed, Prudential's results of operations could be adversely affected.

A further example is the assumption that Prudential makes about future expected levels of the rates of early termination of products by its customers (persistency). This is particularly relevant to its lines of business other than its UK annuity business. Prudential's persistency assumptions reflect recent past experience for each relevant line of business. Any expected deterioration in future persistency is also reflected in the assumption. If actual levels of future persistency are significantly lower than assumed (that is, policy termination rates are significantly higher than assumed), Prudential's results of operations could be adversely affected.

In common with other industry participants, the profitability of the Group's businesses depends on a mix of factors including mortality and morbidity trends, policy surrender rates, investment performance, unit cost of administration and new business acquisition expense.

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

Prudential's insurance and investment management operations are generally conducted through direct and indirect subsidiaries. As a holding company, Prudential's principal sources of funds are dividends from subsidiaries, shareholder-backed funds, the shareholder transfer from Prudential's long-term funds and any amounts that may be raised through the issuance of equity, debt and commercial paper. Certain of the subsidiaries are regulated and therefore have restrictions that can limit the payment of dividends, which in some circumstances could limit the Group's ability to pay dividends to shareholders.

Prudential operates in a number of markets through joint ventures and other arrangements with third parties. These arrangements involve certain risks that Prudential does not face with respect to its consolidated subsidiaries.

Prudential operates, and in certain markets is required by local regulation to operate, through joint ventures. Prudential's ability to exercise management control over its joint venture operations and its investment in them depends on the terms of the joint venture agreements, in particular, the allocation of control among, and continued co-operation between, the joint venture participants. Prudential may also face financial or other exposure in the event that any of its joint venture partners fails to meet its obligations under the joint venture or encounters financial difficulty. In addition, a significant proportion of the Group's product distribution is carried out through arrangements with third parties not controlled by Prudential and is dependent upon continuation of these relationships. A temporary or permanent disruption to these distribution arrangements could affect Prudential's results of operations.