

Registered No: 15454

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

**Annual Report and Financial Statements for the Year Ended
31 December 2010**

**Final
Dated 28 March 2011**

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Incorporated and registered in England and Wales. Registered no. 15454

Registered office: Laurence Pountney Hill, London EC4R 0HH

CONTENTS	Page
Directors and officers	1
Directors' report	2-12
Statement of directors' responsibilities	13
Independent auditor's report	14
Profit and loss account	15-17
Statement of total recognised gains and losses	18
Reconciliation of movement in shareholders' funds	18
Balance sheet	19-20
Notes on the financial statements	21-76

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Directors

Mr T C Thiam (Chairman)
Mr D J Belsham
Mr A M Crossley
Mr R A Devey
Mr N A Nicandrou
Mr F A O'Dwyer

Secretary

Miss S D Windridge

Auditor

KPMG Audit Plc, London

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010

Principal activity

The principal activity of the Company in the course of 2010 was transacting long-term insurance business in the United Kingdom. The Company also owns several insurance subsidiary undertakings and a branch in Hong Kong that transact insurance business in the United Kingdom and overseas. These activities will continue in 2011.

The Company itself is a wholly owned subsidiary undertaking of another company registered in England and Wales and therefore group financial statements and a group business review are not prepared. Accordingly, the financial statements and the following business review present information about the Company as an individual undertaking and are not consolidated.

Business review

Market review and strategy

The Company's long-term products consist of life insurance, pension products and pension annuities. In common with other UK long-term insurance companies, the Company'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 the with-profits sub-fund and can be single or regular premium. The return to shareholders on virtually all with-profits products is in the form of a statutory transfer to the Company's shareholders' funds which is analogous to a dividend from the Company's long-term fund and is dependent upon the level of 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 are determined as a prudent proportion of the long-term expected future investment return on the underlying assets. Once credited, annual bonuses are guaranteed in accordance with the terms of the particular product. In contrast, "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. With-profits policyholders currently receive 90 per cent of the distribution from the 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 Company's 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, the defined charge participating with-profits business reassured into the Company from Prudential International Assurance plc and Canada Life (Europe) Assurance Ltd and the with-profits annuity business transferred to the Company from the Equitable Life Assurance Society on 31 December 2007. All profits in this fund accrue to policyholders in the DCPSF.

There is a substantial volume of non-participating business in the with-profits sub-fund and its wholly owned subsidiary Prudential Annuities Limited (PAL), which is closed to new business; profits from this business accrue to the with-profits sub-fund. The Company also writes non-participating business, the profit on which accrues solely to shareholders, and this business is written in the Company's non-profit sub-fund. On 31 October 2010 the business of two of the Company's subsidiaries, Prudential Holborn Life Limited and Prudential (AN) Limited, transferred into the Company following a Part VII Transfer under the Financial Services and Markets Act 2000. The business transferred into the non-profit sub-fund of the long-term business fund with the exception of a small amount of with-profits business in Prudential (AN) Limited, which was transferred to the with-profits sub-fund.

The Company competes selectively in the UK's retirement savings and income market. The focus of the business is to balance writing profitable new business at attractive returns on capital with sustainable cash generation and capital preservation. It is this discipline that has enabled the Company to deliver another strong performance in 2010.

The UK has a mature life and pensions market which is characterised by an ageing population - in particular, through two waves of baby-boomers born after World War II and in the 1960s – with wealth distribution significantly skewed and very much concentrated in the 45-74 age group. In this context, the retirement and near-retirement segments are highly attractive.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

UK consumers are insufficiently prepared as they will have to face increasingly long periods of retirement. This will result in longer working lives and a more flexible approach towards retirement. It will also mean that the baby-boomers will need to target their wealth on the provision of dependable retirement income. The Company's expertise in areas such as longevity risk management and multi-asset investment, together with its financial strength and strong brand, mean that the business is strongly positioned in the retirement planning space with a particular focus on with-profits and annuities.

The Company is growing its individual annuity business, in particular with-profits annuities, building on a robust pipeline of internal vestings from maturing individual and corporate pensions policies. Sales of with-profits annuities, up 36 per cent on 2009, are due to the continuing success of the innovative Income Choice Annuity (ICA). The ICA is a with-profits product, launched in March 2009, which offers consumers security with a potential for income growth.

Onshore bond sales were up 15 per cent on 2009, including with-profits bond sales which increased 11 per cent with an exceptionally strong fourth quarter. PruFund made up 78 per cent of total with-profits bond sales. Demand for the Company's with-profits products remains resilient and the business has continued to innovate to maintain and enhance its position in the market. This includes broadening access to PruFund across its retail savings product range and PruFund now has over £3bn invested. Unit-linked bond sales were 61 per cent up on 2009, helped by the launch of PruDynamic portfolio funds in January 2010 and the continued success of the PruSelect fund range.

Individual pension sales (including income drawdown) were 3 per cent up on 2009. Sales of the Flexible Retirement Plan, the Company's Retail Distribution Review (RDR)-compliant individual pension and income drawdown product, grew by 4 per cent. PruFund Cautious, launched in the fourth quarter of 2009, and the new PruDynamic portfolio funds, launched in January 2010, together made up 34 per cent of individual pension sales.

Corporate pension sales were 5 per cent above 2009 levels. The Company administers corporate pensions for over 600,000 scheme members sponsored by some of the UK's largest employers and has also built a very strong position in the provision of with-profits Additional Voluntary Contribution (AVC) arrangements. During 2010, the Company continued to focus on strengthening existing relationships through further improvements to online servicing capabilities as well as targeted marketing activity.

In the wholesale market, the Company's aim is to participate very selectively in bulk and back-book buyouts using its financial strength, superior investment track record and annuitant mortality risk assessment and servicing capabilities. The Company will continue to maintain a very strict focus on value and only participate in capital-efficient transactions that meet its strict return on capital requirements.

In August 2010, the Company's venture partner Discovery SA announced the completion of the acquisition of Standard Life Healthcare and its combination with the PruHealth business. As part of the transaction, the Company reduced its shareholding in the PruHealth business from 50 per cent to 25 per cent of the enlarged group and the PruHealth business is now an associate of the Company. The Company made a profit on the partial disposal of £3m.

During 2010, the Company transferred two of its overseas subsidiaries to Prudential Corporation Holdings Limited, another company within the Prudential Group. The transfer of the Company's Indonesian subsidiary, PT Prudential Life Assurance, realised a profit of £562m. The transfer of the Company's Taiwanese subsidiary, PCA Securities Investment Trust Company Limited, realised a small loss of £4m.

On 30th June 2010 the Company entered into a 100% quota share reinsurance agreement, subject to paid claims limits, in respect of its commercial lines general insurance business in run-off. The effective date of the agreement is 1 January 2010. The business reinsured is mostly UK employers' liability and public liability business.

In September 2010, the Company announced a five-year exclusive agreement with Santander to distribute its market-leading investment bonds in the UK. The Company's Flexible Investment Plan, including PruFund, will be available to Santander's UK customers in 1,300 high street branches throughout the country. This new agreement, which is expected to go live in the second half of 2011, forms part of the Company's continuing strategy to develop diversified and complementary distribution across its Direct, Intermediary and Partnership channels.

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

The Company's Hong Kong Branch is a leading life insurer with strong brand recognition in the Hong Kong market. The branch is dedicated to meeting the different needs of its customers by providing a comprehensive range of insurance services. The range of products includes life insurance, general insurance, employee benefits, investment, health and protection products supported by outstanding customer service. Retirement and health are currently two key strategic initiatives to help Hong Kong people lead financially secure lives and to meet customer needs for increased medical protection.

Performance and measurement

The results of the Company for the year as set out on pages 15 to 17 show a profit on ordinary activities before tax of £1,063m (2009: £493m). The results for the year have been dominated by the profit of £562m arising on the transfer of one of the Company's overseas subsidiaries, PT Prudential Life Assurance, to Prudential Corporation Holdings Limited. The Company also transferred another overseas subsidiary, PCA Securities Investment Trust Company Limited, to Prudential Corporation Holdings Limited at a small loss of £4m. The Company made a profit of £3m in 2010 on the partial disposal of its interest in Prudential Health Holdings Limited from a 50 per cent to a 25 per cent share following the acquisition by Discovery SA, the Company's partner in the PruHealth venture, of Standard Life Healthcare. During 2010 the business of Prudential (AN) Limited and Prudential Holborn Life Limited transferred into the Company following a Part VII Transfer under the Financial Services and Markets Act 2000. The long-term funds of both businesses had unallocated surpluses which gave rise to a profit of £38m in total. Excluding these one-off profits, the 2010 results are £29m lower than in 2009; £9m lower in the UK and £20m lower in the Hong Kong branch. In the UK, profits attributable to the with-profits business are £29m higher than in 2009 due to the impact of changes in terminal bonus rates and differences in claims experience. Offsetting this profit is a reduction in profits from the non-profit sub-fund business due to higher protection and pensions losses and lower annuity profits. From 31 December 2008 the Company entered into a reinsurance arrangement with Prudential Retirement Income Limited (PRIL) to accept 15% of PRIL's non-profit annuity business on a quota share basis, which allows all of the reinsurance premiums to be deposited back to PRIL. This has resulted in a profit of £58m (2009: £88m) in the Company, with an equal and offsetting loss in PRIL. In the Hong Kong branch profits are £20m lower than 2009 mainly due to increased new business strain resulting from higher sales, as well as increased interest expense. Commission received on Prudential-branded General Insurance products contributed £46m to profits in 2010, £5m lower than 2009, as the book of business originally transferred to Churchill in 2004 is decreasing as expected.

The shareholders' funds of the Company total £3,610m (2009: £3,699m).

Sales on an APE basis (Regular Premiums plus 1/10th Single Premiums) are £1,017m up 14% from £890m in 2009. This increase is primarily due to demand for the Company's with-profits products remaining resilient with the business continuing to innovate to maintain and enhance its position in the market. Sales of with-profits annuities, up 36 per cent on 2009, are due to the continuing success of the innovative Income Choice Annuity (ICA) launched in March 2009. With-profits bond sales are up 11 per cent on 2009 with PruFund making up 81 per cent of total with-profits bond sales. Unit-linked bond sales are 61 per cent up on 2009, helped by the launch of PruDynamic portfolio funds in January 2010 and the continued success of the PruSelect fund range. Individual pension sales are up 3 per cent on 2009 and corporate pensions sales are up 5 per cent on 2009. In Hong Kong sales are up 21 per cent on 2009 mainly due to the launch of the Smart Wealth Builder product and sales from the Galaxy Life Long Income Savings Plan launched in late 2009, together with various sales promotions throughout the year.

The strength and investment performance of the Company's with-profits fund is widely recognised in the industry and was demonstrated by the 12.7 per cent pre-tax investment return achieved for policyholder asset shares in the fund in 2010. The fund has delivered investment returns of 82.1 per cent over ten years, which compares favourably with other with-profits funds and the FTSE All-Share Index (total return) of 43.3 per cent over the same period. This strong performance has shown that with-profits, when invested in an actively managed, and financially strong fund like the Company's, continues to be a very attractive medium to long-term investment, offering strong annualised returns compared with other investment options. The Company's with-profits customers benefit from the security offered by the Company's large inherited estate, with the free assets of the with-profits fund valued at approximately £6.7bn at the year end, valued on a realistic basis.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

The Company's long-term fund is rated Aa2 by Moody's (negative outlook), AA by Standard & Poor's and AA by Fitch as at the date of signing the accounts.

The Company does not report against Key Performance Indicators in its Business Review. This is because the Company is part of the wider Prudential Group and the Group's business is managed on a divisional basis such as UK Insurance Operations and Prudential Asia. Key Performance Indicators exist for the management of the divisions, of which this Company's business forms a part. The divisional Key Performance Indicators can be found in the Annual Report of Prudential plc.

Risks & uncertainties

As a provider of insurance services, the Company's business is the managed acceptance of risk. The Company is a wholly owned subsidiary of the Prudential Group and is subject to the Group's internal control and risk management processes as detailed in the Group Governance Manual and Group Risk Framework. The control procedures and systems established within the Group are designed to manage, rather than eliminate, the risk of failure to meet business objectives. They can only provide reasonable and not absolute assurance against material misstatement or loss, and focus on aligning the levels of risk-taking with the achievement of business objectives.

The Group's risk governance framework requires all businesses and functions within the Group, including the Company, to establish processes for identifying, evaluating and managing key risks. The risk governance framework is based on the concept of three lines of defence: risk management, risk oversight and independent assurance.

A number of factors (risk factors) affect the Company's results and financial condition. The key risk factors of the Company, mentioned below, should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties.

1) The business is inherently subject to market fluctuations and general economic conditions.

Uncertain or negative trends in international economic and investment climates could adversely affect the Company's business and profitability. The adverse effects of volatility arising from such uncertainty and negative trends, including the unprecedented market dislocation across asset classes and geographical markets witnessed in 2008 and in the first half of 2009, have been and would be felt principally through the following:

- investment impairments or reduced investment returns, as a result of market volatility, could impair the Company's ability to write significant volumes of new business, which would have a negative impact on the Company's assets under management and profit;
- higher credit defaults and wider credit and liquidity spreads resulting in realised and unrealised credit losses, as experienced during 2008 and 2009, when illiquidity and credit spreads reached all-time highs;
- the Company, in the normal course of business enters into a variety of transactions with counterparties, including derivative transactions. Failure of any of these counterparties to discharge their obligations, or where adequate collateral is not in place, could have an adverse impact on the Company's results; and
- estimates of the value of financial instruments are difficult because in certain illiquid or closed markets, determining the value at which financial instruments can be realised is highly subjective. Processes to ascertain value and estimates of value require substantial elements of judgement, assumptions and estimates (which may change over time). Increased illiquidity also adds to uncertainty over the accessibility of financial resources and may reduce capital resources as valuations decline.

During the period of market dislocation in 2008 and the first half of 2009, the Company had to operate against a challenging background of unprecedented volatility in the global capital and equity markets and interest rates and widespread economic uncertainty. Although global markets partially stabilised in 2009 and 2010, interest rates remain low, and many of the challenges of 2008 persist in the credit markets. New challenges may continue to emerge.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

A significant part of the Company's 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, property and fixed income securities, as well as the Company's expectations of future investment returns.

- 2) The Company is subject to the risk of potential sovereign debt credit deterioration owing to the sovereign debt obligations held in its investment portfolio.

The Company is subject to the risk of potential sovereign debt credit deterioration and default. Investment in sovereign debt obligations involves risks not present in debt obligations of corporate issuers. Investing in such instruments creates exposure to the direct or indirect consequences of political, social or economic changes (including changes in governments, heads of states or monarchs) in the countries in which the issuers are located and the creditworthiness of the sovereign. In addition, the issuer of the debt or the governmental authorities that control the repayment of the debt may be unable or unwilling to repay principal or pay interest when due in accordance with the terms of such debt, and the Company may have limited recourse to compel payment in the event of a default. A sovereign debtor's willingness or ability to repay principal and to pay interest in a timely manner may be affected by, among other factors, its cash flow situation, its relations with its central bank, the extent of its foreign currency reserves, the availability of sufficient foreign exchange on the date a payment is due, the relative size of the debt service burden to the economy as a whole, the sovereign debtor's policy toward local and international lenders, and the political constraints to which the sovereign debtor may be subject. Periods of economic uncertainty may affect the volatility of market prices of sovereign debt to a greater extent than the volatility inherent in debt obligations of other types of issues. If a sovereign were to default on its obligations, this could have an adverse effect on the Company's financial condition and results of operations.

- 3) The Company conducts its business subject to regulation and associated regulatory risks, including the effects of changes in laws, regulations, policies and interpretations and accounting standards in the markets in which it operates.

Changes in government policy, legislation (including tax) or regulatory interpretation applying to companies in the financial services and insurance industries in any of the markets in which the Company operates, which in some circumstances may be applied retrospectively, may adversely affect the Company's product range, distribution channels, capital requirements and, consequently, reported results and financing requirements. Also, regulators in jurisdictions in which the Company operates may change the level of capital required to be held by individual businesses or could introduce possible changes in the regulatory framework for pension arrangements and policies, the regulation of selling practices and solvency requirements. Furthermore, as a result of the recent interventions by governments in response to global economic conditions, it is widely expected that there will be a substantial increase in government regulation and supervision of the financial services industry, including the possibility of higher capital requirements, restrictions on certain types of transaction structure, and enhanced supervisory powers.

The UK operates investor compensation schemes that requires 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 the Company, along with other companies, may be required to make such contributions.

Any further changes or modification to Financial Reporting Standards, or adoption of International Financial Reporting Standards (IFRS) may require a change in the reporting basis of future results, or a restatement of reported results.

- 4) The resolution of several issues affecting the financial services industry could have a negative impact on the Company's reported results or on its relations with current and potential customers.

The Company is, and in the future may be, subject to legal and regulatory actions in the ordinary course of its business. These actions could involve a review of business sold in the past under acceptable market practices at the time, such as the requirement to provide redress to certain past purchasers of pension and mortgage endowment policies, changes to the tax regime affecting products and regulatory reviews on products sold and industry practices, including in the latter case businesses it has closed.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

Regulators are moving towards a regime of principles-based regulation which brings an element of uncertainty. Regulators are increasingly interested in the approach that product providers use to select third-party distributors. In some cases product providers can be held responsible for the deficiencies of third-party distributors.

- 5) Litigation, disputes and regulatory investigations may adversely affect the Company's profitability and financial condition.

The Company is, and in the future may be, subject to legal actions, disputes and regulatory investigations in the ordinary course of its insurance, investment management and other business operations. These legal actions, disputes and regulatory investigations may relate to aspects of the Company's businesses and operations that are specific to the Company, or that are common to companies that operate in the Company's markets. Legal actions and disputes may arise under contracts, regulations (including tax) or from a course of conduct taken by the Company, and may be class actions. Although the Company believes it has adequately provisioned 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 the Company's results of operations or cash flows.

- 6) The Company's business is conducted in a highly competitive environment with developing demographic trends and the Company's continued profitability depends on management's ability to respond to these pressures and trends.

The market for UK financial services is highly competitive with several factors affecting the Company'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, historic bonus levels, developing demographic trends and customers' appetite for certain savings products.

The Company's principal competitors in the life insurance market include many of the major retail financial services companies including, in particular, Aviva, Legal & General, Lloyds Banking Group and Standard Life.

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

- 7) Downgrades in the Company's financial strength and credit ratings could significantly impact its competitive position and hurt its relationships with creditors or trading counterparties.

The Company's financial strength and credit ratings, which are used by the market to measure its ability to meet policyholder obligations, are an important factor affecting public confidence in its products, and as a result its competitiveness. Downgrades in ratings, as a result of, for example decreased profitability, increased costs, increased indebtedness or other concerns, could have an adverse effect on the Company's ability to market products and retain current policyholders. In addition, the interest rates the Company pays on its borrowings are affected by its debt credit ratings, which are in place to measure the Company's ability to meet its contractual obligations.

In addition, changes in methodologies and criteria used by rating agencies could result in downgrades that do not reflect changes in the general economic conditions or the Company's financial condition.

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

Operational risks are present 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. The Company'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

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

addition, the Company outsources several operations, including investment management, a significant part of its back office and customer-facing functions as well as a number of IT functions. In turn, the Company is reliant upon the operational processing performance of its outsourcing partners, but their performance is monitored carefully.

Further, because of the long-term nature of much of the Company's business, accurate records have to be maintained for significant periods. The Company's systems and processes incorporate controls which are designed to manage and mitigate the operational risks associated with its activities as any weakness in the administration systems, finance systems and processes or actuarial reserving process could have an impact on its results during the effective period. The Company has not experienced or identified any operational risks in its systems or processes during 2010, which have subsequently caused, or are expected to cause, a significant negative impact on its results of operations.

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

The Company needs to make assumptions about a number of factors in determining the pricing of its products and setting reserves and for reporting its capital levels and the results of its long-term business operations. For example, the assumption that the Company makes about future expected levels of mortality is particularly relevant for its 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. The Company conducts rigorous research into longevity risk, using data from its annuitant portfolio. As part of its pension annuity pricing and reserving policy, the Company assumes that current rates of mortality continue to improve over time at levels based on the Company's calibration of the Continuous Mortality Investigations (CMI) 2009 mortality projection model as published by the Institute and Faculty of Actuaries. If mortality improvement rates significantly exceed the improvement assumed, the Company's results of operations could be adversely affected.

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

- 10) Adverse experience in other parts of the Group could significantly affect the Company's results.

Group risk is present from the consequences of risks arising from other parts of the Group in addition to those risks arising from the Company's own activities. The independent capitalisation of the Company as well as the risk management processes and internal control mechanisms within the Company ensure Group risk is appropriately managed.

Corporate responsibility

The Company is a wholly owned subsidiary within the Prudential Group and corporate responsibility (CR) is a philosophy that is firmly embedded in Prudential's operations around the world as an integral part of how the organisation does business. The organisation strives to minimise the social, ethical and environmental impact of its activities and to maximise the opportunities. The importance of engaging with stakeholders and responding to their concerns is recognised. To do this the organisation maintains a regular dialogue and conducts periodic research on the issues that matter most to them.

The approach to CR is underpinned by the organisation's founding values of integrity, security and prudence. Throughout its 160-year history the organisation has been committed to helping its customers safeguard their financial security and protect their families. This, together with the contribution to the well-being of the communities in which the organisation operates, is as strong today as it has always been.

The Group, of which the Company is a part, has developed a Group Governance Framework which is underpinned by a Group Governance Manual and associated processes. This encompasses all key policies and procedures for example, the Group Code of Business Conduct.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

The CR activities are framed around four core themes:

1. Fair and transparent products meeting customer needs
2. Best people for the best performing business
3. Protecting the environment
4. Supporting local communities

While the Group sets the overall strategy for CR, the framework gives the Company the flexibility to implement programmes that best meet its markets. This recognises that the people on the ground are closest to their customers, and their communities, and know best how to meet their needs and expectations.

The Prudential plc Board discusses the Group's CR performance at least once a year and also reviews and approves the Group CR Report and strategy on an annual basis. Below the Board, the Responsibility Committee comprises senior representatives from relevant Group functions and each of our core businesses. This committee is responsible for monitoring the Group's CR activities and for raising issues that need to be addressed.

Solvency II

The European Union (EU) is developing a new solvency framework for insurance companies, referred to as 'Solvency II'. The Solvency II Directive, which sets out the new framework, was formally approved by the Economic and Financial Affairs Council in November 2009 and is expected to be implemented from 1 January 2013. The new approach is based on the concept of three pillars – minimum capital requirements, supervisory review of firms' assessments of risk, and enhanced disclosure requirements.

Specifically, Pillar 1 covers the quantitative requirements around own funds, valuation rules for assets and liabilities and capital requirements. Pillar 2 provides the qualitative requirements for risk management, governance and controls, including the requirement for insurers to submit an Own Risk and Solvency Assessment (ORSA) which will be used by the regulator as part of the supervisory review process. Pillar 3 deals with the enhanced requirements for supervisory reporting and public disclosure.

A key aspect of Solvency II is that the assessment of risks and capital requirements will be aligned more closely with economic capital methodologies. Companies may be allowed to make use of internal economic capital models if approved by the local regulator.

The European Commission is in the process of consulting on the detailed rules that complement the high-level principles in the Directive, referred to as 'implementing measures', which are not expected to be finalised before late 2011.

In particular, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) published a number of consultation papers in 2009 and 2010 covering advice to the European Commission on the implementing measures but there remains significant uncertainty regarding the outcome from this process.

Having assessed the high-level requirements of Solvency II, an implementation programme was initiated with dedicated teams to manage the required work across the Prudential Group. The activity of the local Solvency II teams is being coordinated centrally to achieve consistency in the understanding and application of the requirements. Over the coming months the Prudential Group will be progressing its implementation plans further and remaining in regular contact with the Financial Services Authority (FSA) as it continues to engage in the 'pre-application' stage of the approval process for the internal model.

Retail Distribution Review

The FSA launched the Retail Distribution Review (the "RDR") in 2006 with the specific aim of improving the retail investment market. In June 2009 the FSA published a consultation paper containing proposals for implementing the RDR with proposals seeking to: (i) improve the clarity with which firms describe their services to consumers; (ii) address the potential for adviser remuneration to distort consumer outcomes; and (iii) increase the professional standards of advisers. In relation to the first two elements of the RDR, on March 26, 2010 the FSA published a policy statement presenting final rules. These rules include requiring firms to describe services as either "independent" or "restricted" and updating the FSA's rules on what is expected of a firm that describes its advice as being independent. The FSA is

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

also proceeding with proposals to introduce a system of "Adviser Charging", which will involve all firms that give investment advice to retail clients setting their own charges. Once the rules come into effect, adviser firms will no longer be able to receive commissions set by product providers in return for recommending their products, but will have to operate their own charging tariffs in accordance with the FSA's new rules. Regarding professionalism, the policy statement was published in January 2011 which details forthcoming changes to the Training and Competence Handbook, reporting and notification requirements and the role of accredited bodies. From the Company's perspective these changes have a wide impact on the organisation, including significant system changes, decisions on what products it will offer to market, quotations and information that will need to be provided to the regulator. The proposals are expected to take effect at the end of 2012.

Subsidiary and associate undertakings and branches

Particulars of the Company's principal subsidiary and associate undertakings at 31 December 2010 are shown on page 45 in note 17. The Company has a branch outside the United Kingdom in Hong Kong.

With-profits governance

The Company produces an annual report, which is available on request, setting out how it has complied with its Principles and Practices of Financial Management (PPFM).

The Board has established a With-profits Committee (WPC), made up of three members (each of whom is external and independent of the Company). The WPC provides the Board with an independent assessment of the way in which the Company manages its with-profits business, its compliance with the PPFM, and how the Company balances the rights and interests of policyholders and shareholders in relation to its with-profits funds. The WPC has the right, if it wishes, to make a statement to with-profits policyholders in addition to the Company's report described above.

The Company has a With-Profits Actuary who has the specific duty to advise the Board on the application of discretion in relation to with-profits business; and an Actuarial Function Holder who will provide the Board with all other actuarial advice. Both of these are Financial Services Authority approved roles.

Post balance sheet events

The Finance (no. 2) Act 2010 enacted the reduction in corporation tax rate from 28% to 27% with effect from April 2011. In addition, the UK Government announced three further annual 1% cuts to reduce the rate to 24% from April 2014. At the Budget 2011 on 23 March 2011 the UK Government announced that the corporation tax rate would instead reduce to 26% from April 2011 with three further annual 1% cuts to 23% by April 2014. Other than the enacted change to 27%, the effects of the announced changes are not reflected in the financial statements for the year ended 31 December 2010 as they have not yet been enacted and the impact has not yet been estimated.

Accounts

The state of affairs of the Company at 31 December 2010 is shown in the balance sheet on pages 19 and 20. The profit and loss account appears on pages 15 to 17.

Share Capital

There have been no changes in the Company's share capital during 2010 as shown on page 47 in note 24.

Dividends

An interim dividend of £450m was declared on 15 April 2010, of which a dividend of £201.8m (2009: £284.0m) on the ordinary shares was paid on 16 April 2010 and the remaining £248.2m was satisfied by

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

a reduction in the balance outstanding on the loan from the Company to Prudential plc. A further interim dividend of £350m was declared on 13 December 2010 and was satisfied by a reduction from the balance outstanding on the loan from the Company to Prudential plc. The result of the two interim dividends is a release of £800m from the retained profit and reserves of the Company. The directors have not declared a final dividend on the ordinary shares for 2010 (2009: £Nil).

A dividend on the A preference shares of £19,813 was paid on 8 May 2010 (2009: £32,769). No dividend was paid on any other preference shares.

Payment policy

It is the policy of the Company to agree terms of payment when orders for goods or services are placed and to pay in accordance with those terms. This policy was strengthened in 2009 by signing up to the Prompt Payment Code, launched in December 2008 by the UK Department for Business, Enterprise and Regulatory Reform. In 2010, the Company's 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 23 days (2009: 22 days).

Directors

The present directors are shown on page 1. There were no changes during the year.

Political and Charitable Donations

During 2010 the Hong Kong branch made donations of £81,312 (2009: £45,324). This is broken down as follows: Education £75,661; Social and Welfare £5,651. No donations were made for political purposes.

Disclosure to auditor

The directors who held office at the date of approval of this directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditor is unaware; and each director has taken all the steps that he ought to have taken as a director to make himself aware of any relevant audit information and to establish that the Company's auditor is aware of that information. This confirmation is given and should be interpreted in accordance with the provisions of Section 418 of the Companies Act 2006.

Financial instruments

The Company is exposed to financial risk through its financial assets, financial liabilities, and policyholder liabilities. The financial risk factors affecting the Company include market risk, credit risk and liquidity risk. Information on the financial risk management objectives and policies of the Company and the exposure of the Company to the financial risk factors is given in note 34 (E) on page 71. Further information on the use of derivatives by the Company is provided in note 34 (C) on page 68.

Auditor

The directors re-appointed KPMG Audit Plc as auditor of the Company on 12 May 2010. An ordinary resolution of the Company for the re-appointment of KPMG Audit Plc as auditor of the Company will be proposed to the members of the Company in accordance with Section 485(4) of the Companies Act 2006.

Directors' and officers' protection

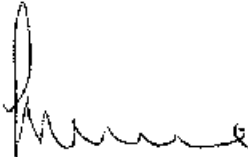
Prudential plc has arranged appropriate insurance cover in respect of legal action against directors and senior managers of companies within the Prudential Group. In addition, the Articles of Association of

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2010 (continued)

the Company provide for the directors, officers and employees of the Company to be indemnified in respect of liabilities incurred as a result of their office. Prudential plc also provides protections for directors and senior managers of companies within the Group against personal financial exposure they may incur in their capacity as such. These include qualifying third party indemnity provisions (as defined by the relevant Companies Act) for the benefit of directors of Prudential plc, including, where applicable, in their capacity as a director of the Company and other companies within the Group. These indemnities were in force during 2010 and remain in force.

On behalf of the Board of directors.

A handwritten signature in black ink, appearing to read 'S D Windridge', written over a horizontal line.

S D Windridge
Secretary
28 March 2011

STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE DIRECTORS' REPORT AND THE FINANCIAL STATEMENTS

The directors are responsible for preparing the Directors' Report and the financial statements in accordance with applicable law and regulations.

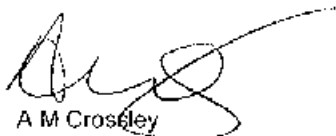
Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice).

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Company and to prevent and detect fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.



A M Crosley
Director
28 March 2011

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF THE PRUDENTIAL ASSURANCE COMPANY LIMITED

We have audited the financial statements of The Prudential Assurance Company Limited for the year ended 31 December 2010 on pages 15 to 76. The financial reporting framework that has been applied in their preparation is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement set out on page 13, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's web-site at www.frc.org.uk/apb/scope/private.cfm.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2010 and of its profit for the year then ended;
- have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.



Chris Moulder (Senior Statutory Auditor)
For and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants
15 Canada Square
Canary Wharf
London
E14 5GL

28 March 2011

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Profit and Loss Account for the year ended 31 December 2010

Note	<u>General Business Technical Account</u>	<u>2010 £m</u>	<u>2009 £m</u>
2b	Gross premiums written	35	34
	Outward reinsurance premiums	(87)	(4)
	Premiums written, net of reinsurance	(52)	30
	Change in the provision for unearned premiums		
	Gross amount	(1)	-
	Earned premiums, net of reinsurance	(53)	30
	Claims paid		
	Gross amount	(19)	(21)
	Reinsurers' share	4	4
	Claims paid, net of reinsurance	(15)	(17)
	Change in provision for claims		
	Gross amount	(5)	4
	Reinsurers' share	88	(4)
	Net of reinsurance	83	-
	Claims incurred, net of reinsurance	68	(17)
5	Net operating expenses	(13)	(12)
2b	Balance on the general business technical account	2	1
	<u>Analysis:</u>		
	Continuing operations	2	1
9	Operations in run-off	-	-
		<u>2</u>	<u>1</u>

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Profit and Loss Account for the year ended 31 December 2010 (continued)

Note	<u>Long-term Business Technical Account</u>	<u>2010 £m</u>	<u>2009 £m</u>
2a	Gross premiums written	6,484	6,238
	Outward reinsurance premiums	(1,052)	(1,137)
	Earned premiums, net of reinsurance	<u>5,432</u>	<u>5,101</u>
3, 11	Investment income	6,513	6,825
	Unrealised gains on investments	3,939	6,131
	Claims paid		
	Gross amount	(9,568)	(9,348)
	Reinsurers' share	1,119	1,065
	Claims paid, net of reinsurance	<u>(8,449)</u>	<u>(8,283)</u>
	Change in provision for claims		
	Gross amount	(17)	7
	Reinsurers' share	-	1
	Claims incurred, net of reinsurance	<u>(8,466)</u>	<u>(8,275)</u>
	Change in long-term business provision		
	Gross amount	(5,605)	(5,881)
	Reinsurers' share	975	1,195
		<u>(4,630)</u>	<u>(4,686)</u>
	Change in technical provision for linked liabilities	(745)	(1,207)
	Change in other technical provisions, net of reinsurance	<u>(5,375)</u>	<u>(5,893)</u>
5	Net operating expenses	(783)	(835)
6	Investment expenses and charges	(260)	(275)
7	Tax attributable to the long-term business	(582)	(852)
	Actuarial and other losses on pension schemes	(45)	(55)
	Transfer to the fund for future appropriations	(69)	(1,580)
	Balance on the long-term business technical account	<u>304</u>	<u>292</u>

All premiums and the balance on the long-term business technical account relate to continuing operations.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Profit and Loss Account for the year ended 31 December 2010 (continued)

Note **Non-Technical Account**

	<u>2010 £m</u>	<u>2009 £m</u>
Balance on the general business technical account	<u>2</u>	<u>1</u>
Balance on the long-term business technical account	304	292
7 Tax credit attributable to the balance on the long-term business technical account	121	111
2a Balance on the long-term business technical account before tax	<u>425</u>	<u>403</u>
3 Investment income	62	77
Unrealised loss on portfolio investments	-	(5)
Other income	43	54
Other charges	(30)	(37)
2c Total profit on other activities	<u>75</u>	<u>89</u>
10 Profit on disposal of related undertakings	561	-
Profit on ordinary activities before tax	<u>1,063</u>	<u>493</u>
7 Tax on profit on ordinary activities	(120)	(144)
Profit for the financial year	<u>943</u>	<u>349</u>

Except for the valuation of investments, there is no material difference between the results for the current year and the previous year as described in the profit and loss account and the results on an unmodified historical cost basis. Accordingly, given the exemptions provided to insurance companies in FRS 3.31A, a note of the historical cost profits and losses for the year is not given.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Statement of Total Recognised Gains and Losses for the year ended 31 December 2010

Note

	<u>2010 £m</u>	<u>2009 £m</u>
Profit for the financial year	943	349
Other recognised gains and losses:		
25 (Decrease) increase in surplus on revaluation of investments in shareholder subsidiaries	(221)	389
25 Transfer to profit and loss reserves of 50% of the revaluation movement accumulated for Prudential Health Holdings Limited prior to its partial disposal	(13)	-
Exchange adjustments	2	(8)
Other movements – transfer of Scottish Amicable Pension Scheme (SAPS) deficit from the Company to another Group Company	-	16
Total recognised gains relating to the financial year	<u>711</u>	<u>746</u>

Reconciliation of Movement in Shareholders' Funds for the year ended 31 December 2010

	<u>2010 £m</u>	<u>2009 £m</u>
Total recognised gains relating to the financial year	711	746
Dividends	(800)	(284)
Net movement in shareholders' funds	<u>(89)</u>	<u>462</u>
Shareholders' funds at beginning of year	<u>3,699</u>	<u>3,237</u>
Shareholders' funds at end of year	<u>3,610</u>	<u>3,699</u>
Included in Shareholders' funds are aggregate net foreign exchange differences as follows:		
Aggregate net foreign exchange differences included in opening Shareholders' funds	3	(6)
Net foreign exchange differences for the year	(1)	(2)
Aggregate net foreign exchange differences included in closing Shareholders' funds	<u>2</u>	<u>(8)</u>

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Balance sheet as at 31 December 2010

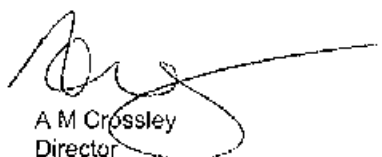
Note	Assets	2010 £m	2009 £m
15	Intangible assets		
	Licence	94	104
	Distribution rights	123	126
		<u>217</u>	<u>230</u>
	Investments		
16	Land and buildings	6,224	5,952
17	Investments in group undertakings and participating interests	6,190	6,243
18	Other financial investments	81,343	76,769
		<u>93,757</u>	<u>88,964</u>
19	Assets held to cover linked liabilities	10,290	7,648
20	Reinsurers' share of technical provisions		
	Provision for unearned premiums	2	2
	Long-term business provision	12,811	11,835
	Claims outstanding	110	22
	Technical provisions for linked liabilities	4,242	4,897
		<u>17,165</u>	<u>16,756</u>
	Debtors		
	Debtors arising out of direct insurance operations		
	Policyholders	47	50
	Intermediaries	18	10
	Debtors arising out of reinsurance operations	2,607	2,401
21	Other debtors	1,338	1,115
		<u>4,010</u>	<u>3,576</u>
	Other assets		
22	Tangible assets	8	7
27	Cash at bank and in hand	955	856
		<u>963</u>	<u>863</u>
	Prepayments and accrued income		
	Accrued interest and rent	612	600
	Deferred acquisition costs		
	General business	7	6
	Long-term business	180	161
	Accrued external dividends receivable	57	55
	Other prepayments and accrued income	169	110
		<u>1,025</u>	<u>932</u>
	Total assets (excluding pension asset)	<u>127,427</u>	<u>118,969</u>
12	Pension asset (net of related deferred tax)	53	46
23	Total assets (including pension asset)	<u>127,480</u>	<u>119,015</u>

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Balance sheet as at 31 December 2010 (continued)

Note	Liabilities	2010 £m	2009 £m
	Capital and reserves		
24	Share capital	330	330
25	Revaluation reserve	726	947
25	Other reserves	536	536
25	Profit and loss account	2,018	1,886
2c	Shareholders' funds - equity interests	<u>3,610</u>	<u>3,699</u>
26	Fund for future appropriations	10,395	10,330
	Technical provisions		
	Provision for unearned premiums	18	16
32	Long-term business provision	92,620	86,900
	Claims outstanding	478	450
8	Equalisation provision	1	1
	Unearned revenue provision	46	43
	Total technical provisions	<u>93,163</u>	<u>87,410</u>
	Technical provisions for linked liabilities	14,532	12,545
	Provisions for other risks and charges		
7	Deferred taxation	841	640
	Other	14	13
		<u>855</u>	<u>853</u>
	Creditors		
	Creditors arising out of direct insurance operations	106	77
	Creditors arising out of reinsurance operations	98	52
	Amounts owed to credit institutions	46	45
	Other borrowings not owed to credit institutions	347	359
28	Other creditors including taxation and social security	4,151	3,733
29	Preference shares	1	1
		<u>4,749</u>	<u>4,267</u>
	Accruals and deferred income	176	111
	Total liabilities	<u>127,480</u>	<u>119,015</u>

The accounts on pages 15 to 76 were approved by the Board of directors on 28 March 2011.


A M Crossley
Director

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements

1. Accounting Policies

A. Basis of Preparation

The financial statements are prepared in accordance with Part 15 of the Companies Act 2006 and Schedule 3 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. The financial statements comply with applicable accounting standards (UKGAAP) and the ABI SORP, and have been prepared under the historical cost accounting rules, modified to include the revaluation of investments.

As the Company is a wholly owned subsidiary undertaking of another company registered in England and Wales, group financial statements are not prepared. Accordingly, the financial statements present information about the Company as an individual undertaking and are not consolidated.

The Company has taken advantage of the exemption under FRS1 (Revised) 'Cash flow statements' from preparing a cash flow statement. The Company has not presented all the supporting disclosures required under FRS 27 'Life Assurance' on the basis that the Company is more than 90 per cent owned within a group and the Company is included in the publicly available Prudential plc group financial statements which provide information on a group basis complying with this requirement.

The directors have a reasonable expectation that the Company will be able to continue in operational existence for the foreseeable future and thus continue to adopt the going concern basis of accounting in preparing the financial statements. This conclusion has been based upon the following: the Company is a subsidiary within the Prudential Group and it, its parent company and the ultimate parent company are continuing to trade and there are no plans for liquidation, the Company has a healthy solvency margin, well in excess of the Minimum Capital Requirement (MCR) and Enhanced Capital Requirement (ECR) (Note 35 on page 72), is supported by its inherited estate (Note 33 on page 54), generates positive cashflows and has very low debt-financing. In addition consideration has also been given to the Company's performance, the market in which it operates, its strategy and risks and uncertainties, as set out in the Business Review on pages 2 to 10, the management of financial risk as set out in note 34, including its exposure to liquidity risk and credit risk.

B. Change in accounting policies

The Company has implemented the following changes in preparing its results for the year ended 31 December 2010. These standards closely reflect the requirements of International Financial Reporting Standards (IFRS) and form part of the continuing convergence of UKGAAP to IFRS requirements in the UK.

The amendments to FRS 20 'Group cash settled share-based payment transactions' which expanded FRS 2 to bring into scope group cash-settled share-based payment transactions became effective for the Company in 2010. These amendments incorporated the guidance in UITF 41, 'Scope of FRS 20' and UITF 44, 'Group and Treasury Share Transactions' which were withdrawn as a result. In particular, the amendments specify that the entity which has the obligation to settle the share-based payment arrangement shall recognise it as an "equity-settled transaction" if it is settled in its own equity instruments and as "cash-settled transaction" otherwise, no matter which entity in the group receives the goods or service in the arrangement. The Company's share-based payment accounting treatment prior to 2010 was consistent with these amendments and accordingly, there was no impact on the Company's results and financial position upon the adoption of these amendments.

In addition, following the UK Government's announcement in July 2010 of the use of the Consumer Price Index (CPI) rather than the Retail Price Index (RPI) in its determination of the statutory minimum pension increases for private sector occupational pension schemes, in December 2010, the ASB's Urgent Issue Task Force (UITF) published its abstract UITF 48 providing guidance on the accounting implications of the change. See note 12 for further details.

Further, in 2010, the Company adopted the Improvements to Financial Reporting Standards 2009, the Amendment to FRS 25 'Financial Instruments: Presentation' – Puttable Financial Instruments and Obligations Arising On Liquidation. Their adoption had no material impact on the financial statements of the Company.

Notes on the financial statements (continued)

1. Accounting Policies (continued)

C. Long-term Business

The measurement basis of assets and liabilities of long-term business contracts is dependent upon the classification of the contracts under FRS 26 as either insurance contracts, if the level of insurance risk is significant, or investment contracts if the risk is insignificant. A further distinction is made between investment contracts with and without discretionary participation features. Discretionary participation features represent the contractual right to receive additional profit-sharing benefits as a supplement to guaranteed benefits. The Company's insurance contracts and investment contracts with discretionary participation features are primarily with-profits and other protection type or annuity policies. The investment contract without discretionary participation features classification applies primarily to certain unit-linked and similar contracts written by the Company. Insurance contracts and investment contracts with discretionary participation features are accounted for under previously applied UKGAAP, as set out in the ABI SORP. Investment contracts without discretionary participation features are accounted for as financial liabilities under FRS 26 and, where relevant the provisions of the ABI SORP in respect of the attaching investment management features of the contracts. FRS 26 applies a different accounting treatment to these contracts than that previously applied primarily in respect of deferred acquisition costs, deferred income reserves and provisions for future expenses commonly called "sterling reserves" (see below).

A further feature is that investment contracts without discretionary participation features are closer in nature to a deposit style arrangement between the investors and the Company. Premiums and withdrawals for these contracts are recorded within the balance sheet as a movement on the investors' liability and the long-term business technical account reflects the fee income, expenses and taxation on the contracts. The provisions for investment contracts without discretionary participation features are included in Technical Provisions for Linked Liabilities in the balance sheet.

Technical account treatment:

Premiums and annuity considerations for conventional with-profit policies and other protection type life insurance and annuity policies are accounted for when due. For unit-linked business and unithised with-profit policies, premiums are accounted for when the liabilities arising from the premiums are created. Premiums exclude any taxes or duties based on premiums. Pensions annuity contracts that vest during the year are included in claims incurred and premium income at the annuity purchase price.

Claims paid include maturities, annuities, surrenders and death. Maturity claims are accounted for on the policy maturity date. Annuity claims are accounted for when the annuity becomes due for payment. Surrenders are accounted for when paid and death claims when notified.

Under FRS 26, the accounting treatment for investment contracts without discretionary participation features reflects the deposit nature of the arrangement with premiums and claims reflected as deposits and withdrawals taken directly to the balance sheet as a movement on the investors' liability with the long-term technical account reflecting fee income, expenses and taxation on these contracts.

The costs of acquiring new non-profit insurance contracts, principally commission and certain costs associated with policy issue and underwriting, which are not matched by policy charges are capitalised and amortised against margins in future revenues on the related insurance contracts for non-profit business to the extent that the amounts are recoverable out of margins.

Under FRS 26, for the investment contracts without discretionary participation features, only the incremental, directly attributable acquisition costs relating to the securing of investment management element of the contracts can be capitalised and amortised in line with related revenue. If these contracts involve up-front charges, this income is also deferred and amortised through the technical account in line with contractual service provision.

Sterling reserves, as defined above, are not permitted to be recognised under FRS 26 for investment contracts.

Bonus additions made to policies are included in the change in the long-term business provision or, where the policy is no longer in force, in claims incurred.

Profits comprise actuarial surpluses allocated to shareholders adjusted, other than for with-profits business, for the deferral of acquisition costs and movements in the shareholders' interest in reserves held within long-term funds. For with-profits business, unappropriated surplus is carried forward in the

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

1. Accounting Policies (continued)

fund for future appropriations and no allocation is made to the shareholders. There is no deferral of acquisition costs for with-profits business.

The fund for future appropriations comprises amounts arising in relation to participating policies and other non-linked policies, the allocation of which to policyholders or to shareholders has not been determined at the balance sheet date.

The assumptions used to calculate the long-term business provisions are described in note 32.

The Company applies FRS 27, which impacts the basis of reporting for the with-profits business provisions. FRS 27 is underpinned by the FSA's Peak 2 realistic basis of reporting.

Realistic reserves are established using best estimate assumptions, and taking into account the firm's regulatory duty to treat its customers fairly.

The FSA realistic value of liabilities is calculated as:

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

The WPBR is the main component of the product related liability, and is mainly determined using a retrospective asset share calculation.

Asset shares are calculated by rolling up the premiums paid, less expenses and charges using the actual investment returns earned on the with-profits fund. The assumptions used within the asset share calculations are consistent with those that are actually used to determine policyholders' bonuses. A number of adjustments are made to reflect future expected policyholder benefits and other outgoings. For certain classes of business including conventional with-profits whole life, industrial branch and many pension contracts (which have capped charges) a prospective bonus reserve valuation is performed instead, valuing future claims and expenses using the expected future bonus rates.

The FPRL includes a market consistent valuation of the costs of guarantees, options and smoothing. This is determined using stochastic modelling. The FPRL also includes other liabilities such as tax on shareholder transfers and enhancements to policy benefits arising from the distribution of surplus from non-profit business written within the with-profits fund or from the Company's subsidiary, Prudential Annuities Limited (PAL). For the Scottish Amicable Insurance Fund (SAIF), the FSA realistic liability calculation requires that all of the surplus within the fund is distributed to policyholders and therefore the FPRL is increased up to the point where the fund has no working capital.

The FSA realistic value of liabilities is adjusted in accordance with FRS 27 to remove the present value of shareholder transfers and related tax. Shareholder transfers are recognised as a liability for the purposes of FSA regulatory returns but, for accounting purposes under FRS 27, shareholders' transfers are recognised only on declaration, consistent with the current basis of financial reporting.

The reported assets include the Company's interest in its subsidiary, PAL, adjusted from the value reported in the FSA realistic balance to reflect differences in the provisioning and capital requirements between the accounting and FSA realistic basis.

Under FSA reporting, the assets include the present value of future profits of PAL and of non-profit business written within the with-profit funds. Under FRS 27 these items are not recognised. Similarly, that part of these future profits which is included in the FSA FPRL is excluded under FRS 27.

D. General Business

General insurance business is accounted for on an annual accounting basis.

Premiums are accounted for when risks are assumed. Premiums are shown gross of commission and exclude any taxes or duties based on premiums. In determining the result, the proportion of premiums written relating to periods of risk beyond the year end is carried forward to subsequent accounting

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

1. Accounting Policies (continued)

periods as unearned premiums, calculated on a daily basis, so that earned premiums relate to risks carried during the accounting period. A similar treatment is applied to acquisition expenses.

Claims incurred comprise the settlement and handling costs of paid and outstanding claims arising from events occurring in the year and adjustments to prior years' claims provisions. Outstanding claims comprise claims incurred up to but not paid at the end of the accounting period whether reported or not.

An unexpired risks provision is established for any excess of expected claims and deferred acquisition costs over unearned premiums and investment return. The assessment of expected claims has regard to claims experience up to the end of the accounting period. No specific provision is made for major events occurring after this date.

An equalisation provision has been established in accordance with the requirements of the Prudential Sourcebook for Insurers in order to reduce the impact of claims volatility.

Transactions in respect of general business operations in run-off are accounted for within the general business technical account.

E. Reinsurance

In the normal course of business the Company seeks to reduce loss exposure by reinsuring certain levels of risk in various areas of exposure with other insurance companies or reinsurers. An asset or liability is recognised in the balance sheet representing premiums due to or payments due from reinsurers and the share of benefits and claims recoverable from reinsurers. The measurement of reinsurance assets is consistent with the measurement of the underlying direct insurance contracts.

F. Investments

Investment income and realised and unrealised gains or losses in respect of long-term business are included in the long-term business technical account. Other investment income and realised gains or losses and, except in respect of shareholder investments in subsidiaries, unrealised gains or losses, are included in the non-technical account.

Realised gains or losses are determined as the difference between net proceeds on disposal and the purchase price. Movements in unrealised gains or losses comprise the change in the value of investments held at the balance sheet date and the reversal of unrealised investment gains and losses recognised in earlier accounting periods in respect of investment disposals.

Shareholder investments in entities that undertake long-term business are shown at current values using embedded values as determined in accordance with the European Embedded Value principles issued by the CFO Forum of European Insurance Companies in May 2004 and expanded by the Additional Guidance on European Embedded Value Disclosures issued in October 2005. Investments in other subsidiaries are valued at net asset value. The movement in values is taken to the revaluation reserve, other than a permanent diminution in value, which is taken to the non-technical account. Investments in participating interests are carried at fair value.

Under FRS 26, upon initial recognition financial investments are recognised at fair value. Subsequently, the Company is permitted, subject to specific criteria, to designate its investments as either financial investments at fair value through profit and loss, financial investments held on an available-for-sale basis, financial investments held to maturity, or loans and receivables. The Company holds financial investments on the following bases:

- (i) Financial investments at fair value through profit and loss – this comprises assets designated by management as fair value through profit and loss on inception and derivatives which are deemed to be held for trading. These investments are valued at fair value with all changes thereon being recognised in the profit and loss account. An analysis of net gains/losses is disclosed separately in note 3 on page 30 and note 18 on page 46.
- (ii) The Company uses bid prices to value its quoted financial investments. Actively traded investments without quoted prices are valued using external broker bid prices. If there is no active established market for an investment, the Company applies an appropriate

Notes on the financial statements (continued)

1. Accounting Policies (continued)

- valuation technique such as discounted cash flow technique. Further information on valuation techniques is provided in note 34 (A) on pages 55 to 58.
- (iii) Loans and receivables – these comprise investments that have fixed or determinable payments and are not designated as fair value through profit and loss or available-for-sale. These investments include loans secured by mortgages, deposits and loans to policyholders and other unsecured loans and receivables. These investments are carried at amortised cost using the effective interest method and subject to impairment reviews. The Company measures the amount of the impairment loss by comparing the amortised cost with the present value of its estimated future cash flows discounted at the original effective interest rate. Certain mortgage loans of the Company have been designated at fair value through profit and loss as this loan portfolio is managed and evaluated on a fair value basis and these are included within loans in the balance sheet.

The Company uses derivatives for efficient portfolio management to obtain cost effective and efficient exposure to various markets and to manage exposure to interest rate, currency, credit and other business risks. The Company designates as a fair value hedge certain fixed to floating rate swaps which hedge the fair value exposure to interest rate movements of certain of the Company's operational borrowings. Movements in the fair value of the hedging instruments are recorded in the long term technical account. All derivatives that do not meet the relevant hedging criteria are carried at fair value with movements in fair value being recorded in the long term technical account.

Properties are valued annually, by a number of different professional external valuers, at market value as defined in the Appraisal and Valuation Manual issued by the Royal Institute of Chartered Surveyors in particular Practice statement 3.2. In accordance with SSAP 19, no depreciation is provided on investment properties as the directors consider that to depreciate them would not give a true and fair view.

In accordance with the provisions of Schedule 3, paragraph 76 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, there is a requirement to show the net book value on a historical cost basis of properties in a note to the accounts. For this purpose properties are depreciated over forty years. Leasehold properties are depreciated over forty years, or if the lease is less than forty years, over the length of the lease.

G. Financial Liabilities

Financial liabilities are designated as either fair value through profit and loss, amortised cost or investment contracts with discretionary participation features accounted for under FRS 26 and the ABI SORP.

The Company holds financial liabilities on the following bases:

- (i) Financial liabilities at fair value through profit and loss – these comprise derivatives, investment contracts without discretionary participation features and certain creditors. Derivative liabilities and certain creditors are valued at fair value with all changes thereon being recognised in the profit and loss account. An analysis of net gains/losses is disclosed separately in note 3 on page 30 and note 18 on page 46. Investment contracts without discretionary participation features are covered in section C above.
- (ii) Financial liabilities that are not valued at fair value through profit and loss and are not investment contracts with discretionary participation features are mainly creditors shown at settlement value. The Company also has some operational borrowings where it has chosen to designate as a fair value hedge certain fixed to floating rate swaps which hedge the fair value exposure to interest rate movements of these borrowings.
- (iii) Investment contracts with participation features. The accounting policy is covered in section C above.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

1. Accounting Policies (continued)

H. Tax

Tax is charged on all taxable profits arising in the accounting period. The UK HM Revenue & Customs rules for taxing long-term business are significantly different to those applying to non-insurance companies and the different classes of business written by the Company are themselves subject to distinct rules. Furthermore the tax calculations are performed using data from the regulatory returns submitted to the FSA rather than the financial statements. There may be significant and complex differences between the regulatory and accounting bases.

Except where otherwise required by accounting standards, full provision for deferred tax without discounting is made for all timing differences which have arisen but not reversed at the balance sheet date.

I. Foreign Currencies

Foreign currency revenue transactions are translated at average exchange rates for the year. Monetary foreign currency assets and liabilities are translated at year end exchange rates. Exchange differences on long-term business and on net investments in foreign enterprises less matching borrowings are taken to reserves. Other exchange differences are included in the profit and loss account.

J. Tangible Assets

Tangible assets, principally fixtures and fittings, building improvements, computer equipment and software development expenditure, are capitalised and depreciated by equal annual instalments over their estimated useful lives. Fixtures and fittings and building improvements are depreciated over ten years, computer hardware over five years and software over three years.

K. Pension Costs

The Company applies the requirements of FRS 17 'Retirement Benefits' as amended December 2006. The Prudential Group operates a number of defined contribution and defined benefit pension schemes and a portion of these defined benefit pension schemes' surplus or deficits is attributed to the Company. Further details are disclosed in note 12. Contributions in respect of defined contribution schemes are recognised when incurred.

The assets and liabilities of the defined benefit pension schemes of the Prudential Group are subject to a full triennial actuarial valuation using the projected unit method. Estimated future cash flows are discounted at a high quality corporate bond rate, adjusted to allow for the difference in duration between the bond index and the pension liabilities where appropriate, to determine its present value. The Prudential Staff Pension Scheme (PSPS) is the largest defined benefit scheme and accounts for 86% of the underlying scheme liabilities of the Prudential Group's defined benefit schemes under FRS 17. The difference between the fair value of the scheme assets and the actuarial value of the scheme liabilities is a surplus or deficit on the scheme. The Company's share of pension surplus is recognised to the extent that the Company is able to recover a surplus either through reduced contributions in the future or through refunds from the scheme.

The aggregate of the actuarially determined service cost of the currently employed personnel, the unwind of discount on liabilities at the start of the period, gains and losses on settlements and curtailments, less the expected investment return on the scheme assets at the start of the reporting period are recognised in the profit and loss account. To the extent that part or all of the Company's interest in the pension surplus is not recognised as an asset, the unrecognised surplus is initially applied to extinguish any past service costs, losses on settlements or curtailments that would otherwise be included in the profit and loss account. Next, the expected investment return on the scheme assets is restricted so that it does not exceed the total of the current service cost, interest cost and any increase in the recoverable surplus. Any further adjustment for the unrecognised surplus is treated as an actuarial gain or loss.

The actuarial gains and losses which arise from assumptions, the difference between actual and expected investment return on the scheme assets, and experience gains and losses on liabilities are recognised in the long-term technical account. Actuarial gains and losses also include adjustment for unrecognised pension surplus as described above.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

1. Accounting Policies (continued)

L. Intangible Assets

Intangible assets are carried at cost less amortisation and any accumulated impairment losses.

Intangible assets include a licence, which represents the value of an agreement with a fellow subsidiary company for the use of certain Scottish Amicable assets, which is being amortised over a period of 20 years to 30 September 2017, on a basis consistent with the revenue stream from the agreement.

Intangible assets also include distribution rights which relate to facilitation fees paid in relation to the bancassurance partnership arrangements in Asia for the bank distribution of insurance products for a fixed period of time. The distribution rights amounts are amortised on the basis to reflect the pattern in which the distribution rights' future economic benefits are expected to be consumed by the Company by reference to new business levels.

M. Dividend Policy

Interim and final dividends are recognised in the period in which they are declared to the extent that they are unconditional on any future events. Dividends declared after the balance sheet in respect of the prior reporting period are treated as a non-adjusting event.

N. Share-based Payments

The Company offers share award and option plans for certain key employees and a SAYE plan for all UK and certain overseas employees. The Company has both equity-settled plans and cash-settled plans.

Share options and awards of the parent company's equity instruments, for which the parent company (Prudential plc) has the obligation to settle, are valued using the share price at the date of grant and are accounted for as equity-settled i.e. recognised in equity as a capital contribution from Prudential plc. Share options and awards for which the Company has the obligation to settle are valued using the share price at the balance sheet date and are accounted for as cash-settled i.e. as an obligation to transfer the equity instruments of Prudential plc. The compensation costs for all awards and options are recognised in net income over the plans' respective vesting periods.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

2. Segmental analysis

(a) Long-term business

<u>Premiums and profit</u>	<u>Gross premiums written</u>		<u>Balance on the technical account before tax</u>	
	<u>2010 £m</u>	<u>2009 £m</u>	<u>2010 £m</u>	<u>2009 £m</u>
United Kingdom	5,072	4,976	389	345
Hong Kong	1,224	1,003	36	57
France	188	259	-	1
	<u>6,484</u>	<u>6,238</u>	<u>425</u>	<u>403</u>

New business

	<u>Regular premiums</u>		<u>Single premiums</u>	
	<u>2010 £m</u>	<u>2009 £m</u>	<u>2010 £m</u>	<u>2009 £m</u>
United Kingdom	260	237	4,264	3,930
Hong Kong	273	225	106	92
France	31	-	157	259
	<u>564</u>	<u>462</u>	<u>4,527</u>	<u>4,281</u>

Single premiums include UK Department of Work and Pensions rebates business and increments under existing group pension schemes. Regular premiums are determined on an annualised basis.

New business premiums include those contracts excluded from premium income in the 2010 technical account under FRS26 and the ABI SORP (as amended in December 2006). These are investment contracts without discretionary participation features and carry no significant insurance risk.

<u>Analysis of premium income</u>	<u>2010 £m</u>	<u>2009 £m</u>
Gross written premiums:-		
Direct	5,957	5,747
Reinsurance accepted	527	491
	<u>6,484</u>	<u>6,238</u>
Analysis of gross direct premiums:-		
Individual business	5,390	5,190
Group contracts	567	557
	<u>5,957</u>	<u>5,747</u>
Regular premiums	2,285	2,167
Single premiums	3,672	3,580
	<u>5,957</u>	<u>5,747</u>
Participating contracts	4,745	4,567
Non-participating contracts	508	549
Linked long-term contracts (excluding investment contracts without discretionary participation features)	704	631
	<u>5,957</u>	<u>5,747</u>
United Kingdom	4,733	4,744
Hong Kong	1,224	1,003
France	-	-
	<u>5,957</u>	<u>5,747</u>

Net reinsurance income

Net reinsurance income in respect of long-term business for the year ended 31 December 2010 was £387m (2009: income of £2,035m).

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

2. Segmental analysis (continued)

(b) General business

<u>Premiums and underwriting result</u>		<u>Gross premiums written</u>		<u>Underwriting result</u>	
		<u>2010</u> <u>£m</u>	<u>2009</u> <u>£m</u>	<u>2010</u> <u>£m</u>	<u>2009</u> <u>£m</u>
Continuing operations	Hong Kong	35	34	2	1
Operations in run-off	United Kingdom	-	-	-	-
		<u>35</u>	<u>34</u>	<u>2</u>	<u>1</u>

<u>Analysis of technical account</u>	<u>Gross Premiums Written</u>		<u>Gross Premiums Earned</u>		<u>Gross Claims Incurred</u>		<u>Gross Operating Expenses</u>		<u>Reinsurance Balance</u>	
	<u>2010</u> <u>£m</u>	<u>2009</u> <u>£m</u>	<u>2010</u> <u>£m</u>	<u>2009</u> <u>£m</u>	<u>2010</u> <u>£m</u>	<u>2009</u> <u>£m</u>	<u>2010</u> <u>£m</u>	<u>2009</u> <u>£m</u>	<u>2010</u> <u>£m</u>	<u>2009</u> <u>£m</u>
Motor										
-other classes	2	2	2	2	-	2	1	1	6	1
Marine, aviation and transport	-	-	-	-	-	-	-	-	-	-
Fire and other damage	4	4	4	4	7	2	2	2	(1)	(2)
Other	29	28	28	28	17	13	11	11	1	(1)
	<u>35</u>	<u>34</u>	<u>34</u>	<u>34</u>	<u>24</u>	<u>17</u>	<u>14</u>	<u>14</u>	<u>6</u>	<u>(2)</u>

The geographical analyses of long-term and general business premiums are based on the territory of the operating unit assuming the risk. Premiums by territory of risk are not materially different.

(c) Shareholders' other income and funds

Shareholders' other income and shareholders' funds, taking into account the location of business operations of subsidiaries, relate to the following countries:

	<u>Total profit on other activities</u>		<u>Shareholders' funds</u>	
	<u>2010 £m</u>	<u>2009 £m</u>	<u>2010 £m</u>	<u>2009 £m</u>
United Kingdom	71	57	3,610	3,100
Taiwan	4	4	-	15
Indonesia	-	28	-	584
	<u>75</u>	<u>89</u>	<u>3,610</u>	<u>3,699</u>

THE PRUDENTIAL ASSURANCE COMPANY LIMITED
Notes on the financial statements (continued)

3. Investment income

	Long-term business		Non-technical account	
	<u>2010 £m</u>	<u>2009 £m</u>	<u>2010 £m</u>	<u>2009 £m</u>
Income from:				
Group undertakings	566	385	-	22
Other investments				
Land and buildings	446	564	-	-
Listed investments	2,641	2,694	-	1
Unlisted investments	269	288	-	-
Other investments	287	247	58	56
	<u>4,209</u>	<u>4,178</u>	<u>58</u>	<u>79</u>
(Losses) on loans and receivables	(17)	(126)	-	-
Gains on the realisation of investments at fair value through profit and loss other than derivatives	3,022	2,285	3	2
(Losses) gains on the realisation of derivatives – see note 34	(819)	650	-	-
Exchange gains (losses)	90	(177)	1	(4)
Fees for policy administration and asset management services arising from unit-linked investment contracts	28	15	-	-
	<u>6,513</u>	<u>6,825</u>	<u>62</u>	<u>77</u>

4. Bonuses

Bonuses added during the year are included in the change in the long-term business provision or, where the policy is no longer in force, in claims incurred. The total cost of bonuses was £2,668m (2009: £2,545m).

5. Net operating expenses

	Long-term business		General business	
	<u>2010 £m</u>	<u>2009 £m</u>	<u>2010 £m</u>	<u>2009 £m</u>
Depreciation	3	3	-	-
Acquisition costs	445	395	10	10
Change in deferred acquisition costs	(19)	(2)	(1)	(1)
Administrative expenses	337	424	4	3
Amortisation of licence and distribution rights (Note 15)	17	15	-	-
	<u>783</u>	<u>835</u>	<u>13</u>	<u>12</u>

Acquisition costs include commissions in respect of long-term direct insurance business of £294m (2009: £266m) and general direct insurance business of £9m (2009: £10m). Administrative expenses are principally recharged from Prudential Distribution Limited, a service company within the Prudential Group.

No exchange differences have been credited (charged) to administrative expenses.

6. Investment expenses and charges

	Long-term business		Non-technical account	
	<u>2010 £m</u>	<u>2009 £m</u>	<u>2010 £m</u>	<u>2009 £m</u>
Investment management expenses	233	268	-	-
Interest on bank borrowings	27	7	-	-
	<u>260</u>	<u>275</u>	<u>-</u>	<u>-</u>

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

7. Tax

<u>a) Tax charged (credited)</u>	Long-term funds		Shareholders' Profits	
	<u>2010 £m</u>	<u>2009 £m</u>	<u>2010 £m</u>	<u>2009 £m</u>
Current Tax				
UK corporation tax	376	510	16	13
Double tax relief	(17)	(15)	-	(1)
Overseas tax	35	34	1	3
Adjustments in respect of prior year	(7)	39	(22)	16
Total current tax	<u>387</u>	<u>568</u>	<u>(5)</u>	<u>31</u>
Deferred tax				
Origination and reversal of timing differences	184	285	(1)	1
Effect of changes in tax rate on closing balances (Note i)	(6)	-	-	-
Adjustments in respect of prior year	21	-	1	-
Total deferred tax	<u>199</u>	<u>285</u>	<u>-</u>	<u>1</u>
Shareholders' attributable tax				
Current	-	-	49	166
Deferred	-	-	72	(57)
Total shareholders' attributable tax	-	-	<u>121</u>	<u>111</u>
Tax allocated to non-technical account	(4)	(1)	4	1
Tax charge on profit on ordinary activities	<u>582</u>	<u>852</u>	<u>120</u>	<u>144</u>

Note (i) The UK government's tax rate changes to 27 per cent has had an effect of reducing the net deferred tax balances as at 31 December 2010 by £6m. The UK government has proposed future phased rate changes to 23 per cent, which are not factored into the tax charge above.

b) Factors affecting tax charge for the period

	<u>2010 £m</u>	<u>2009 £m</u>
Profit on ordinary activities before tax	1,063	493
Profit on ordinary activities multiplied by effective rate of corporation tax in the UK of 28 per cent (2009: effective rate of 28 per cent)	298	138
Permanent differences	5	(1)
Adjustment to current tax in respect of previous periods	(25)	13
Different tax bases of long-term insurance (current and deferred)	(63)	56
Effect of short term timing differences	1	5
Effect of overseas tax	(2)	(2)
Non-taxable dividend income	(9)	(9)
Gains not taxable	(157)	-
Current tax charge for the period	<u>48</u>	<u>200</u>

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

c) Balance Sheet

	Attributable to Long-term funds		Attributable to Shareholders' funds	
	2010 £m	2009 £m	2010 £m	2009 £m
Provision for Deferred Tax				
Accelerated capital allowances	(2)	(5)	-	-
Policy reserves	121	115	-	-
Short term timing differences	(41)	(103)	(3)	(3)
Unrealised gains	831	707	-	-
Deferred acquisition costs	(65)	(71)	-	-
Undiscounted provision for deferred tax liability (deferred tax asset)	<u>844</u>	<u>643</u>	<u>(3)</u>	<u>(3)</u>
Deferred tax liability (deferred tax asset) at start of the period	643	354	(3)	(4)
Deferred tax charged in technical/ non-technical account for the period	<u>201</u>	<u>289</u>	<u>-</u>	<u>1</u>
Deferred tax liability (deferred tax asset) at end of the period	<u>844</u>	<u>643</u>	<u>(3)</u>	<u>(3)</u>

The deferred tax liability relating to the pension asset attributable to the Company of £4m (2009: £5m) has been netted off against the pension asset on the balance sheet. The movement in this deferred tax liability has been included in the tax charge within the technical account.

8. Equalisation provision

An equalisation provision has been established in accordance with the requirements of the Prudential Sourcebook for Insurers. The provision, which is in addition to the provisions required to meet the anticipated ultimate cost of settlement of outstanding claims at the balance sheet date, is required by Schedule 3 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 to be included within technical provisions in the balance sheet, notwithstanding that it does not represent a liability at the balance sheet date. This has had the effect of reducing shareholders' funds by £1m (2009: £1m). There has been no movement in the equalisation provision during the year (2009: Nil). An IBNR (Incurred but not reported) provision has been maintained.

9. Operations in run-off

Operations in run-off comprise UK personal and commercial lines of general insurance business. The profit and loss account includes the following amounts in respect of these operations:

	2010 £m	2009 £m
Premiums earned, net of reinsurance	(83)	-
Claims incurred, net of reinsurance		
Claims paid	-	(2)
Change in provision for claims	<u>84</u>	<u>3</u>
Total	<u>1</u>	<u>1</u>
Net operating expenses	<u>(1)</u>	<u>(1)</u>
Technical result	-	-
Investment return	-	-
Operating profit before tax	<u>-</u>	<u>-</u>

Notes on the financial statements (continued)

The significant movement in premiums and change in provision for claims from 2009 is because the Company entered into a 100% quota share reinsurance agreement, subject to paid claims limits, in respect of its commercial lines general insurance business in run-off, on 30 June 2010. The effective date of the agreement is 1 January 2010. The business reinsured is mostly UK employers' liability and public liability business. These arrangements exclude the business covered by the Solvent Scheme of Arrangement.

During 2005, the Company entered into a Solvent Scheme of Arrangement under Section 425 of the Companies Act 1985, the legislation in force at the time of the arrangement, in respect of certain closed Marine and London Market business. All claims lodged by creditors by the Scheme submission date have now been settled, and related claims provisions in these financial statements have been released. In accordance with the terms of the Scheme claims notified after the final claims submission date are not valid, however an IBNR reserve has been maintained to meet legal fees incurred repudiating late reported claims and to meet claims from countries outside the jurisdiction of the Scheme.

10. Acquisition and disposal of subsidiaries and participating interests

On 1 August 2010 the Company's interest in Prudential Health Holdings Limited reduced from 50% to 25%. The dilution followed the acquisition by Discovery SA, the Company's partner in the PruHealth venture, of Standard Life Healthcare. The profit on the partial disposal is £3m. The profit is calculated as the difference between the reduction in carrying value following the dilution to 25% (£32m), offset by the Company's share of the increase in value of the venture following the acquisition of Standard Life Healthcare (£35m). Prior to the partial disposal, movements in the value of this company, were taken to the revaluation reserve. The impact of the disposal on the revaluation reserve is shown in note 25.

On 29 June 2010 the Company transferred PT Prudential Life Assurance, its life assurance subsidiary in Indonesia, to Prudential Corporation Holdings Limited for £584m. After taking into account the cost of £22m the profit on disposal was £562m. Prior to the disposal, movements in the value of this company, were taken to the revaluation reserve. The impact of the disposal on the revaluation reserve is shown in note 25.

The Company transferred PCA Securities Investment Trust Company Limited, its subsidiary in Taiwan, to Prudential Corporation Holdings Limited in two tranches on 17 May 2010 and 3 June 2010 for a total of £74m. After taking into account the cost of £78m the loss on disposal was £4m. Prior to the disposal, movements in the value of this company, were taken to the revaluation reserve. The impact of the disposal on the revaluation reserve is shown in note 25.

There were no acquisitions or disposals of subsidiaries or participating interests in 2009.

11. Transfer of Prudential Holborn Life Limited and Prudential (AN) Limited

On 31 October 2010 the business of Prudential Holborn Life Limited transferred into the Company following a Part VII Transfer under the Financial Services and Markets Act 2000. The business transferred into the non-profit sub-fund of the long-term business fund. The long-term funds transferred contained unallocated surplus of £33m which is included as profit in "Investment Income" in the Long-term Business Technical Account.

On 31 October 2010 the business of Prudential (AN) Limited transferred into the Company following a Part VII Transfer under the Financial Services and Markets Act 2000. The business transferred into the non-profit sub-fund and with-profit sub-fund of the long-term business fund. The long-term funds transferred contained unallocated surplus of £5m which is included as profit in "Investment Income" in the Long-term Business Technical Account.

12. Information on staff and pension costs

The average number of persons employed by the Company during the year was:

United Kingdom	<u>16</u>	19
Hong Kong	<u>797</u>	782
	<u>813</u>	<u>801</u>

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

The majority of employees in the UK are employed by Prudential Distribution Limited, a service company within the Prudential Group.

The costs of employment were:	<u>2010 £m</u>	<u>2009 £m</u>
Wages and salaries	41	36
Social security and pension costs	2	3
	<u>43</u>	<u>39</u>

Defined Benefit Pension Schemes

The majority of staff employed by the Prudential Group in the UK are members of the Prudential Group's pension schemes. The largest scheme is the Prudential Staff Pension Scheme (PSPS). This scheme is primarily a defined benefit scheme but no employees with employment offers after 31 July 2003 are eligible for membership of the defined benefit section of the Scheme. At 31 December 2010, on the FRS 17 'Retirement Benefits' (FRS 17) basis of valuation, the underlying PSPS liabilities account for 86% (2009: 86%) of the aggregate liabilities of the Prudential Group's defined benefit schemes. There is also a smaller defined benefit scheme, Scottish Amicable Pension Scheme (SAPS) in which the Company staff participate.

For the purposes of preparing consolidated financial statements, the Prudential Group applies IFRS basis accounting including IAS 19 'Employee Benefits' (IAS 19). However, individual company accounts of the parent, Prudential plc and the Company continue to apply UKGAAP including FRS 17. The FRS 17 disclosures are aligned with IAS 19. The Prudential Group applies IFRIC 14, interpretation guidance to IAS 19 with the effect of derecognising the Prudential Group's interest in PSPS surplus and recognising an additional liability for the deficit funding obligation for PSPS in the Group financial statements.

For both schemes, the projected unit method was used for the most recent full actuarial valuations. Defined benefit schemes 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 2009 using the projected unit method. This valuation demonstrated the Scheme to be 106 per cent funded by reference to the Scheme Solvency Target that forms the basis of the Scheme's statutory funding objective. Accordingly, the total contributions to be made by the Group to the Scheme were reduced from the previous arrangement of £70m – £75m per annum to £50m per annum effective from 1 July 2009. As PSPS was in a surplus position at the valuation date, no formal recovery plan was required. However, recognising that there had been a significant deterioration in the value of the Scheme's assets from 5 April 2008 to the date of the finalisation of the valuation, an additional funding akin to deficit funding agreed with the PSPS Trustees. This is subject to a reassessment when the next valuation is completed. Deficit funding for PSPS is apportioned in the ratio of 70/30 between the Company's with-profits fund and Prudential plc following detailed consideration in 2005 of the sourcing of previous contributions. Employer contributions for ongoing service of current employees have been apportioned in the ratio relevant to current activity. In 2010, total contributions for the year, including expenses and augmentations, were £55m (2009: £67m).

The valuation of SAPS as at 31 March 2008 demonstrated the scheme to be 91 per cent funded, with a shortfall of actuarially determined liabilities of 9 per cent, representing a deficit of £38m. Based on this valuation, deficit funding amounts designed to eliminate the actuarial deficit over a seven year period were made from July 2009 of £7.3m per annum. Since the valuation date, there has been deterioration in the funding level. During 2010, the Group agreed to pay additional funding of £5.8m per annum from October 2010 until conclusion of the next formal valuation, or until the funding level reaches 90 per cent, whichever is the earlier.

For SAPS, it is estimated that approximately 50% of the FRS 17 deficit is attributable to the Company's with-profits sub-fund. Prior to 2009, the other proportion was attributable to the Company's shareholders' funds and recognised in the Company's financial statements. In 2009, following a reassessment, the shareholders' share of the deficit of SAPS was transferred to be borne by Prudential

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Financial Services Limited, a fellow subsidiary undertaking of the Prudential Group with effect from 1 January 2009.

The next triennial valuations for PSPS and SAPS are scheduled to take place as at 5 April 2011 and 31 March 2011, respectively.

Corporate Governance

The rules of the defined benefit section of PSPS, a final salary scheme, specify that, in exercising its investment powers, the Trustee's objective is to achieve the best overall investment return consistent with the security of the assets of the scheme. In doing this, consideration is given to the nature and duration of the scheme's liabilities. The Trustee sets the benchmark for the asset mix, following analysis of the liabilities by the Scheme's Actuary and, having taken advice from the Investment Managers, then selects benchmark indices for each asset type in order to measure investment performance against a benchmark return.

The Trustee reviews strategy, the asset mix benchmark and the Investment Managers' objectives every three years, to coincide with the Actuarial Valuation, or earlier if the Scheme Actuary recommends. Interim reviews are conducted annually based on changing economic circumstances and financial market levels.

The Trustee sets the general investment policy and specifies any restrictions on types of investment and the degrees of divergence permitted from the benchmark, but delegates the responsibility for selection and realisation of specific investments to the Investment Managers. In carrying out this responsibility, the Investment Managers are required by the Pensions Act 1995 to have regard to the need for diversification and suitability of investments. Subject to a number of restrictions contained within the relevant investment management agreements, the Investment Managers are authorised to invest in any class of investment asset. However, the Investment Managers will not invest in any new class of investment asset without prior consultation with the Trustee.

The Trustee consults the Principal Employer, the Company, on these investment principles, but the ultimate responsibility for the investment of the assets of the scheme lies with the Trustee.

The investment policies and strategies for the other defined benefit scheme, SAPS, which is a final salary scheme, follow similar principles, but have different target allocations, reflecting the particular requirements of the schemes.

The key assumptions adopted for the FRS 17 valuations in PSPS and SAPS were:

	2010	2009
	%	%
Price inflation	3.55	3.7
Rate of increase in salaries	5.55	5.7
Rate of increase of pensions in payments:		
PSPS		
Guaranteed - LPI (Max 5%)	3.55	3.7
Guaranteed - LPI (Max 2.5%)	2.5	2.5
Discretionary	2.5	2.5
SAPS	3.55	3.7
Rate used to discount scheme liabilities	5.45	5.8

Long-term expected rates of return	Prospectively for 2011	2010	2009
	%	%	%
Equities	8.20	8.50	6.80
Bonds	4.60	5.30	4.80
Properties	6.90	6.75	6.05
Other assets	4.75	4.75	2.00
Weighted average long-term expected rate of return	5.10	5.90	4.50

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

The long-term expected rates of return have been determined after applying due consideration to the requirements of paragraph 54 of FRS 17, in particular, taking account of the values of the assets.

The calculations are based on current actuarially calculated mortality estimates with a specific allowance made for future improvements in mortality. The 2010 specific allowance is in line with custom calibration of the 2009 mortality model from the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries ("CMI"). The 2009 specific allowance is broadly based on adjusted versions of the medium cohort projections prepared by the CMI.

The tables used for PSPS immediate annuities in payment at 31 December 2010 were:

Male: 108.6 per cent PNMA 00 with improvements in line with a custom calibration of the CMI's 2009 mortality model, with a long-term mortality improvement rate of 1.75 per cent per annum; and
Female: 103.4 per cent PNFA 00 with improvements in line with a custom calibration of the CMI's 2009 mortality model, with a long-term mortality improvement rate of 1.00 per cent per annum.

The tables used for PSPS immediate annuities in payment at 31 December 2009 were:

Male: 100 per cent PMA92 with CMIR17 improvements to the valuation date and medium cohort improvements subject to a floor of 1.75% up to the age of 90, decreasing linearly to zero by the age of 120.
Female: 100 per cent PFA92 with CMIR17 improvements to the valuation date and 75% medium cohort improvements subject to a floor of 1.0% up to the age of 90, decreasing linearly to zero by the age of 120.

The assumed life expectancies on retirement at age 60, based on the mortality table used was:

	2010 Years		2009 Years	
	Male	Female	Male	Female
Retiring today	27.7	29.0	27.4	28.6
Retiring in 20 years time	30.3	31.1	30.1	30.8

The mean term of the current PSPS liabilities is around 18 years.

Using external actuarial advice provided by the professionally qualified actuaries, Towers Watson for the valuation of PSPS and Xfinity Consulting for SAPS, the most recent full valuations have been updated to 31 December 2010 applying the principles prescribed by FRS 17.

In July 2010, the UK Government announced plans to use the Consumer Price Index (CPI) in place of the Retail Price Index (RPI) in its determination of the statutory minimum pension increases for private sector occupational pension schemes. In December 2010, the Government published the statutory revaluation order for 2011 which confirms the change to use CPI. In addition, the Government has also published in December 2010 a consultation paper which sets out the Government's views on the impact of the switch from RPI to CPI will have on the private sector occupational pension schemes. The consultation period closed on 2 March 2011.

For the Company's defined benefit schemes, the pensions in deferment and/or pensions in payment for certain tranches of these schemes are subject to statutory increases in accordance with the schemes' rules and may therefore be affected by the Government's decision to change the indexation from RPI to CPI. Other tranches, where RPI is specified in the scheme rules, are unaffected.

In line with the guidance of UITF 48, the above has no impact on the results for the year ended 31 December 2010. The impact of this change, if and when made, will be recognised in a future period. However, due to the allocation of a share of the interest in financial position of the PSPS and SAPS to the Company's with-profits fund, any reduction in the schemes' liabilities would have no effect on the shareholders' profit or shareholders' funds of the Company.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

The assets and liabilities of PSPS and SAPS were:

	31 Dec 10		31 Dec 09		31 Dec 08	
	£m	%	£m	%	£m	%
Equities	728	13	1,018	19	978	19
Bonds	4,096	71	3,587	68	2,619	51
Properties	205	3	278	5	290	6
Other assets	748	13	442	8	1,270	24
Total value of assets	<u>5,777</u>	<u>100</u>	<u>5,325</u>	<u>100</u>	<u>5,157</u>	<u>100</u>
Present value of underlying scheme liabilities	5,438		4,951		4,473	
Underlying surplus (deficit) in the schemes	339		374		684	

Of which the following amounts have been attributed to the Company:

Attributable to the Company's with-profits fund	57	51	98
Attributable to the Company's shareholders' funds*	-	-	(22)
	<u>57</u>	<u>51</u>	<u>76</u>

After deducting deferred tax, the amounts reflected in the balance sheet of the Company are:

	2010 £m	2009 £m	2008 £m
With-profits fund	53	46	88
Shareholders' funds*	-	-	(16)
	<u>53</u>	<u>46</u>	<u>72</u>

* The shareholders' share of the deficit of SAPS previously borne by the Company's shareholders' funds was transferred to Prudential Financial Services Limited, a fellow subsidiary undertaking of the Prudential Group from 2009.

The surplus in the Prudential Staff Pension Scheme recognised in the balance sheet of the Company represents the element of the amount which is recoverable through reduced future contributions that is attributable to the Company and is net of the apportionment to Prudential plc.

Underlying scheme assets and liabilities of PSPS and SAPS

The change in the present value of scheme liabilities and the change in the fair value of the scheme assets of PSPS and SAPS are as follows:

	2010 £m	2009 £m
Present value of scheme liabilities at beginning of year	4,951	4,473
Service costs – current	32	30
Interest cost	281	266
Employee contributions	1	2
Actuarial losses	399	412
Benefit payments	(226)	(232)
Present value of scheme liabilities at end of year	<u>5,438</u>	<u>4,951</u>
	2010 £m	2009 £m
Fair value of scheme assets at beginning of year	5,325	5,157
Expected return on scheme assets	312	232
Employee contributions	1	2
Employer contributions*	69	76
Actuarial gains	296	90
Benefit payments	(226)	(232)
Fair value of scheme assets at end of year	<u>5,777</u>	<u>5,325</u>

* The contributions include deficit funding, ongoing service contributions, expenses and augmentations.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Pension (charge) credit and actuarial (losses) gains of PSPS and SAPS

	2010 £m	2009 £m
Pension (charge) credit		
Operating charge – current service cost	(32)	(30)
Finance income (expense):		
Interest on pension scheme liabilities	(281)	(266)
Expected return on pension scheme assets	312	232
	31	(34)
Total pension (charge) credit of the schemes	(1)	(64)
Of which the following amounts have been attributed to the Company:		
With-profits fund	11	(33)
Shareholders' funds	-	-
	11	(33)

The pension (charge) credit relating to PSPS attributable to the Company is related to the surplus recognised on the balance sheet of the Company. No adjustment was made to the pension (charge) credit in 2010 and 2009 relating to the unrecognised portion of the PSPS surplus.

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Actuarial (losses) gains					
Actual less expected return on scheme assets * (5%, 2%, (6%), 0%, 3% of pension scheme assets)	296	91	(325)	(3)	150
Experience gains (losses) on scheme liabilities (0%, 1%, 3%, 0%, 0% of the present value of scheme liabilities)**	(1)	62	148	(14)	18
Changes in assumptions underlying the present value of scheme liabilities	(398)	(475)	250	307	254
Total actuarial (losses) gains of the schemes (7%), (7%), 2%, 6%, 8% of the present value of the scheme liabilities)	(103)	(322)	73	290	422
Of which the following amounts have been attributed to the Company:					
With-profits fund	(45)	(55)	(287)	205	288
Shareholders' funds	-	-	2	(6)	16
	(45)	(55)	(285)	199	304

* The total actual return on scheme assets for both PSPS and SAPS is a net gain of £607m (2009: net gain of £323m) of which a net gain of £413m (2009: net gain of £207m) relates to the amounts attributable to the Company's with-profits funds.

** The experience gains on scheme liabilities in 2008 of a gain of £148m related mainly to the 'true-up' reflecting improvements in data consequent upon the ongoing triennial valuation of PSPS.

The actuarial (losses) gains relating to PSPS attributable to the Company's with-profits fund are related to the surplus (deficit) recognised on the balance sheet of the Company. In 2010, the actuarial (losses) gains attributable to the Company's with-profits fund included a credit of £28m (2009: £152m) for the adjustment to the unrecognised portion of the PSPS surplus which has not been applied against the pension credit (charge). Since the shareholders' profit in respect of the Company's with-profits fund is a function of the actuarially determined surplus for distribution, the overall profit and loss account result is not directly affected by the level of pension cost or other expenses relating to the with-profits fund. The amounts of pension credit of £11m (2009: charge of £33m) and actuarial losses of £45m (2009: actuarial losses of £55m) attributable to the Company's with-profits fund are included in the technical account and reflected in the transfer to or from the fund for future appropriations.

Total employer contributions expected to be paid into PSPS and SAPS for the year ending 31 December 2011 amounts to £73m, reflecting the annual accrual cost and deficit funding, and expenses.

The table below shows the sensitivity of the underlying PSPS and SAPS liabilities at 31 December 2010 of £4,866m (2009: £4,436m) and £572m (2009: £515m) to changes in discount rates, inflation rates and mortality rate assumptions. For 31 December 2009, only the sensitivity to changes in discount rates and inflation rates are shown.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Assumption	Change in assumption	Impact on PSPS and SAPS scheme liabilities on FRS17 basis
2010		
Discount rate	Decrease by 0.2% from 5.45% to 5.25%	Increase scheme liabilities by: PSPS 3.6% SAPS 5.2%
Discount rate	Increase by 0.2% from 5.45% to 5.65%	Decrease scheme liabilities by: PSPS 3.5% SAPS 4.9%
Rate of inflation	Decrease by 0.2% from 3.55% to 3.35% with consequent reduction in salary increases	Decrease scheme liabilities by: PSPS 1.0% SAPS 5.0%
Mortality rate	Increase life expectancy by 1 year	Increase scheme liabilities by: PSPS 2.1% SAPS 2.5%
2009		
Discount rate	Decrease by 0.2% from 5.8% to 5.6%	Increase scheme liabilities by: PSPS 3.5% SAPS 5.2%
Discount rate	Increase by 0.2% from 5.8% to 6.0%	Decrease scheme liabilities by: PSPS 3.2% SAPS 4.8%
Rate of inflation	Decrease by 0.2% from 3.7% to 3.5% with consequent reduction in salary increases	Decrease scheme liabilities by: PSPS 0.9% SAPS 4.9%

The sensitivity of the underlying pension scheme liabilities to changes in discount rates and inflation rates as shown above does not directly equate to an impact on shareholders' profit or shareholders' funds due to the allocation of a share of the interest in financial position of the PSPS and SAPS to the Company's with-profits fund as described above.

The amounts attributable to the Company's with-profits fund for both PSPS and SAPS are absorbed by the transfer to or from the fund for future appropriations and therefore have no direct effect on shareholders' profit or shareholders' funds.

Defined Contribution Pension Schemes

The Company operates defined contribution schemes in Hong Kong. The cost of these contributions was £1.7m (2009: £1.7m). £1.3m was outstanding at 31 December 2010 (2009: £1.2m).

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Share-based payments

Employees of the Company participate in a number of share award and share option plans relating to Prudential plc shares, which are described below.

The Group Performance Share Plan (GPSP) is the incentive plan in which all executive directors and other senior executives within the Prudential Group, of which the Company is a part, can participate. This scheme was established as a replacement for the Restricted Share Plan (RSP) under which no further awards could be made after March 2006. Awards are granted either in the form of a nil cost option, conditional right over shares, or such other form that shall confer to the participant an equivalent economic benefit, with a vesting period of three years. The performance measure for the awards is that Prudential's Total Shareholder Return (TSR) outperforms an Index comprising of peer companies. Vesting of the awards between each performance point is on a straight-line sliding scale basis. Participants are entitled to the value of reinvested dividends that would have accrued on the shares that vest. Shares are currently purchased in the open market by a trust for the benefit of qualifying employees. Beginning 2010, newly issued shares will be used in settling the awards that vest and are released.

The RSP was, until March 2006, the long-term incentive plan for executive directors and other senior executives designed to provide rewards linked to shareholder return. Each year participants were granted a conditional option to receive a number of shares. There was a deferment period of three years at the end of which the award vested to an extent that depended on the performance of the Group's shares including notional reinvested dividends and on the Group's underlying financial performance. After vesting, the option may be exercised at zero cost at any time, subject to closed period rules, in the balance of a 10-year period. Shares are purchased in the open market by a trust for the benefit of qualifying employees.

The Business Unit Performance Plan (BUPP) is an incentive plan created to provide a common framework under which awards would be made to senior employees. Awards under this plan are based on growth in Shareholder Capital Value on the European Embedded Value (EEV) basis with performance measured over three years. Upon vesting of awards made up to 2008, half of the awards will be released as shares and the other half released in cash. Since the year ended 31 December 2009, all awards made will be settled in shares after vesting. Participants are entitled to receive the value of reinvested dividends over the performance period for those shares that vest. The growth parameters for the awards are relevant to each region and vesting of the awards between each performance point is on a straight-line sliding scale basis. Beginning in 2010, newly issued shares will be used in settling the awards that vest and are released. During 2009, the Group Remuneration Committee decided that future BUPP awards for the UK business unit would be based on the same relative TSR measure applied to GPSP awards. As a result, 2010 awards made under the UK BUPP reflect those TSR conditions applied to 2010 GPSP awards.

UK-based executive directors are eligible to participate in the Prudential HM Revenue and Customs (HMRC) approved UK Savings Related Share Option Scheme (SAYE scheme) and the Asia-based executive directors can participate in the equivalent International SAYE scheme. The schemes allow employees to save towards the exercise of options over Prudential plc shares, at an option price set at the beginning of the savings period as determined by reference to the average market value of the ordinary shares on the three business days immediately preceding the invitation at a discount of 20 per cent to the market price. Employees may save up to £250 per month for three or five years. On maturity at the end of the set term, participants may exercise their options within six months of the end of the savings period and purchase Prudential plc shares. If an option is not exercised within six months, participants are entitled to a refund of their cash contributions plus interest if applicable under the rules. The exercise period of the options granted may be advanced to an earlier date in certain circumstances, for example on retirement, and may be extended in certain circumstances, for example on the death of the participant the personal representative may exercise the options beyond the normal exercise period. Shares are issued to satisfy options that are exercised. No options may be granted under the schemes if the grant would cause the number of shares which have been issued, or which remain issuable pursuant to options granted in the preceding 10 years under the scheme and other share option schemes operated by the Company, or which have been issued under any other share incentive scheme of the Company, to exceed 10 per cent of the Company's ordinary share capital at the proposed date of grant.

Notes on the financial statements (continued)

UK-based executive directors are also eligible to participate in the Company's HMRC approved Share Incentive Plan (SIP) which allows all UK-based employees to purchase shares of Prudential plc (partnership shares) on a monthly basis out of gross salary. For every four partnership shares bought, an additional matching share is awarded, purchased on the open market. Dividend shares accumulate while the employee participates in the plan. Partnership shares may be withdrawn from the scheme at any time. If the employee withdraws from the plan within five years the matching shares are forfeit and if within three years, dividend shares are forfeit.

The Prudential Corporation Asia Long-Term Incentive Plan (PCA LTIP) is an incentive plan created in 2008 for senior employees and Chief Executive Officers to replace the Asia Business Unit Performance Plan (BUPP). The Company has a branch in Hong Kong and is therefore eligible to participate. Awards under the new PCA LTIP will vest after three years subject to the employee being in employment at the time of vesting without any performance conditions. Awards will be discretionary and on a year by year basis determined by Prudential's full year financial results and the employee's contribution to the business. All awards will be in Prudential shares.

In addition, there are other share awards including the Group Deferred Bonus Plan (GDBP) and other arrangements. There are no performance conditions attaching to these deferred bonus plans and awards vest in full subject to the individual being employed by Prudential at the end of the vesting period. The other arrangements relate to various awards that have been made without performance conditions to individual employees, typically to ensure their appointment or retention.

Movements in share options outstanding under the Company's share-based compensation plans relating to Prudential plc shares during 2010 and 2009 were as follows:

	2010		2009	
	Number of options	Weighted average exercise price £	Number of options	Weighted average exercise price £
Options outstanding (including conditional options)				
Beginning of year:	227,863	3.17	247,188	3.83
Granted	26,166	4.61	225,383	2.96
Exercised	(7,428)	3.21	(1,458)	3.05
Forfeited	(20,995)	2.91	(16,036)	3.65
Cancelled	(16,943)	3.39	-	-
Lapsed	(9,057)	3.36	(227,214)	5.18
End of year	199,606	3.36	227,863	3.17
Options immediately exercisable, end of year	7,204	5.58	1,547	5.65

Note: The Group Performance Share Plan (GPSP) was reclassified from options to awards in 2010 and 2009 has been restated.

The weighted average share price of Prudential plc for the year ended 31 December 2010 was £5.68 compared to £4.17 for the year ended 31 December 2009.

Movements in share awards outstanding under the Group's share-based compensation plans relating to Prudential plc shares at 31 December 2010 and 2009 were as follows:

	2010	2009
	Number of awards	Number of awards
Awards outstanding		
Beginning of year:	515,224	470,062
Granted	467,892	418,207
Exercised	(128,952)	(175,764)
Forfeited	(27,989)	(102,539)
Expired	(63,085)	(94,742)
End of year	763,090	515,224

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

The following table provides a summary of the range of exercise prices for Prudential plc options (including conditional options) outstanding at 31 December 2010.

2010	Number outstanding	Outstanding Weighted average remaining contractual life (years)	Weighted average exercise prices £	Exercisable Number exercisable	Weighted average exercise prices £
Range of exercise prices					
Between £0 and £1	-	-	-	-	-
Between £1 and £2	-	-	-	-	-
Between £2 and £3	148,717	2.56	2.88	-	-
Between £3 and £4	-	-	-	-	-
Between £4 and £5	38,591	2.99	4.49	-	-
Between £5 and £6	12,298	0.51	5.55	7,204	5.58
Between £6 and £7	-	-	-	-	-
	199,606	2.51	3.36	7,204	5.58

The following table provides a summary of the range of exercise prices for Prudential plc options (including conditional options) outstanding at 31 December 2009.

2009	Number outstanding	Outstanding Weighted average remaining contractual life (years)	Weighted average exercise prices £	Exercisable Number exercisable	Weighted average exercise prices £
Range of exercise prices					
Between £0 and £1	-	-	-	-	-
Between £1 and £2	-	-	-	-	-
Between £2 and £3	195,813	3.45	2.88	-	-
Between £3 and £4	-	-	-	-	-
Between £4 and £5	15,952	3.13	4.28	-	-
Between £5 and £6	16,098	1.34	5.55	1,547	5.65
Between £6 and £7	-	-	-	-	-
	227,863	3.28	3.17	1,547	5.65

The years shown above for weighted average remaining contractual life include the time period from end of vesting period to expiration of contract.

The weighted average fair values of Prudential plc options and awards granted during the period are as follows:

2010			2009		
Weighted average fair value			Weighted average fair value		
GPSP	SAYE Options	Awards	GPSP	SAYE Options	Awards
£	£	£	£	£	£
6.88	2.94	6.17	5.60	1.55	5.79

The fair value amounts relating to all options including conditional nil cost options were determined using the Black-Scholes and the Monte Carlo option-pricing models using the following assumptions:

	2010		2009	
	GPSP	SAYE Options	GPSP	SAYE Options
Dividend yield (%)	3.43	3.43	4.41	4.41
Expected volatility (%)	34.30	67.33	37.58	60.66
Risk-free interest rate (%)	1.58	0.91	1.77	2.17
Expected option life (years)	3.00	3.05	3.00	3.61
Weighted average exercise price (£)	-	4.61	-	2.97
Weighted average share price (£)	5.83	6.38	6.40	3.82

Notes on the financial statements (continued)

Compensation costs for all share-based compensation plans are determined using either the Black-Scholes model or the Monte Carlo model. Share options and awards granted by the parent company are valued using the share price at the date of grant. Share options and awards granted by the Company are valued using the share price at the balance sheet date. The compensation costs for all awards and options are recognised in net income over the plans' respective vesting periods. The Black-Scholes model is used to value all options and awards other than GPSP, for which the Monte Carlo model is used in order to allow for the impact of the TSR performance conditions. The models are used to calculate fair values at the grant date or balance sheet date, as appropriate, based on the quoted market price of the stock at the measurement date, the amount, if any that the employees are required to pay, the dividend yield, expected volatility, risk-free interest rates and exercise prices.

The expected volatility is measured as the standard deviation of expected share price returns based on statistical analysis of daily share prices over a period up to the grant date equal to the expected life of options. Risk free interest rates are UK gilt rates with projections for three, five and seven year terms to match corresponding vesting periods. Dividend yield is determined as the average yield over the year of the grant and expected dividends are not incorporated into the measurement of fair value. For GPSP, volatility and correlation between Prudential and an index constructed from a simple average of TSR growth of 11 companies is used. For grants in 2010, an average index volatility and correlation of 35% and 82%, respectively were used. Changes to the subjective input assumptions could materially affect the fair value estimate.

When options are granted or awards made to employees, an estimate is made of what percentage is more than likely to vest, be forfeited, lapse or cancelled based on historical information. Based on these estimates, compensation expense to be accrued at that date is calculated and amortised over the vesting period. For early exercises of options or release of awards due to redundancy, death or resignation, the compensation expense is immediately recognised and for forfeitures due to employees leaving the Group, any previously recognised expense is reversed. However, if an employee loses their award because of the Group's failure to meet the performance criteria, previously recognised expense is not reversed.

The total share-based payment expense recognised in the non-technical account for 2010 is £1.4m (2009: £0.4m) of which £0.1m (2009: £0.3m) is accounted for as equity-settled and £1.3m (2009: £0.1m) is accounted for as cash-settled.

13. Directors' emoluments

	2010	2009
	£	£
Aggregate emoluments	1,973,720	2,392,645
Aggregate amounts receivable (excluding shares) under long term incentive schemes	-	-
Excess retirement benefits:		
Current directors	-	87,819
Past directors	-	-
Other cash payments (note i)	-	448,075
	<u>1,973,720</u>	<u>2,928,539</u>
Highest Paid Director:		
Aggregate emoluments and amounts receivable (excluding shares) under long term incentive schemes	<u>700,002</u>	<u>1,086,574</u>

Note i: Mr Nick Prettejohn resigned from the Company and the Prudential Group on 30 September 2009. The remuneration arrangements on leaving that were approved by the Remuneration Committee of the Prudential Group include a payment equivalent to nine months salary and benefits, paid in instalments in October 2009 and January 2010 relating to restrictions on employment up to 1 April 2010.

No directors (2009: nil) exercised share options during the year. Six directors (2009: seven) were entitled to shares under Prudential's main long-term incentive scheme and two directors (2009: two) were entitled to retirement funds under defined benefit schemes. The highest paid director did not exercise any share options and did not receive shares under long-term incentive schemes. The highest paid director in 2009 did not exercise any share options but did receive shares under long-term incentive schemes.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

14. Auditors' remuneration

During the year the Company obtained the following services from KPMG Audit Plc (KPMG) at costs as detailed below:

	<u>2010 £m</u>	<u>2009 £m</u>
Audit services		
Fees payable to KPMG for the audit of the Company's accounts	1.9	2.0
Non-audit services		
Fees payable to KPMG and its associates for other services:		
Other services pursuant to legislation, including the audit of the regulatory return	0.9	0.7
	<u>2.8</u>	<u>2.7</u>

15. Intangible assets

	Distribution Rights £m	Licence £m	Total £m
Cost:			
At 1 January 2010	132	174	306
Exchange differences	4	-	4
Additions	-	-	-
Disposals	-	-	-
At 31 December 2010	<u>136</u>	<u>174</u>	<u>310</u>
Amortisation:			
At 1 January 2010	6	70	76
Exchange differences	-	-	-
Provided in the year in the long-term business technical account	7	10	17
Disposals	-	-	-
At 31 December 2010	<u>13</u>	<u>80</u>	<u>93</u>
Net book value at 31 December 2010	<u>123</u>	<u>94</u>	<u>217</u>
Net book value at 31 December 2009	<u>126</u>	<u>104</u>	<u>230</u>

The charge for amortisation for the year ended 31 December 2009 was £15m charged to the long-term business technical account.

The licence primarily represents the value of an agreement with a fellow subsidiary company for the use of certain Scottish Amicable assets, which is being amortised over a period of 20 years to 30 September 2017, on a basis consistent with the revenue stream from the agreement. Under this basis, the amortisation commenced in the year 2000, when the benefits from the agreement first started to arise.

The distribution rights relate to facilitation fees paid in relation to the bancassurance partnership arrangements in Asia for the bank distribution of insurance products for a fixed period of time. The distribution rights amounts are amortised on the basis to reflect the pattern in which the distribution rights' future economic benefits are expected to be consumed by the Company by reference to new business levels.

There have been no impairments during the year (2009: £Nil).

16. Land and buildings

	<u>2010 £m</u>	<u>2009 £m</u>
Current value		
Freeholds	3,869	3,855
Leaseholds with a term of over 50 years	1,871	1,113
Leaseholds with a term of less than 50 years	484	984
	<u>6,224</u>	<u>5,952</u>
Cost	<u>4,767</u>	<u>4,843</u>

The value of land and buildings occupied by the Company amounted to £87m (2009: £79m)

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

If the revalued land and buildings were stated on the historical cost basis, the amounts would be:

Freehold and leasehold land and buildings

	<u>2010 £m</u>	<u>2009 £m</u>
At cost	4,767	4,843
Aggregate depreciation	<u>(1,458)</u>	<u>(909)</u>
Net book value based on historical cost	<u>3,309</u>	<u>3,934</u>

17. Investments in group undertakings and participating interests

	Cost		Current value	
	2010 £m	2009 £m	2010 £m	2009 £m
Shares in group undertakings				
Long-term fund investments	1,624	1,566	3,294	3,189
Shareholder investments	<u>1,146</u>	<u>1,227</u>	<u>1,979</u>	<u>2,294</u>
	<u>2,770</u>	<u>2,793</u>	<u>5,273</u>	<u>5,483</u>
Loans to group undertakings				
Long-term fund loans	<u>917</u>	<u>760</u>	<u>917</u>	<u>760</u>
Total	<u>3,687</u>	<u>3,553</u>	<u>6,190</u>	<u>6,243</u>

The principal subsidiary undertakings of the Company at 31 December 2010, all wholly owned:

	<u>Class of shares held</u>	<u>Principal Activity</u>	<u>Country of Incorporation</u>
Prudential Retirement Income Limited	Ordinary shares £1 Preference shares £1	Pension annuities	Scotland
* Prudential Annuities Limited	Ordinary shares £1	Pension annuities	England and Wales
* Prudential European Assurance Holdings Limited	Preference shares £1	Financial Services Holding Company	Scotland
Prudential Pensions Limited	Ordinary shares £1	Pensions	England and Wales
Prudential Lifetime Mortgages Limited	Ordinary shares £1 Preference shares £1	Mortgage lending and administration	Scotland

* Owned by the long-term fund.

The Company has one associate at 31 December 2010:

	<u>Class and proportion of shares held</u>	<u>Principal Activity</u>	<u>Country of Incorporation</u>
Prudential Health Holdings Limited	A ordinary shares £1 25% holding	Private medical insurance	England and Wales

Notes on the financial statements (continued)

18. Other financial investments

	Cost		Carrying value	
	2010 £m	2009 £m	2010 £m	2009 £m
Shares and other variable yield securities and units in unit trusts	24,225	23,644	34,295	31,510
Debt securities and other fixed income securities	34,609	31,382	36,739	32,809
Derivative assets	128	126	739	687
Loans secured by mortgages	1,065	679	1,138	679
Loans to policyholders secured by insurance policies	80	74	80	74
Other loans	976	930	976	930
Deposits with credit institutions	7,376	10,080	7,376	10,080
	<u>68,479</u>	<u>66,915</u>	<u>81,343</u>	<u>76,769</u>

The change in carrying value of other financial investments included in the Profit and Loss account was a gain of £2,946m (2009: £5,604m gain) analysed between a gain of £2,946m (2009: £5,609m gain) included in the Long-term business technical account and £Nil (2009: £5m loss) included in the Non-technical account. The change in carrying value of £2,946m (2009: £5,604m) included a gain of £2,088m (2009: £4,293m gain) in respect of equity securities, a gain of £723m (2009: £1,557m gain) in respect of debt securities, a gain of £69m (2009: £16m loss) in respect of derivatives and a gain of £68m (2009: £230m loss) in respect of other financial instruments.

Amounts included in the above relating to listed investments:	Carrying value	
	2010 £m	2009 £m
Shares and other variable yield securities and units in unit trusts	30,614	23,585
Debt securities and other fixed income securities	33,960	30,360
	<u>64,574</u>	<u>53,945</u>

The table below analyses the derivative positions of the Company.

	2010 £m		2009 £m	
	Fair value assets	Fair value liabilities	Fair value assets	Fair value liabilities
Derivative financial instruments held to manage interest rate and currency profile:				
Interest rate swaps	216	13	240	77
Cross currency swaps	5	24	-	15
Inflation swaps	-	-	1	2
Currency exchange forward contracts	309	433	339	297
Interest rate swaptions	-	-	55	1
Bond futures	93	49	38	33
Credit Default Swaps	4	1	2	1
Derivative financial instruments held to manage market risk and efficient investment management:				
Equity options	91	-	4	-
Equity futures	20	7	7	20
Total return swaps	1	22	1	9
Total	<u>739</u>	<u>549</u>	<u>687</u>	<u>455</u>

The nature and extent of the derivative financial instruments used by the Company in 2010 are similar to those used in 2009 and their use and notional amounts are disclosed in note 34.

19. Assets held to cover linked liabilities

	Cost		Current value	
	2010 £m	2009 £m	2010 £m	2009 £m
Assets held to cover linked liabilities (net of reinsurance)	8,669	6,764	10,290	7,648

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

20. Reinsurers' share of technical provisions

The reinsurers' share of the long-term business provision relates mainly to cessions to Prudential Annuities Limited and Prudential Retirement Income Limited, subsidiaries of the Company. The reinsurers' share of the technical provisions for linked liabilities relates mainly to cessions to other group companies.

21. Other debtors

	<u>2010 £m</u>	<u>2009 £m</u>
Amounts owed by fellow subsidiaries and holding company	672	536
Amounts owed by subsidiary companies	427	420
Tax recoverable	151	59
Other	88	100
	<u>1,338</u>	<u>1,115</u>

22. Tangible fixed assets

	Computer Equipment £m	Fixtures & Fittings £m	Total £m
Cost:			
At 1 January 2010	40	79	119
Exchange differences	-	-	-
Additions	2	2	4
Disposals	(34)	-	(34)
At 31 December 2010	<u>8</u>	<u>81</u>	<u>89</u>
Depreciation:			
At 1 January 2010	39	73	112
Exchange differences	-	-	-
Provided in the year	1	2	3
Disposals	(34)	-	(34)
At 31 December 2010	<u>6</u>	<u>75</u>	<u>81</u>
Net book value at 31 December 2010	<u>2</u>	<u>6</u>	<u>8</u>
Net book value at 31 December 2009	<u>1</u>	<u>6</u>	<u>7</u>

The charge for depreciation for the year ended 31 December 2009 was £3m.

23. Assets attributable to the long-term business fund

Of the total amount of assets shown in the balance sheet on page 19, £123,455m (2009: £115,063m) is attributable to the long-term business fund.

24. Share capital

The Company's issued share capital is £330,517,064 comprising 970,468,254 ordinary shares of 25p each fully paid, 1,000,000 A Preference Shares of £1 each fully paid, and 347,600,000 B Preference Shares of 25p each fully paid. No changes in the share capital of the Company took place during the year.

The A Preference Shares issued shall be redeemed by the Company without notice on 8 May 2016. The premium payable on redemption amounts to 28.08p, which is increased by the percentage of the RPI from a date 30 days prior to the first issue of any preference shares to a date 30 days prior to redemption. The A Preference Shares carry the right to receive an index linked cumulative preferential dividend, payable annually. The A Preference Shares carry no voting rights except if a resolution is proposed abrogating, varying or modifying any of the rights or privileges of the holders of the A Preference Shares, but carry preferential rights in priority to other shareholders to payment on a return of capital in the event of the winding up of the Company. The B Preference Shares issued carry the right to receive a non-cumulative preferential dividend which shall accrue at the rate of two pence per annum. The B Preference Shares may not be redeemed otherwise than at the option of the Company at any time after the fifth anniversary of the date of issue of such B Preference Share. The B Preference Shares carry no voting rights except if a resolution is proposed in relation to (i) the winding up of the Company, a voluntary arrangement with creditors of the Company or proposed receivership, administrative receivership or administration of the Company; or (ii) an alteration of the rights of the B Preference Shares or in relation to any other matter which will have detrimental effect upon the rights of the B Preference Shares.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

25. Shareholders' reserves

	Revaluation reserve	Other reserves	Profit and loss account	Total
	£m	£m	£m	£m
Balance at 1 January 2010	947	536	1,886	3,369
Exchange adjustments	-	-	2	2
Profit for the financial year	-	-	943	943
Dividends	-	-	(800)	(800)
Revaluation of subsidiaries	265	-	-	265
Movement on transfer of PT Prudential Life Assurance (note 10)	(562)	-	-	(562)
Movement on transfer of PCA Securities Investment Trust Company Limited (note 10)	63	-	-	63
Transfer of 50% of the revaluation movement accumulated for Prudential Health Holdings Limited prior to its partial disposal (note 10)	13	-	(13)	-
Balance at 31 December 2010	<u>726</u>	<u>536</u>	<u>2,018</u>	<u>3,280</u>

	<u>2010 £m</u>	<u>2009 £m</u>
Analysis of profit and loss account:		
Distributable retained profit	1,730	1,481
Undistributable retained profit	288	405
	<u>2,018</u>	<u>1,886</u>

26. Fund for future appropriations

	<u>2010 £m</u>	<u>2009 £m</u>
Prudential Assurance Company with-profits fund (excluding SAIF)	<u>10,395</u>	<u>10,330</u>

27. Bank current accounts

Under the terms of the Company's arrangements with the Prudential Group's main UK banker, the bank has a right of set-off between credit balances (other than those of long term business funds) and all overdrawn balances of those Group undertakings with similar arrangements.

28. Other creditors including taxation and social security

	<u>2010 £m</u>	<u>2009 £m</u>
Amounts owed to fellow subsidiaries and holding company	70	150
Amounts owed to subsidiary companies	1,367	1,067
Tax	255	356
Derivative liability (see note 18)	549	455
Other creditors	<u>1,910</u>	<u>1,705</u>
	<u>4,151</u>	<u>3,733</u>

29. Preference shares

	<u>2010 £m</u>	<u>2009 £m</u>
A preference shares of £1 each – see note 24	1	1

30. Ultimate parent company

The ultimate and immediate parent company is Prudential plc, which is the parent company that prepares group accounts. Copies of these accounts can be obtained from the Company Secretary, Laurence Pountney Hill, London EC4R 0HH.

Notes on the financial statements (continued)

31. Related party transactions

The Company has taken advantage of the exemption under paragraph 3(c) of FRS 8 'Related party disclosures' from disclosing transactions with other wholly-owned subsidiary undertakings of the Prudential Group.

During 2010, in respect of the Company's associate (Prudential Health Holdings Limited), a £19m (2009: £14m) capital injection was made. £24m (2009: £11m) was recharged to the Company from Prudential Health Services Limited for services provided in respect of the PruProtect product underwritten by the Company. £2m (2009: £Nil) of interest was recharged by the Company to Prudential Health Services Limited in respect of the use of negative reserves in the Company's balance sheet for PruProtect. An agreement was entered into on 3 September 2007 which allows the Company to borrow from Prudential Health Holdings Limited up to an aggregate amount of £250m. The loan amount is principally linked to the emergence of regulatory losses arising in respect of all income and costs associated with selling and underwriting the Flexible Protection Plan and PruProtect Plan. The loan is to be repaid as regulatory surpluses arise in the future. In 2010 the Company borrowed £18m (2009: £19m) under this arrangement.

32. Long-term business provision

The principal valuation methods and bases adopted for the main relevant classes of business which are not reinsured are as follows:

Business in With-Profits Sub-Fund, SAIF and Defined Charge Participating Sub-Fund

The overarching principle in assumption setting is that realistic provisions are established using best estimate assumptions, taking into account the firm's regulatory duty to treat its customers fairly.

Assumptions are required in three areas, namely:

- (i) Retrospective assumptions.
- (ii) Prospective assumptions, and
- (iii) Stochastic modelling assumptions relating to the economic asset model and management actions.

Retrospective assumptions

Retrospective assumptions are required for the accumulation of past asset shares up to the valuation date. These assumptions are determined by reference to actual past experience primarily in relation to investment returns, expenses and miscellaneous surplus. The assumptions include past expense write-offs and enhancements to asset shares, and are as used when calculating specimen asset shares for the purpose of bonus setting.

The 2010 year end Investment Return for asset shares is:

Return	With-Profits Sub Fund	High Reversionary Bonus fund (held within the With-Profits Sub-Fund)	PruFund Cautious Fund (held within the With-Profits Sub-Fund)	SAIF
Gross return	12.70%	11.76%	10.97%	11.96%
Net return*	10.92%	10.79%	10.01%	10.20%

* This represents the pure net of tax investment return on the funds. Additionally, the net of tax investment return allocated to the asset shares of With-Profits Sub Fund UK life policies during 2010 was retrospectively increased by 0.78% to allow for the difference between the tax charged to asset shares and the tax that was actually paid to the Inland Revenue over the years 2005-2009.

The High Reversionary Bonus and PruFund Cautious funds are contained within the With-Profits Sub-Fund. Compared with the assets backing the main asset share fund, the High Reversionary Bonus and PruFund Cautious funds are both allocated a higher proportion of fixed interest securities and a lower proportion of equities.

Notes on the financial statements (continued)

Prospective assumptions

Prospective assumptions are required for the adjustments to asset shares where a prospective calculation gives a higher result and for the stochastic modelling of the cost of guarantees, options and smoothing.

For asset share adjustments, the economic assumptions used represent our best estimate assumptions allowing for prevailing market conditions at the valuation date.

Expense assumptions have been taken as the level of expenses incurred during 2010.

The mortality assumption has been set to the realistic component of the statutory basis. This means that for a given business class, the margin for adverse deviations (MAD) has been removed from the corresponding statutory assumption.

The table below shows the 2010 mortality bases:

Product	Mortality Table (M/F)	Age Rating Years	Multiplier % (M/F)
Prudence Bond	AM92 / AF92	-1/-1	100/ 100
PSA / PIB	AM92 / AF92	-0.5/-0.5	100 / 100
Personal Pensions	AM92 / AF92	-1/-1	100 / 100
Ordinary Branch assurances	AM92 / AF92	-0.5/-0.5	100 / 100
Industrial Branch	PAC 78 WL (Internal Table)	+0 / +0	70/70
With-Profit Deferred Annuities	AM92 / AF92	-1/-1	100 / 100
SAIF Conventional With-Profits	AM92 / AF92	+1 / +1	70/70
SAIF/ex-SAL Accumulating With-Profits Life	AM92 / AF92	+1 / +1	70/70

For persistency, the assumptions for most products are based on those used for European Embedded Value calculations. The persistency assumptions used to value the cost of options and guarantees are reduced by a 10% margin to make an allowance for the impact of policyholders' group actions in extreme market scenarios.

Stochastic asset model economic calibration and management actions

The cost of options, guarantees and smoothing are assessed on a market consistent basis, so that the reserves held are equal to the theoretical cost of hedging the guarantees in the market. In the absence of a deep, liquid market these costs are assessed using a "market consistent" model, with a market consistent calibration.

In order to value the Company's guarantees and options, the stochastic asset/liability model projects the with-profits liabilities forward over the next 40 years for 5,000 separate economic scenarios.

The risk free rate was assumed to be the long term gilt rate.

Separate asset models are used for the risk free rate, UK equities, overseas equities, corporate bonds, property and real interest rates. Where appropriate securities or derivatives are traded, it has been demonstrated that the model is able to closely reproduce these prices. Where this is not the case (for example for property and corporate bonds) expert judgement has been applied. Allowance has also been made for the correlation of investment returns between different asset classes.

The cost of guarantees, options and smoothing is very sensitive to the bonus, market value reduction and investment policies that the Company will employ under varying investment conditions. The stochastic modelling incorporates several management actions to protect the fund in adverse

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

investment scenarios. These management actions are consistent with the PPFM and the obligation to treat customers fairly.

Other non-linked business

Provisions are calculated by the net premium valuation method. Discount rates are derived from the returns available on appropriate investments and, for equity and property assets, are based on expected income and/or earnings with no allowance for potential future capital growth. Allowance is made as follows for the risk that some or all of the anticipated future income will not be received:

- (a) For equity and property assets the income is restricted where necessary to ensure that no individual holding had a yield in excess of the annual yield on the Merrill Lynch over 10 years corporate bond index, less a risk margin.
- (b) For fixed interest securities, aggregate bond asset yields have been adjusted to allow for potential defaults within the non-linked and index-linked asset portfolios respectively.

The following discount and mortality bases were used:

	Interest Rate %	Actuarial Mortality Table Reference*
<u>UK (excluding Scottish Amicable Insurance Fund)</u>		
Term assurances - life business	3.00	AM/AF92+1
Term assurances – pensions business	3.75	AM/AF92+1
<u>Scottish Amicable Insurance Fund</u>		
Term assurances - life business	3.00	AM/AF92+1
Term assurances – pensions business	3.75	AM/AF92+1

*For assurances, provision for AIDS is made either by increasing the underlying mortality rates or by holding an explicit additional provision. In both cases, the adjustment is one-third of the "R6A" tables.

Linked business in the Non-Profit Sub-Fund

The provision for mortality, morbidity and expenses is calculated using a discounted cashflow method on the following bases:

Discount Rate	4.00% gross
Fund Growth	5.75% gross
Mortality	AM/AF92+1 plus 1/3 AIDS "R6A" for most contracts
Administration Expenses	£25 to £225 p.a. depending on the product type
Expense Inflation	4.25% p.a.

Compared with the 2009 valuation the assumptions regarding administration expenses have been revised to allow for actual and forecast costs.

Linked business in the With-Profit Sub-Fund

The provision for mortality, morbidity and expenses is calculated using a discounted cashflow method on the following bases:

Discount Rate	4.00% gross
Fund Growth	5.75% gross
Mortality	AM/AF92 -3 years
Administration Expenses	£26 to £143 p.a. depending on the product type
Expense Inflation	4.25% p.a.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Compared with the 2009 valuation the assumptions regarding administration expenses have been revised to allow for actual and forecast costs.

Other long-term business provisions

Additional provisions have been established, the most significant being for the potential costs and expenses of compensating the Company's pension policyholders under the FSA review of pension opt-outs and transfer cases, for the potential costs of compensating endowment mortgage policyholders, for the potential cost of meeting annuity rate guarantees at vesting, for Industrial Branch whole of life and endowment assurances unclaimed after maturity date or policy anniversary after age 90 and for additional expenses, not otherwise catered for in the basic net premium valuation, of running off the industrial branch business.

33. Contingencies and Related Obligations

Consistent with FRS 12 'Provisions, contingent liabilities and contingent assets', appropriate provision has been made in the financial statements where the Company either has an obligation, or it is probable that it has an obligation, arising from the events or activities described below, where a reliable estimate of the obligation can be made, but not for contingent liabilities which are discussed below.

Pension Mis-selling Review

In 1988, the UK government introduced new pensions legislation intended to encourage more individuals to make their own arrangements for their pensions. During the period from April 1988 to June 1994, many individuals were advised by insurance companies, Independent Financial Advisers and other intermediaries to not join, to transfer from or to opt out of their occupational pension schemes in favour of private pension products introduced under the UK Income and Corporation Taxes Act 1988. The UK insurance regulator (previously the Personal Investment Authority, now the Financial Services Authority, (FSA)), subsequently determined that many individuals were incorrectly advised and would have been better off not purchasing the private pension products sold to them. Industry participants are responsible for compensating the persons to whom private pensions were mis-sold. As a result, the FSA required that all UK life insurance companies review their potential cases of pension mis-selling and pay compensation to policyholders where necessary and, as a consequence, record a provision for the estimated costs. The Company met the requirement of the FSA to issue offers to all cases by 30 June 2002.

Provisions in respect of the costs associated with the review have been included in the change in long-term technical provisions in the Company's profit and loss account and the transfer to or from the fund for future appropriations has been determined accordingly. The table below summarises the change in the pension mis-selling provision for the year ended 31 December 2010.

	Year ended 31 December 2010	Year ended 31 December 2009
	£m	£m
Balance at start of the period	322	345
Changes to actuarial assumptions and method of calculation	37	20
Discount unwind	2	3
Redress to policyholders	(46)	(44)
Payment of administrative costs	(1)	(2)
Balance at end of the period	<u>314</u>	<u>322</u>

The Financial Ombudsman Service periodically updates the actuarial assumptions to be used in calculating the compensation payments, including interest rates and mortality assumptions. The pension mis-selling provision represents the discounted value of future expected payments, including benefit payments and all internal and external legal and administrative costs of adjudicating, processing and settling those claims. To the extent that amounts have not been paid, the provision increases each year reflecting the shorter period of discount.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

The directors believe that, based on current information, the provision, together with future investment return on the assets backing the provision, will be adequate to cover the costs of pension mis-selling.

Such provision represents the best estimate of probable costs and expenses. However, there can be no assurance that the current provision level will not need to be increased.

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

In 1998, Prudential stated that deducting mis-selling costs from the inherited estate would not impact its bonus or investment policy and it gave an assurance that if this unlikely event were to occur, it would make available support to the fund from shareholder resources for as long as the situation continued, so as to ensure that policyholders were not disadvantaged. The assurance was designed to protect both existing policyholders at the date it was announced, and policyholders who subsequently purchased policies while the pension mis-selling review was continuing.

This review was completed on 30 June 2002. The assurance will continue to apply to any policy in force at 31 December 2003, both for premiums paid before 1 January 2004, and for subsequent regular premiums (including future fixed, retail price index or salary related increases and Department of Work and Pensions rebate business). The assurance has not applied to new business since 1 January 2004. New business in this context consists of new policies, new members to existing pension schemes plus regular and single premium top-ups, transfers and switches to existing arrangements. The maximum amount of capital support available under the terms of the assurance will reduce over time as claims are paid on the policies covered by it.

The bonus and investment policy for each type of with-profits policy is the same irrespective of whether or not the assurance applies. Hence removal of the assurance for new business has had no impact on policyholder returns and this is expected to continue for the foreseeable future.

During 2009, the FSA issued a policy statement confirming that certain payments of compensation and redress for events occurring after 31 July 2009 may only be paid from assets attributable to shareholders. As the pensions mis-selling review was concluded prior to this date, the requirements of the policy statement do not impact the provisions outlined above.

Mortgage Endowment Products Review

In common with several other UK insurance companies, the Company used to sell low-cost endowment products related to repayment of residential mortgages. At sale, the initial sum assured is set at a level such that the projected benefits, including an estimate of the annual bonus receivable over the life of the policy, will equal or exceed the mortgage debt. The FSA is concerned that the maturity value of some of these products will be less than the mortgage debt because of a decrease in expected future investment returns since these products were sold. The FSA has worked with insurance companies to devise a programme whereby the companies write to customers indicating whether they may have a possible shortfall and outline the actions that the customers can take to prevent this possibility.

The Company is exposed to mortgage endowment products in respect of policies issued by Scottish Amicable Life plc (SAL) and policies issued by Scottish Amicable Life Assurance Society (SALAS) and transferred into the Scottish Amicable Insurance Fund (SAIF). Technical provisions of £2m in the non-profit sub-fund and £20m in SAIF were held at 31 December 2010 to cover potential compensation in respect of mortgage endowment product mis-selling claims. As SAIF is a separate sub-fund of the Company's long-term business fund, wholly attributable to the policyholders of the fund, this provision has no impact on shareholders.

In addition, the Company's main with-profits fund paid compensation of £2m in respect of mortgage endowment products mis-selling claims in the year ended 31 December 2010 and held a technical provision of £32m at 31 December 2010, in respect of further compensation. This provision has no impact on the Company's profit before tax.

In May 2006 the Company introduced a deadline for both Prudential and Scottish Amicable mortgage endowment complaints. In line with the time limit prescribed by the FSA and the ABI, impacted customers have three years to lodge a mis-selling complaint from the date they receive their first "red"

Notes on the financial statements (continued)

letter indicating that there is a high risk their mortgage endowment may not achieve its projected final value.

Guaranteed Annuities

The Company used to sell guaranteed annuity products in the UK and held a technical provision of £24m at 31 December 2010, within the main with-profits fund to honour guarantees on these products. The Company's main exposure to guaranteed annuities in the UK is through the Scottish Amicable Insurance Fund (SAIF) and a technical provision of £336m was held in SAIF at 31 December 2010, to honour the guarantees. As SAIF is a separate sub-fund of the Company's long-term business fund, wholly attributable to the policyholders of the fund, this provision has no impact on shareholders.

Guarantees and Commitments

The Company has provided, from time to time, other guarantees and commitments to third parties entered into in the normal course of business but the directors do not consider that the amounts involved are significant.

Inherited Estate

The assets of the with-profits sub-fund (WPSF) within the long-term fund of the Company 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 WPSF 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 WPSF is called the 'inherited estate' and has accumulated over many years from various sources.

The inherited estate, as working capital, enables the Company 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.

Support of Long-term Business Funds by Shareholders' Funds

As a proprietary insurance company, the Company is liable to meet its obligations to policyholders even if the assets of the long-term funds are insufficient to do so. The assets, represented by the unallocated surplus of with-profits funds, in excess of amounts expected to be paid for future terminal bonuses and related shareholder transfers ('the excess assets') in the long-term funds could be materially depleted over time by, for example, a significant or sustained equity market downturn, costs of significant fundamental strategic change or a material increase in the pension mis-selling provision. In the unlikely circumstance that the depletion of the excess assets within the long-term fund was such that the Company's ability to satisfy policyholders' reasonable expectations was adversely affected, it might become necessary to restrict the annual distribution to shareholders or to contribute shareholders' funds to the long-term funds to provide financial support.

In 1997, the business of Scottish Amicable Life Assurance Society, a mutual society, was transferred to the Company. In effecting the transfer, a separate sub-fund, the Scottish Amicable Insurance Fund (SAIF), was established within the Company's long-term business fund. This sub-fund contains all the with-profits business and all other pension business that was transferred. No new business has been or will be written in the sub-fund and the sub-fund is managed to ensure that all the invested assets are distributed to SAIF policyholders over the lifetime of the SAIF policies. With the exception of certain amounts in respect of the unutilised with-profits life business, all future earnings arising in SAIF are retained for SAIF policyholders. Any excess (deficiency) of revenue over expense within SAIF during a period is offset by a change in the SAIF technical provisions (no FFA is shown for SAIF in 2010 because technical provisions are set at a level at which the realistic working capital is zero). Shareholders have no interest in the profits of SAIF but are entitled to the investment management fees paid on this business. With the exception of certain guaranteed annuity products mentioned earlier in this note, the majority of SAIF with-profits policies do not guarantee minimum rates of return to policyholders.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Should the assets of SAIF be inadequate to meet the guaranteed benefit obligations to the policyholders of SAIF, the Company's long-term fund would be liable to cover any such deficiency. Due to the quality and diversity of the assets in SAIF, and the ability of SAIF to revise guaranteed benefits in the event of an asset shortfall, the directors believe that the probability of either the Company's long-term fund or the Company's shareholders' funds having to contribute to SAIF is remote.

34. Financial assets and liabilities

A. Financial instruments – designation and fair values

All financial assets of the Company are designated as either fair value through profit and loss or loans and receivables. Financial liabilities are designated as either fair value through profit and loss, amortised cost or investment contracts with discretionary participation features accounted for under FRS 26 and the ABI SORP as described in the Accounting Policies section.

2010	Fair value through profit and loss £m	Loans and receivables £m		Total carrying value £m	Fair value £m
Financial Assets					
Deposits with credit institutions	-	7,376		7,376	7,376
Equity securities and portfolio holdings in unit trusts	32,209	-		32,209	32,209
Debt securities and other fixed income securities (note i)	36,739	-		36,739	36,739
Loans (note ii):	227	1,967		2,194	2,154
Other investments (note iii)	2,086	-		2,086	2,086
Derivative assets	739	-		739	739
Assets held to cover linked liabilities	10,290	-		10,290	10,290
Accrued investment income	-	837		837	837
Other debtors	-	1,188		1,188	1,188
Cash at bank and in hand	-	955		955	955
Total	82,290	12,323		94,613	94,573
	Fair value through profit and loss £m	Amortised cost £m	ABI SORP/ FRS26 £m	Total carrying value £m	Fair value £m
Financial Liabilities					
Amounts owed to credit institutions	-	46	-	46	46
Other borrowings not owed to credit institutions (note iv)	-	347	-	347	347
Investment contracts with discretionary participation features (note v)	-	-	25,115	25,115	-
Investment contracts without discretionary participation features	5,600	-	-	5,600	5,600
Creditors arising out of direct insurance operations	-	106	-	106	106
Creditors arising out of reinsurance operations	-	98	-	98	98
Other creditors	227	3,116	-	3,343	3,343
Derivative liabilities	549	-	-	549	549
Total (note v)	6,376	3,713	25,115	35,204	10,089

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

2009	Fair value through profit and loss £m	Loans and receivables £m		Total carrying value £m	Fair value £m
Financial Assets					
Deposits with credit institutions	-	10,080		10,080	10,080
Equity securities and portfolio holdings in unit trusts	29,660	-		29,660	29,660
Debt securities and other fixed income securities (note i)	32,809	-		32,809	32,809
Loans (note ii)	-	1,683		1,683	1,604
Other investments (note iii)	1,850	-		1,850	1,850
Assets held to cover linked liabilities	7,648	-		7,648	7,648
Derivative assets	687	-		687	687
Accrued investment income	-	766		766	766
Other debtors	-	1,056		1,056	1,056
Cash at bank and in hand	-	856		856	856
Total	72,654	14,441		87,095	87,016
	Fair value through profit and loss £m	Amortised cost £m	ABI SORP/ FRS26 £m	Total carrying value £m	Fair value £m
Financial Liabilities					
Amounts owed to credit institutions	-	45	-	45	45
Other borrowings not owed to credit institutions (note iv)	-	359	-	359	359
Investment contracts with discretionary participation features (note v)	-	-	24,815	24,815	-
Investment contracts without discretionary participation features	5,829	-	-	5,829	5,829
Creditors arising out of direct insurance operations	-	77	-	77	77
Creditors arising out of reinsurance operations	-	52	-	52	52
Other creditors	-	2,922	-	2,922	2,922
Derivative liabilities	455	-	-	455	455
Total (note v)	6,284	3,455	24,815	34,554	9,739

Notes

- (i) As at 31 December 2010, £655m (2009: £648m) of convertible bonds were included in debt securities. There were no convertible bonds included in borrowings.
- (ii) Loans and receivables are reported net of allowance for loan losses of £44m (2009: £38m).
- (iii) Other investments include participation in various investment funds and limited liability property partnerships.
- (iv) As at 31 December 2010, £347m (2009: £359m) of loan repayable, contingent on regulatory surplus emerging, was included in "Other borrowings not owed to credit institutions".
- (v) It is impractical to determine fair value of investment contracts with discretionary participation features due to the lack of a reliable basis to measure such features.
- (vi) For financial liabilities designated as fair value through profit and loss there was no material impact on profit from movements in credit risk during 2010 and 2009.

Determination of fair value

The fair values of the financial assets and liabilities as shown in the table above have been determined on the following bases.

The fair values of the financial instruments for which fair valuation is required under UKGAAP are determined by the use of current market bid prices for quoted investments, or by using quotations from independent third-parties, such as brokers and pricing services or by using appropriate valuation techniques. Investments valued using valuation techniques include financial investments which by their nature do not have an externally quoted price based on regular trades and financial investments for which markets are no longer active as a result of market conditions e.g. market illiquidity. The valuation techniques used include comparison to recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option adjusted spread models and, if applicable, enterprise valuation. These techniques may include a number of assumptions relating to

Notes on the financial statements (continued)

variables such as credit risk and interest rates. Changes in assumptions relating to these variables could positively or negatively impact the reported fair value of these instruments. When determining the inputs into the valuation techniques used priority is given to publicly available prices from independent sources, when available but overall, the source of pricing is chosen with the objective of arriving at a fair value measurement which reflects the price at which an orderly transaction would take place between market participants on the measurement date.

The fair value estimates are made at a specific point in time, based upon available market information and judgements about the financial instruments, including estimates of the timing and amount of expected future cash flows and the credit standing of counterparties. Such estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument, nor do they consider the tax impact of the realisation of unrealised gains or losses from selling the financial instrument being fair valued. In some cases the fair value estimates cannot be substantiated by comparison to independent markets, nor can the disclosed value be realised in immediate settlement of the financial instrument.

The loans and receivables have been shown net of provisions for impairment. The fair value of loans has been estimated from discounted cash flows expected to be received. The rate of discount used was the market rate of interest.

The estimated fair value of derivative financial instruments reflects the estimated amount the Company would receive or pay in an arm's length transaction. This amount is determined using quoted prices if exchange listed, quotations from independent third-parties or valued internally using standard market practices.

The fair value of other financial liabilities is determined using discounted cash flows of the amounts expected to be paid.

Level 1, 2 and 3 fair value measurement hierarchy of financial instruments

The table below includes financial instruments carried at fair value analysed by level of the FRS29 defined fair value hierarchy. This hierarchy is based on the inputs to the fair value measurement and reflects the lowest level input that is significant to that measurement.

The classification criteria and its application to the Company can be summarised as follows:

Level 1 – quoted prices (unadjusted) in active markets for identical assets and liabilities

Level 1 principally includes exchange listed equities, mutual funds with quoted prices, exchange traded derivatives such as futures and options, and national government bonds unless there is evidence that trading in a given instrument is so infrequent that the market could not possibly be considered active. It also includes other financial instruments where there is clear evidence that the year end valuation is based on a traded price in an active market.

Level 2 – inputs other than quoted prices included within level 1 that are observable either directly (i.e. as prices) or indirectly (i.e. derived from prices)

Level 2 principally includes corporate bonds and other non-national government debt securities which are valued using observable inputs, together with over-the-counter derivatives such as forward exchange contracts and non-quoted investment funds valued with observable inputs. It also includes investment contract liabilities that are valued using observable inputs.

In addition level 2 includes debt securities that are valued internally using standard market practices. Of the total level 2 debt securities of £30,458m (2009: £28,068m), £1,374m (2009: £1,414m) are valued internally. The majority of such securities use matrix pricing, which is based on assessing the credit quality of the underlying borrower to derive a suitable discount rate relative to government securities. Under matrix pricing, the debt securities are priced taking the credit spreads on comparable quoted public debt securities and applying these to the equivalent debt instruments factoring a specified liquidity premium. The significance of the parameters used in this valuation technique are readily observable in the market and, therefore, are not subject to interpretation.

Notes on the financial statements (continued)

Level 3: Significant inputs for the asset or liability that are not based on observable market data (unobservable inputs)

Level 3 principally includes investments in private equity funds, investments in property funds which are exposed to bespoke properties or risks and investments which are internally valued or subject to a significant number of unobservable assumptions. It also includes debt securities which are rarely traded or traded only in privately negotiated transactions and hence where it is difficult to assert that these have been based on observable market data. The inherent nature of the vast majority of these assets means that, in normal market conditions, there is unlikely to be significant change in the specific underlying assets classified as level 3.

At 31 December 2010 the Company held £2,225m (2009: £2,070m), 3% (2009: 3%) of the fair valued financial instruments, within level 3. Of these amounts £2,224m (2009: £2,069m) was held by the Company's participating funds and therefore shareholders' profit and equity are not impacted by movements in the valuation of these financial instruments. Total level 3 assets represented 3% (2009: 4%) of the total assets of the participating funds at 31 December 2010.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

	31 December 2010			
	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
With-profits				
Equity securities and portfolio holdings in unit trusts	30,472	1,155	395	32,022
Debt securities	5,304	28,435	246	33,985
Other investments (including derivative assets)	137	988	1,583	2,708
Derivative liabilities	(56)	(393)	-	(449)
Total financial investments, net of derivative liabilities	35,857	30,185	2,224	68,266
Percentage of total	53%	44%	3%	100%
Unit-linked				
Assets held to cover linked liabilities	8,723	63	-	8,786
Total financial investments net of derivative liabilities	8,723	63	-	8,786
Investment contract without discretionary participation features held at fair value	-	(5,600)	-	(5,600)
Total	8,723	(5,537)	-	3,186
Percentage of total	274%	(174%)	-	100%
Non-linked shareholder-backed				
Equity securities and portfolio holdings in unit trusts	112	75	-	187
Debt securities	730	2,023	1	2,754
Other investments (including derivative assets)	6	111	-	117
Derivative liabilities	-	(100)	-	(100)
Total financial investments, net of derivative liabilities	848	2,109	1	2,958
Percentage of total	29%	71%	-	100%
Company total				
Equity securities and portfolio holdings in unit trusts	30,584	1,230	395	32,209
Debt securities	6,034	30,458	247	36,739
Other investments (including derivative assets)	143	1,099	1,583	2,825
Assets held to cover linked liabilities	8,723	63	-	8,786
Derivative liabilities	(56)	(493)	-	(549)
Total financial investments, net of derivative liabilities	45,428	32,357	2,225	80,010
Investment contract without discretionary participation features held at fair value	-	(5,600)	-	(5,600)
Total	45,428	26,757	2,225	74,410
Percentage of total	61%	36%	3%	100%

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

	31 December 2009			
	Level 1	Level 2	Level 3	Total
	£m	£m	£m	£m
With-profits				
Equity securities and portfolio holdings in unit trusts	28,484	637	398	29,519
Debt securities	3,874	26,197	330	30,401
Other investments (including derivative assets)	79	1,026	1,341	2,446
<u>Derivative liabilities</u>	<u>(54)</u>	<u>(326)</u>	<u>-</u>	<u>(380)</u>
Total financial investments, net of derivative liabilities	32,383	27,534	2,069	61,986
Percentage of total	52%	44%	4%	100%
Unit-linked				
<u>Assets held to cover linked liabilities</u>	<u>6,591</u>	<u>52</u>	<u>-</u>	<u>6,643</u>
Total financial investments net of derivative liabilities Investment contract without discretionary participation features held at fair value	6,591	52	-	6,643
<u>Investment contract without discretionary participation features held at fair value</u>	<u>-</u>	<u>(5,829)</u>	<u>-</u>	<u>(5,829)</u>
Total	6,591	(5,777)	-	814
Percentage of total	810%	(710%)	-	100%
Non-linked shareholder-backed				
Equity securities and portfolio holdings in unit trusts	139	2	-	141
Debt securities	536	1,871	1	2,408
Other investments (including derivative assets)	7	84	-	91
<u>Derivative liabilities</u>	<u>(1)</u>	<u>(74)</u>	<u>-</u>	<u>(75)</u>
Total financial investments, net of derivative liabilities	681	1,883	1	2,565
Percentage of total	27%	73%	-	100%
Company total				
Equity securities and portfolio holdings in unit trusts	28,623	639	398	29,660
Debt securities	4,410	28,068	331	32,809
Other investments (including derivative assets)	86	1,110	1,341	2,537
Assets held to cover linked liabilities	6,591	52	-	6,643
<u>Derivative liabilities</u>	<u>(55)</u>	<u>(400)</u>	<u>-</u>	<u>(455)</u>
Total financial investments, net of derivative liabilities Investment contract without discretionary participation features held at fair value	39,655	29,469	2,070	71,194
<u>Investment contract without discretionary participation features held at fair value</u>	<u>-</u>	<u>(5,829)</u>	<u>-</u>	<u>(5,829)</u>
Total	39,655	23,640	2,070	65,365
Percentage of total	61%	36%	3%	100%

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Assets held to cover linked liabilities, shown in the table, only covers those assets which are required to be disclosed under the provisions of FRS29 'Financial Instruments' for the fair value hierarchy. There are a further £1,504m (2009: £1,005m) of assets which comprise the total assets held to cover linked liabilities, which consist mainly of cash at bank, other debtors and property.

Reconciliation of movements in level 3 financial instruments measured at fair value

The following table reconciles the value of level 3 financial instruments at 1 January 2010 to that presented at 31 December 2010. Total gains and losses recorded in the long-term technical account in the period represents realised gains and losses, including interest and dividend income, unrealised gains and losses on financial instruments classified at fair value through profit and loss and foreign exchange movements on overseas investments. All these amounts are included within "investment income" and "unrealised gains (losses)" in the long-term technical account.

Transfers out of level 3 are primarily debt securities reclassifications from level 3 to level 2 which reflect improving liquidity during the period.

	At 1 Jan 2010 £m	Total gains or (losses) in long-term technical account £m	Purchases £m	Sales £m	Transfers into level 3 £m	Transfers out of level 3 £m	At 31 Dec 2010 £m
With-profits							
Equity securities and portfolio holdings in unit trusts	398	30	48	(38)	-	(43)	395
Debt securities	330	74	8	(108)	11	(69)	246
Other investments (including derivative assets)	1,341	131	239	(128)	-	-	1,583
Derivative liabilities	-	-	-	-	-	-	-
Total financial investments net of derivative liabilities	2,069	235	295	(274)	11	(112)	2,224
Total	2,069	235	295	(274)	11	(112)	2,224
Non-linked shareholder-backed							
Equity securities and portfolio holdings in unit trusts	-	-	-	-	-	-	-
Debt securities	1	-	-	-	-	-	1
Other investments (including derivative assets)	-	-	-	-	-	-	-
Derivative liabilities	-	-	-	-	-	-	-
Total financial investments net of derivative liabilities	1	-	-	-	-	-	1
Total	1	-	-	-	-	-	1
Company total							
Equity securities and portfolio holdings in unit trusts	398	30	48	(38)	-	(43)	395
Debt securities	331	74	8	(108)	11	(69)	247
Other investments (including derivative assets)	1,341	131	239	(128)	-	-	1,583
Derivative liabilities	-	-	-	-	-	-	-
Total financial investments net of derivative liabilities	2,070	235	295	(274)	11	(112)	2,225
Total	2,070	235	295	(274)	11	(112)	2,225

Of the total profits of £235m (2009: loss of £270m) in the period, £184m (2009: loss of £267m) relates to Level 3 financial instruments still held at the end of the year, which can be analysed as £22m (2009: £15m) for equity securities, £32m (2009: £61m) for debt securities and £130m (2009: £191m) for other investments.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

	At 1 Jan 2009 £m	Total gains or (losses) in long-term technical account £m	Purchases £m	Sales £m	Transfers into level 3 £m	Transfers out of level 3 £m	At 31 Dec 2009 £m
With-profits							
Equity securities and portfolio holdings in unit trusts	376	(15)	39	(2)	-	-	398
Debt securities	380	(60)	6	(71)	100	(25)	330
Other investments (including derivative assets)	1,454	(195)	133	(51)	-	-	1,341
Derivative liabilities	-	-	-	-	-	-	-
Total financial investments net of derivative liabilities	2,210	(270)	178	(124)	100	(25)	2,069
Total	2,210	(270)	178	(124)	100	(25)	2,069
Non-linked shareholder-backed							
Equity securities and portfolio holdings in unit trusts	-	-	-	-	-	-	-
Debt securities	1	-	-	-	-	-	1
Other investments (including derivative assets)	-	-	-	-	-	-	-
Derivative liabilities	-	-	-	-	-	-	-
Total financial investments net of derivative liabilities	1	-	-	-	-	-	1
Total	1	-	-	-	-	-	1
Company total							
Equity securities and portfolio holdings in unit trusts	376	(15)	39	(2)	-	-	398
Debt securities	381	(60)	6	(71)	100	(25)	331
Other investments (including derivative assets)	1,454	(195)	133	(51)	-	-	1,341
Derivative liabilities	-	-	-	-	-	-	-
Total financial investments net of derivative liabilities	2,211	(270)	178	(124)	100	(25)	2,070
Total	2,211	(270)	178	(124)	100	(25)	2,070

Transfers between level 1 and level 2

During 2010, transfers from level 1 to level 2 amounted to £354m in respect of certain investment funds held by the Company's with-profit sub-fund which arose to reflect the change in the observability of the inputs issued in valuing these funds. There were no significant transfers between level 1 and level 2 during 2009.

Interest income and expense

The interest income on financial assets not at fair value through profit and loss was £134m for the year ended 31 December 2010 (2009: £123m).

The interest expense on financial liabilities not at fair value through profit and loss was £25m for the year ended 31 December 2010 (2009: £3m).

Notes on the financial statements (continued)

B. Market Risk

The financial assets and liabilities attaching to the Company's life assurance business are, to varying degrees, subject to market risk that may have a material effect on the profit or loss and equity.

Market risk is the risk that the fair value or future cash flows of a financial instrument or, in the case of liabilities of insurance contracts, their carrying value will fluctuate because of changes in market prices.

Market risk comprises four types of risk, namely:

- Interest rate risk: due to changes in market interest rates,
- Liquidity risk: inability to meet payment of obligations in a timely manner at a reasonable cost or the risk of unexpected increases in the cost of funding the portfolio at appropriate maturities or rates
- Currency risk: due to changes in foreign exchange rates, and
- Other price risk: due to fluctuations in market prices (other than those arising from interest rate risk or currency risk).

With-profits business

The shareholder results of the Company's with-profits business are sensitive to market risk only through the indirect effect of investment performance on declared policyholder bonuses. The investment assets of the Company's with-profits fund are subject to market risk. However, changes in their carrying value, net of the related changes to asset-share liabilities of with-profit contracts, affect the level of funds for future appropriations, which is accounted for as a liability, movements in its value do not affect shareholders' profit or shareholders' funds.

The shareholder results of the Company's with-profits fund correspond to the shareholders' share of the cost of bonuses declared on the with-profits business. This currently corresponds to one-ninth of the cost of bonuses declared.

Investment performance is a key driver of bonuses, and hence the shareholders' share of cost of bonuses. Due to the 'smoothed' basis of bonus declaration the sensitivity to investment performance in a single year is low. However, over multiple periods it is important.

SAIF

SAIF is a ring-fenced fund in which, apart from asset management fees, shareholders have no interest. Accordingly, the Company's profit and shareholders' funds are insensitive to the direct effects of market risk attaching to SAIF's assets and liabilities.

Shareholder-backed non-profit sub-fund

The Company's non-profit sub-fund principally comprises annuity business previously written by Scottish Amicable Life, credit life, unit-linked and other non-participating business. The financial assets covering the liabilities for those types of business are subject to market risk. The liabilities for annuity contracts are subject to market risk arising from changes in the returns of the attaching assets. Except mainly to the extent of any minor asset/liability duration mismatch, and exposure to credit risk, the sensitivity of the Company's non-profit sub-fund's annuity business' results to market risk for movements in the carrying value of liabilities and covering assets is broadly neutral on a net basis.

The liabilities of the unit-linked business change in line with the matching linked assets. Amounts under unit-linked contracts are generally repayable on demand and the Company is responsible for ensuring there is sufficient liquidity within the asset portfolio to enable liabilities to unit-linked policyholders to be met as they fall due. Other liabilities of the Company's non-profit sub-fund are broadly insensitive to market risk.

The principal items affecting the results of the Company's non-profit sub-fund are mortality experience and assumptions and credit risk.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Interest rate risk

The following table shows an analysis of the classes of financial assets and liabilities and their direct exposure to interest rate risk. Each applicable class of the Company's assets or liabilities are analysed between those exposed to fair value interest rate risk, cash flow interest rate risk and those with no direct interest rate risk exposure.

2010	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
	£m	£m	£m	£m
Financial Assets				
Deposits with credit institutions	2	7,374	-	7,376
Debt securities and other fixed income securities	34,141	2,598	-	36,739
Loans	1,232	962	-	2,194
Derivative asset	523	-	216	739
Cash at bank and in hand	-	955	-	955
	35,898	11,889	216	48,003
Financial Liabilities				
Amounts owed to credit institutions	-	46	-	46
Other borrowings not owed to credit institutions	-	347	-	347
Investment contracts without discretionary participation features	-	-	5,600	5,600
Derivative liabilities	321	-	228	549
	321	393	5,828	6,542

2009	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
	£m	£m	£m	£m
Financial Assets				
Deposits with credit institutions	2	10,078	-	10,080
Debt securities and other fixed income securities	30,459	2,350	-	32,809
Loans	765	918	-	1,683
Derivative asset	407	-	280	687
Cash at bank and in hand	-	856	-	856
	31,633	14,202	280	46,115
Financial Liabilities				
Amounts owed to credit institutions	-	45	-	45
Other borrowings not owed to credit institutions	-	359	-	359
Investment contracts without discretionary participation features	-	-	5,829	5,829
Derivative liabilities	261	-	194	455
	261	404	6,023	6,688

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Liquidity Analysis

(i) Contractual maturities of financial liabilities

The following tables set out the contractual maturities and repricing dates for applicable classes of financial liabilities, excluding derivative liabilities and investment contracts, which are separately presented. The financial liabilities are included in the column relating to the contractual maturities and repricing dates at the undiscounted cash flows (including contractual interest payments) due to be paid assuming conditions are consistent with those of year end.

2010	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	No stated maturity	Total undiscounted cashflows	Total carrying value
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Financial Liabilities									
Amounts owed to credit institutions	-	46	-	-	-	-	-	46	46
Other borrowings not owed to credit institutions	112	262	-	-	-	-	-	374	347
	112	308	-	-	-	-	-	420	393

2009	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	No stated maturity	Total undiscounted cashflows	Total carrying value
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Financial Liabilities									
Amounts owed to credit institutions	-	45	-	-	-	-	-	45	45
Other borrowings not owed to credit institutions	140	272	-	-	-	-	-	412	359
	140	317	-	-	-	-	-	457	404

ii) Maturity analysis of derivatives and investment contracts

The following table provides a maturity analysis of derivative assets and liabilities:

2010	Total carrying value	1 year or less	After 1 to 3 years	After 3 to 5 years	After 5 years	Total
	£m	£m	£m	£m	£m	£m
Net derivative position	190	190	-	-	-	190

2009	Total carrying value	1 year or less	After 1 to 3 years	After 3 to 5 years	After 5 years	Total
	£m	£m	£m	£m	£m	£m
Net derivative position	232	232	-	-	-	232

The net derivative positions as shown in the table above comprise the following derivative assets and liabilities:

	2010 £m	2009 £m
Derivative assets	739	687
Derivative liabilities	(549)	(455)
Net derivative position	190	232

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

The derivative assets and liabilities have been included at fair value within the 1 year or less column representing the basis on which they are managed (i.e. to manage principally asset or liability value exposures). Contractual maturities are not considered essential for an understanding of the timing of the cash flows for these instruments and in particular the Company has no cash flow hedges.

The table below shows the maturity profile for investment contracts on an undiscounted basis to the nearest billion. This maturity profile has been based on the cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing the European Embedded Value (EEV) basis results.

	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	Total undiscounted value	Total carrying value
	£bn	£bn	£bn	£bn	£bn	£bn	£bn	£bn
2010								
Life assurance investment contracts	3	12	14	13	11	15	68	31
2009								
Life assurance investment contracts	3	10	13	12	11	16	65	31

This table has been prepared on an undiscounted basis and accordingly the amounts shown for life assurance investment contracts differ from those included in the balance sheet. Durations of long-term business contracts, covering both insurance and investment contracts, on a discounted basis are included below.

Durations of long-term business contracts on a discounted basis:

With the exception of most utilised with-profit bonds and other whole of life contracts the majority of the contracts of the Company have a contract term. However, in effect, the maturity term of contracts reflects the earlier of death, maturity, or lapsation. In addition, with-profit contracts include projected future bonuses based on current investment values. The actual amounts payable will vary with future investment performance of SAIF and the WPSF. Instead the Company uses cash flow projections of expected benefit payments as part of the determination of the value of in-force benefits when preparing the European Embedded Value basis results for the Prudential Group. The following table shows the maturity profile of the cash flows used for insurance contracts i.e. those containing significant insurance risk, and investment contracts, which do not contain significant insurance risk:

2010	With-profits business			Other		Total
	Insurance contracts	Investment contracts	Total	Insurance contracts	Investment contracts	
	%	%	%	%	%	%
0-5 years	47	31	39	35	29	32
5-10 years	25	25	25	26	21	23
10-15 years	13	19	16	18	20	19
15-20 years	7	14	11	10	11	11
20-25 years	4	8	6	6	8	7
Over 25 years	4	3	3	5	11	8
2009						
	With-profits business			Other		Total
	Insurance contracts	Investment contracts	Total	Insurance contracts	Investment contracts	
	%	%	%	%	%	%
0-5 years	50	28	40	33	34	34
5-10 years	26	25	25	25	22	24
10-15 years	13	19	16	18	19	18
15-20 years	6	14	10	11	11	11
20-25 years	3	9	6	7	6	6
Over 25 years	2	5	3	6	8	7

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Notes:

- (i) The cash flow projections of expected benefit payments used in the maturity profile table above are from in-force business and exclude the value of future new business, including vesting of internal pension contracts.
- (ii) Benefit payments do not reflect the pattern of bonuses and shareholder transfers in respect of the with-profits business.
- (iii) Investment contracts under Other comprise unit-linked and similar contracts.
- (iv) For business with no maturity term included within the contracts, for example with-profits investment bonds such as Prudence Bond, an assumption is made as to likely duration based on prior experience.

Sensitivity to interest rate movement

As described above, the net exposure to interest rate movement for the Company is very substantially ameliorated by virtue of the close matching of assets with appropriate duration to the liabilities.

The close matching by the Company of assets of appropriate duration to its non-profit sub fund's annuity liabilities is based on maintaining economic and regulatory capital. The measurement of liabilities under capital reporting requirements and UKGAAP is not the same, with contingency reserves and some other margins for prudence within the assumptions required under the FSA regulatory solvency basis not included for UKGAAP reporting purposes. As a result UKGAAP's shareholders' funds are higher than regulatory capital and therefore more sensitive to interest rate risk.

The estimated sensitivity of the shareholder-backed business to a movement in interest rates of 1% and 2% as at 31 December 2010 and 2009 are as follows:

	2010				2009			
	Fall of 1% £m	Rise of 1% £m	Fall of 2% £m	Rise of 2% £m	Fall of 1% £m	Rise of 1% £m	Fall of 2% £m	Rise of 2% £m
Carrying value of debt securities and derivatives	339	(282)	755	(522)	294	(249)	647	(463)
Long term business provision	(290)	243	(640)	448	(276)	231	(610)	427
Related tax effects	(13)	11	(31)	20	(5)	5	(10)	10
Net sensitivity of profit after tax and shareholders' funds	36	(28)	84	(54)	13	(13)	27	(26)

Currency Risk

As at 31 December 2010, the Company held 39% and 3% (2009: 40% and 4%) of its financial assets and financial liabilities respectively, in currencies, mainly US dollar and Euro, other than the functional currency of the relevant business unit.

The financial assets, of which 81% (2009: 82%) are held by the with-profit fund, allow the fund to obtain exposure to foreign equity markets.

The financial liabilities, of which 81% (2009: 88%) are held by the with-profit fund, mainly relate to investment contracts with discretionary participation features.

The exchange risks inherent in these exposures are mitigated through the use of derivatives, mainly forward currency contracts.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Other Price Risk – Equities and Property

In addition, the shareholder backed portfolio of the Company includes equity securities and property. Excluding any second order effects on the measurement of the liabilities for future cash flow to the policyholder a fall in their value would have given rise to the following effects on pre-tax profit, profit after tax, and shareholders' equity.

	2010		2009	
	Decrease of 20% £m	Decrease of 10% £m	Decrease of 20% £m	Decrease of 10% £m
Pre-tax profit	(89)	(44)	(92)	(46)
Related deferred tax effects	24	12	26	13
Net sensitivity of profit after tax and shareholders' funds	(65)	(32)	(66)	(33)

A 10% or 20% increase in their value would have an approximately equal and opposite effect on profit and shareholders' equity to the sensitivities shown above.

In the equity risk sensitivity analysis given above the Company has considered the impact of an instantaneous 20 per cent fall in equity markets. If equity markets were to fall by more than 20 per cent, the Company believes that this would not be an instantaneous fall but rather this would be expected to occur over a period of time during which the Company would be able to put in place mitigating management actions.

C. Derivatives and Hedging

The Company uses derivatives for efficient portfolio management to obtain cost effective and efficient exposure to various markets and to manage exposure to interest rate, currency, credit and other business risks.

The Company uses various interest rate derivative instruments such as interest rate swaps to reduce exposure to interest rate volatility.

The Company also uses various currency derivatives in order to limit volatility due to foreign currency exchange rate fluctuations arising on securities denominated in currencies other than sterling.

The Company also holds interest-rate sensitive investments that contain credit risks on which a certain level of defaults is expected. In order to manage the default risk on certain underlying assets and hence reduce the amount of regulatory capital held to support the assets the Company purchases swaptions.

As part of the efficient portfolio management of the PAC with-profits fund, the fund may, from time to time, invest in cash-settled forward contracts over Prudential plc shares, which are accounted for consistently with other derivatives. This is in order to avoid a mismatch of the with-profits investment portfolio with the investment benchmarks set for its equity-based investment funds. The contracts will form part of the long-term investments of the with-profits fund. The contracts are subject to a number of limitations for legal and regulatory reasons.

All over-the-counter derivative transactions are conducted under standardised ISDA (International Swaps and Derivatives Association Inc) master agreements and the Group has collateral agreements between the individual group entities, of which the Company is one, and relevant counterparties in place under each of these market master agreements.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

The total fair value balances of derivative assets and derivative liabilities are shown in note 18. The notional amount of the derivatives were as follows at 31 December 2010 and 31 December 2009:

2010	Notional amount on which future payments are based	
	Asset £m	Liability £m
Cross-currency swaps	31	38
Equity index options	-	1,458
Swaptions	-	-
Futures	3,052	7,146
Forwards	19,380	19,504
Equity options	34	-
Credit default swaps	145	3
Credit derivatives	7	-
Total return swaps	215	215
Interest rate swaps	3,259	3,259

2009	Notional amount on which future payments are based	
	Asset £m	Liability £m
Cross-currency swaps	31	37
Equity index options	-	-
Swaptions	900	900
Futures	2,254	2,879
Forwards	19,526	19,486
Single stock options	30	552
Credit default swaps	85	12
Credit derivatives	-	-
Total return swaps	420	421
Interest rate swaps	4,812	4,813

There are hedging arrangements in place for the liabilities, the main objective being to broadly match a proportion of the market consistent liabilities and hence protect the Pillar II solvency of the with-profits business against market movements. A benchmark of theoretical equity put options representing the liabilities has been determined, based on characteristics of the with-profits liability. The company deals in an appropriate amount of hedging instruments so that movements in the instruments held reflect movements in the benchmark put options representing the liabilities.

The actual and required hedging positions are compared on a regular basis (at least weekly), and the 1-month Value at Risk between the assets and benchmark is calculated. If this amount is significant, then an assessment is made as to whether or not to address the balance, and how much to rebalance. Automatic rebalancing is triggered if the monthly Value at Risk and the actual and required position is greater than £25m.

The Company has chosen to designate as a fair value hedge certain fixed to floating rate swaps which hedge the fair value exposure to interest rate movements of certain of the Company's operational borrowings. The fair value of the derivatives designated as fair value hedges above at 31 December 2010, were an asset of £5m (2009: a liability of £1m). Movements in the fair value of the hedging instruments of a net gain of £5m (2009: net loss of £1m) and the hedged items of a net loss of £6m (2009: net gain of £1m) are recorded in the long term technical account in respect of the fair value hedges above.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

D. Credit risk

Debt Securities and Other Fixed Income Securities

The following table summarises by rating the securities held by the Company as at 31 December 2010 and 2009.

	With-profits			With-profits		
	sub fund	Other funds	Total 2010	sub fund	Other funds	Total 2009
	£m	£m	£m	£m	£m	£m
S&P – AAA	8,009	994	9,003	6,451	778	7,229
S&P – AA+ to AA-	2,345	255	2,600	2,596	218	2,814
S&P – A+ to A-	8,639	845	9,484	8,056	716	8,772
S&P – BBB+ to BBB-	7,916	426	8,342	7,178	452	7,630
S&P – Other	2,628	21	2,649	1,792	24	1,816
	29,537	2,541	32,078	26,073	2,188	28,261
Moody's – Aaa	544	10	554	357	7	364
Moody's – Aa1 to Aa3	100	26	126	138	24	162
Moody's – A1 to A3	198	19	217	224	42	266
Moody's – Baa1 to Baa3	420	32	452	389	26	415
Moody's – Other	128	4	132	167	9	176
	1,390	91	1,481	1,275	108	1,383
Fitch – AAA	20	-	20	85	-	85
Fitch – AA+ to AA-	-	-	-	20	1	21
Fitch – A+ to A-	178	21	199	170	29	199
Fitch – BBB+ to BBB-	6	-	6	32	-	32
Fitch – Other	28	-	28	39	1	40
	232	21	253	346	31	377
Other	2,827	100	2,927	2,708	80	2,788
Total debt securities and other fixed income securities	33,986	2,753	36,739	30,402	2,407	32,809

In the table above S&P ratings have been used where available. For securities where S&P ratings are not immediately available those produced by Moody's and then Fitch have been used as an alternative.

Where no external ratings are available internal ratings produced by the Prudential Group's asset management operations, which are prepared on a comparable basis to external ratings, are used where possible. Of the total debt securities held at 31 December 2010 which are not externally rated, £562m (2009: £583m) were internally rated AAA to A-, £1,725m (2009: £1,457m) were internally rated BBB+ to B- and £640m were internally rated as below B- or unrated (2009: £748m). The majority of the unrated debt security investments were held by the Company's with-profits fund and relate to convertible debt and other investments which are not covered by rating analysts nor have an internal rating attributed to them.

As detailed in section B the primary sensitivity of profit or loss and shareholders' equity of the Company relates to non-linked shareholder-backed business which covers the "other funds" in the table above.

Excluded from the table above is £119m (2009: £159m) of assets backing unit-linked contracts which are included within assets held to cover linked liabilities. The holders of these contracts bear the credit risk arising from these assets.

Loans and receivables

In accordance with accounting policy, impairment reviews were performed for loans and receivables. During the year ended 31 December 2010, impairment losses of £6m (2009: £10m) were recognised for loans and receivables.

Notes on the financial statements (continued)

Of the total loans and receivables held £11m (2009: £7m) are past their due date but have not been impaired. 95% (2009: 98%) of the loans and receivables that are past due but not impaired are less than one year past their due date for 2010. The Company expects full recovery of these loans and receivables.

Financial assets that would have been past due or impaired had the terms not been renegotiated amounted to £Nil (2009: £Nil).

Securities lending and reverse repurchase agreements

The Company has entered into securities lending (including repurchase agreements) whereby blocks of securities are loaned to third parties, primarily major brokerage firms. The amounts above the fair value of the loaned securities required to be held as collateral by the agreements, depend on the quality of the collateral, calculated on a daily basis. The loaned securities are not removed from the Company's balance sheet; rather they are retained within the appropriate investment classification. Collateral, typically consists of cash, debt securities, equity securities and letters of credit. At 31 December 2010, the Company had lent £4,936m (2009: £6,393m) of securities and held collateral under such agreements of £5,244m (2009: £6,534m).

At 31 December 2010, the Company had entered into reverse repurchase transactions under which it purchased securities and had taken on the obligation to resell the securities for the purchase price, £883m (2009: £913m), together with accrued interest.

Collateral and pledges under derivative transactions

At 31 December 2010, the Company had pledged £223m (2009: £129m) for liabilities and held collateral of £413m (2009: £243m) in respect of over-the-counter derivative transactions.

Reinsurer's share of technical provisions

The majority of the reinsurers' share of technical provisions relate to cessions to subsidiaries of the Company or other group companies. See note 20.

Of the reinsurer's share of technical provisions at 31 December 2010 of £17,165m (2009: £16,756m), 4% (2009: 2%) of the balance relates to companies outside of the Prudential Group and of this 7% (2009: 11%) of the balances were from reinsurers with S&P's rating of AA- and above, based on the ratings at the time of signing these financial statements.

E. Risk Management

The Company's business involves the acceptance and management of risk. The Company has in place a risk management process, which is undertaken in accordance with the Group Risk Framework adopted by the Prudential Group in 1999.

A number of risk factors affect the Company's operating results and financial condition. The financial risk factors affecting the Company include the effects of market risk, credit risk and liquidity risk on the financial instruments of the Company.

The Company uses derivatives to facilitate efficient portfolio management or to reduce investment risk. The most widely used derivatives by the Company are exchange traded futures and currency forwards.

The Company also uses over-the-counter swaps (including total return swaps), options, swaptions and warrants.

It is the Company's policy that cash or corresponding assets cover amounts at risk through derivative transactions. Derivative financial instruments used to facilitate efficient portfolio management and for investment purposes are carried at fair value with changes in fair value included in the profit and loss account. The Company has not applied hedge accounting to its derivatives.

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

Market risk

Market risk is the risk that arises from adverse changes in the value of, or income from, assets and changes in interest rates or exchange rates.

The primary market risks that the Company faces are equity risk and interest rate risk because most of its assets are investments that are either equity type of investments and subject to equity price risk, or bonds, mortgages or cash deposits, the values of which are subject to interest rate risk. The amount of risk borne by the Company's shareholders depends on the extent to which its customers share the investment risk through the structure of the Company's products.

The split of the Company's investments between equity investments and interest-sensitive instruments depends principally on the type of liabilities supported by those investments and the amount of capital the Company has available. This mix of liabilities allows the Company to invest a substantial portion of its investment funds in equity and property investments that the Company believes produce greater returns over the long term. On the other hand the Company has some liabilities that contain guaranteed returns which generally will be supported by fixed income investments.

Credit risk

Credit risk is the risk of loss to the Company if another party fails to perform its obligations, or fails to perform them in a timely manner. The Company's long-term fund holds large amounts of interest-sensitive investments that contain credit risk on which a certain level of defaults is expected. These expected losses are considered when the Company determines the crediting rates, deposit rates and premium rates for the products that will be supported by these assets. Certain over-the-counter derivatives contain a credit risk element that is controlled through evaluation of collateral agreements and master netting agreements on interest rate and currency swaps. The Company is also exposed to credit-related losses in the event of non-performance by counterparties.

Liquidity risk

Liquidity risk is the risk that the Company may be unable to meet payment of obligations in a timely manner at a reasonable cost or the risk of unexpected increases in the cost of funding the portfolio at appropriate maturities or rates. Liquidity management in the Company seeks to ensure that, even under adverse conditions, the Company has access to the funds necessary to cover surrenders, withdrawals and maturing liabilities.

In practice, most of the Company's assets are marketable securities. This, combined with the fact that a large proportion of the liabilities contain discretionary surrender values or surrender charges, reduces the liquidity risk.

35. Capital Requirements and Management

Regulatory capital requirements apply at both an individual company level and at the Prudential Group level, of which the Company is a part, for life assurance and investment management business. The Prudential Group is currently subject to the solvency requirements of the Insurance Groups Directive (IGD) as implemented by the FSA. Under the IGD a parent company continuous solvency test is applied. Under this test the surplus unrestricted capital held in each of the regulated subsidiaries, including the Company, is aggregated with the free assets of non-regulated subsidiaries. From this total, Prudential Group borrowings are deducted, other than subordinated debt issues which qualify as capital.

In addition to obligations under subsidiary and Prudential Group regulatory requirements, the Prudential Group applies an economic framework to its management of capital. Economic capital provides a realistic and consistent view of the Group's capital requirements, allowing for diversification benefits.

At the Company level, the FSA rules which govern the prudential regulation of insurance form part of the Prudential Sourcebook for Insurers, the General Prudential Sourcebook and Interim Prudential Sourcebook for Insurers. Overall, the net requirements of the General Prudential Sourcebook are intended to align the capital adequacy requirements for insurance business more closely with those of banking and investment firms and building societies, for example, by addressing tiers of capital, rather

Notes on the financial statements (continued)

than looking at net admissible assets. An insurer must hold capital resources equal at least to the Minimum Capital Requirement (MCR).

The Prudential Sourcebook for Insurers also contains rules on Individual Capital Assessments. Under these rules and the rules of the General Prudential Sourcebook all insurers must assess for themselves the amount of capital needed to back their business. If the FSA views the results of this assessment as insufficient, it may draw up its own Individual Capital Guidance for a firm, which can be superimposed as a requirement.

With-Profits Sub-Fund, SAIF and Defined Charge Participating Sub-Fund

Under FSA rules, insurers with with-profits liabilities of more than £500m must hold capital equal to the higher of the MCR and the Enhanced Capital Requirement (the "ECR"). The ECR is intended to provide a more risk responsive and "realistic" measure of a with-profit insurers capital requirements, whereas the MCR is broadly speaking equivalent to the previous required minimum margin under the Interim Prudential Sourcebook and satisfies the minimum EU Standards.

Determination of the ECR involves the comparison of two separate measurements of the firm's resources requirement, which the FSA refers to as the "twin peaks" approach. The two separate peaks are:

- (i) the requirement comprised by the mathematical reserves plus the "Long-Term Insurance Capital Requirement" (the "LTICR"), together known as the "regulatory peak"; and
- (ii) a calculation of the "realistic" present value of the insurer's expected future contractual liabilities together with projected "fair" discretionary bonuses to policyholders, plus a risk capital margin, together known as the "realistic peak".

Available capital of the WPSF and SAIF and DCPSF of £6.7bn (2009: £6.4bn) represents the excess of assets over liabilities on the FSA realistic basis. Unlike the previously discussed FRS 27 basis, realistic liabilities on the regulatory basis include the shareholders' share of future bonuses. These amounts are shown before deduction of the risk capital margin (RCM) which is £1.6bn (2009: £1.5bn) at 31 December 2010.

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

The Company has discretion in its management actions in the case of adverse investment conditions. Management actions encompass, but are not confined to, investment allocation decisions, levels of reversionary bonuses, crediting rates and total claim values. To illustrate the flexibility of management actions, rates of regular bonus are determined for each type of policy primarily by targeting them at a prudent proportion of the long-term expected future investment return on the underlying assets. The expected future investment return is reduced as appropriate for each type of policy to allow for items such as expenses, charges, tax and shareholders' transfers. However, the rates declared may differ by product type, or by date of payment of the premiums or date of issue of the policy, if the accumulated annual bonuses are particularly high or low relative to a prudent proportion of the achieved investment return.

When target bonus levels change, the Company's board has regard to the overall financial strength of the long-term fund when determining the length of time over which it will seek to achieve the amended product target bonus level.

In normal investment conditions, the Company expects changes to regular bonus rates to be gradual over time and changes are not expected to exceed one per cent per annum over any year. However, discretion is retained as to whether or not a regular bonus is declared each year, and there is no limit on the amount by which regular bonus rates can be changed.

As regards smoothing of maturity and death benefits, in normal circumstances the Company does not expect most pay-out values on policies of the same duration to change by more than 10 per cent up or down from one year to the next, although some larger changes may occur to balance pay-out values between different policies. Greater flexibility may be required in certain circumstances, for example following a significant rise or fall in market values (either sudden or over a period of years) and in such

THE PRUDENTIAL ASSURANCE COMPANY LIMITED

Notes on the financial statements (continued)

situations the Company's board may decide to vary the standard bonus smoothing limits to protect the overall interests of policyholders.

For surrender benefits, any substantial fall in the market value of the assets of the with-profits sub-fund would lead to immediate changes in the application of MVRs for accumulating with-profits policies, firstly to increase the size of MVRs already being applied and, secondly, to extend the range of policies for which an MVR is applied.

Non-Profit Sub-Fund

The available capital of £140m (2009: £119m) reflects the excess of regulatory basis assets over liabilities of the Company. The regulatory capital resources requirement of £366m (2009: £342m) is covered in part (as is permitted by the FSA Regulations) by assets in the shareholder funds. The available capital and capital resources requirement is monitored during the year. In addition, a realistic assessment of available capital and capital requirements sufficient to cover a 1 in 200 year event is undertaken. Additional capital is sought from the parent company as necessary.

The capital requirement required by regulation was maintained during the year.

The Company's capital position for life assurance businesses with reconciliations to shareholders' funds is shown below. Available capital for each fund is determined by reference to the FSA regulations at 31 December 2010 and 2009.

31 December 2010							
	SAIF £m	WPSF and DCPSF £m	Total with- profits fund £m	Non-profit sub-fund £m	Total life assurance £m	Shareholders' funds £m	Company total £m
Shareholders' funds							
Held outside long-term funds							
Net assets						3,082	3,082
Goodwill							
Total						3,082	3,082
Held in long-term funds (note i)				528	528		528
Total shareholders' funds				528	528	3,082	3,610
Adjustments to regulatory basis							
Funds for future appropriation (note ii)		10,395	10,395		10,395		
Shareholders' share of realistic liabilities		(2,938)	(2,938)		(2,938)		
Deferred acquisition costs of non-participating business and intangible assets (distribution rights and licence) not recognised for regulatory reporting purposes		(100)	(100)	(297)	(397)		
Adjustment from FRS17 basis pension surplus attributable to WPSF to pension liability for regulatory purposes		(89)	(89)		(89)		
Valuation difference on PAL between UKGAAP basis and regulatory basis		(1,202)	(1,202)		(1,202)		
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) (note iii)		609	609	(91)	518		
Total adjustments		6,675	6,675	(388)	6,287		
Total available capital resources of life assurance businesses on FSA regulatory bases		6,675	6,675	140	6,815		

Notes on the financial statements (continued)

31 December 2009							
	SAIF £m	WPSF and DCPSF £m	Total with- profits fund £m	Non-profit sub- fund £m	Total life assurance £m	Shareholders' funds £m	Company total £m
Shareholders' funds							
Held outside long-term funds:							
Net assets	-	-	-	-	-	3,075	3,075
Goodwill	-	-	-	-	-	-	-
Total						3,075	3,075
Held in long-term funds (note i)				624	624	-	624
Total shareholders' funds				624	624	3,075	3,699
Adjustments to regulatory basis							
Funds for future appropriation (note ii)		10,330	10,330	-	10,330		
Shareholders' share of realistic liabilities		(3,001)	(3,001)		(3,001)		
Deferred acquisition costs of non-participating business and intangible assets (distribution rights and licence) not recognised for regulatory reporting purposes	(2)	(95)	(97)	(294)	(391)		
Adjustment from FRS17 basis pension surplus attributable to WPSF to pension liability for regulatory purposes		(91)	(91)		(91)		
Valuation difference on PAL between UKGAAP basis and regulatory basis		(1,294)	(1,294)		(1,294)		
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) (note iii)	2	592	594	(211)	383		
Total adjustments		6,441	6,441	(505)	5,936		
Total available capital resources of life assurance businesses on FSA regulatory bases		6,441	6,441	119	6,560		

Notes

- (i) The term shareholders' funds held in long-term funds refers to the excess of assets over liabilities attributable to shareholders of funds which are required by law to be maintained with segregated assets and liabilities.
- (ii) Other adjustments to shareholders' funds and funds for future appropriation include amounts for the value of non-participating business for with-profits funds, deferred tax, admissibility and other items measured differently on the regulatory basis.
- (iii) Insurance business accounted for as financial instruments under FRS26.

36. Litigation

The Company is currently awaiting the decision of the English High Court in a case that was heard in early 2011 involving PSPS. This case relates to the defined benefit section of PSPS and was heard at the request of the trustees of the scheme who are seeking to clarify the Company's obligations relating to discretionary pension increases.

In the event that the English High Court decides that the obligations relating to discretionary pension increases are greater than the Company currently believes, the assumptions applied for FRS 17 reporting purposes, and therefore the level of surplus of the Scheme may be affected. The Court decision might also affect the level of future deficit funding agreed concurrently with the next actuarial valuation as at 5 April 2011.

Notes on the financial statements (continued)

The impact of such changes on the deficit funding obligations of the Company's with-profits fund would be determined in the context of the pre-existing features applicable to the PSPS scheme described below:

- (i) although underlying surpluses of the scheme are recognised only to the extent of the amount which is recoverable through reduced future contributions for FRS 17 accounting purposes, the surplus determined on the actuarial valuation basis would be considered in the context of setting altered levels of future deficit funding, and
- (ii) the allocation of any such altered future deficit funding between the Company's with-profits fund and Prudential plc would be in a 70/30 ratio. This ratio was determined following detailed consideration in 2005 of the source of previous contributions and has been applied from then when deficit funding has been required.

Additional details on PSPS and these features are included in note 12.

Consistent with the Company's expectations as to the decision of the Court, no amount has been provided in the 2010 financial statements for this item in respect of the Company's with-profits fund.

The Company is, and in the future may be, subject to legal actions and disputes in the ordinary course of its business. Whilst the outcome of such matters cannot be predicted with certainty, the directors believe that the ultimate outcome of such litigation will not have a material adverse effect on the Company's financial condition and results.

