A: BACKGROUND AND ACCOUNTING POLICIES

A1: NATURE OF OPERATIONS

Prudential plc (the Company) together with its subsidiaries (collectively, the Group or Prudential) is an international financial services group with its principal operations in the UK, the US and Asia. The Group operates in the UK through its subsidiaries, primarily The Prudential Assurance Company Limited (PAC), Prudential Annuities Limited (PAL), Prudential Retirement Income Limited (PRIL) and M&G Investment Management Limited.

In the US, the Group's principal subsidiary is Jackson National Life Insurance Company (Jackson). The Group also has operations in Hong Kong, Malaysia, Singapore, Indonesia and other Asian countries.

Prudential offers a wide range of retail financial products and services and asset management services throughout these territories. The retail financial products and services principally include life insurance, pensions and annuities as well as collective investment schemes.

Long-term business products written in the UK and Asia are principally with-profits deposit administration, other conventional and unitised with-profits policies and non-participating pension annuities in the course of payment. Long-term business also includes linked business written in the UK and Asia. In Asia these policies are usually sold with insurance riders, such as health cover. The principal products written by Jackson are interest-sensitive deferred annuities and whole-life policies, variable annuities, guaranteed investment contracts, fixed index deferred annuities and term life insurance.

Prudential plc is a public limited company incorporated and registered in England and Wales. The registered office is:

Laurence Pountney Hill
London
EC4R 0HH
Registered number: 1397169

A2: BASIS OF PREPARATION

The consolidated financial statements consolidate the Group and the Group's interest in associates and jointly-controlled entities. The parent company financial statements present information about the Company as a separate entity and not about the Group.

The consolidated financial statements have been prepared and approved by the directors in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) and as endorsed by the European Union (EU) as required by EU law (IAS regulation EC 1606/2032). The Company has elected to prepare its parent company financial statements in accordance with UK Generally Accepted Accounting Practice (GAAP). These are presented on pages 375 to 386. A reconciliation to IFRS has also been provided for shareholders' equity and profit for the year of the parent company.

The Group has applied all IFRS standards and interpretations adopted by the EU that are effective for financial years commencing on or before 1 January 2010. Further details on the new accounting pronouncements and accounting policy changes are provided in note A5.

The Group has applied the same accounting policies in preparing the 2010 results as for 2009 except for the adoption of IFRS 3 (Revised) on business combinations and associated amendments to other standards. However, as discussed in note A4 (d)(ii), the measurement of the segment measure of IFRS operating profit based on longer-term investment returns for US insurance operations has altered. Comparative segment results have been adjusted accordingly.

A3: CRITICAL ACCOUNTING POLICIES, ESTIMATES AND JUDGEMENTS

a Critical accounting policies

Prudential's discussion and analysis of its financial condition and results of operations are based upon Prudential's consolidated financial statements, which have been prepared in accordance with IFRS as issued by the IASB and as endorsed by the EU. EU-endorsed IFRS may differ from IFRS as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. As at 31 December 2010, there were no unendorsed standards effective for the two years ended 31 December 2010 affecting the consolidated financial information of Prudential and there were no differences between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to Prudential. Accordingly, Prudential's financial information for the two years ended 31 December 2010 is prepared in accordance with IFRS as issued by the IASB. It is Prudential's policy to adopt mandatory requirements of new or altered EU-adopted IFRS standards where required, with earlier adoption applied where permitted and appropriate in the circumstances.

The preparation of these financial statements requires Prudential to make estimates and judgements that affect the reported amounts of assets, liabilities, and revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, Prudential evaluates its estimates, including those related to long-term business provisioning, the fair value of assets and the declaration of bonus rates. Prudential bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgements about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgements and uncertainties, and potentially give rise to different results under different assumptions and conditions. Prudential believes that its critical accounting policies are limited to those described below.

The critical accounting policies in respect of the items discussed below are critical for the Group's results insofar as they relate to the Group's shareholder-financed business. In particular this applies for Jackson which is the largest shareholder-backed business in the Group. The policies are not critical in respect of the Group's with-profits business. This distinction reflects the basis of recognition of profit and accounting treatment of unallocated surplus of with-profits funds as a liability. Additional explanation is provided later in this note and cross-referenced notes as to why the distinction between with-profits business and shareholder-backed business is relevant.

The items discussed below and in cross-referenced notes explain the effect of changes in estimates and the effect of reasonably likely changes in the key assumptions underlying these estimates as of the latest statement of financial position date so as to provide analysis that recognises the different accounting effects on profit and loss or equity. In order to provide relevant analysis that is appropriate to the circumstances applicable to the Group's businesses, the explanations refer to types of business, fund structure, the relationship between asset and policyholder liability measurement, and the differences in the method of accounting permitted under IFRS 4 for accounting for insurance contract assets, policyholder liabilities and unallocated surplus of the Group's with-profits funds.

Insurance contract accounting

With the exception of certain contracts described in note D1, the contracts issued by the Group's life assurance business are classified as insurance contracts and investment contracts with discretionary participating features. As permitted by IFRS 4, assets and liabilities of these contracts are accounted for under previously applied GAAP. Accordingly, except as described below, the modified statutory basis (MSB) of reporting as set out in the revised Statement of Recommended Practice (SORP) issued by the Association of British Insurers (ABI) has been applied.

In 2005 the Group chose to improve its IFRS accounting for UK regulated with-profits funds by the voluntary application of the UK accounting standard FRS 27, 'Life Assurance'. Under this standard, the main accounting changes that were required for UK with-profits funds were:

- derecognition of deferred acquisition costs and related deferred tax; and
- replacement of MSB liabilities with adjusted realistic basis liabilities.

The results included in the financial statements for 2010 and 2009 reflect this basis.

Unallocated surplus represents the excess of assets over policyholder liabilities for the Group's with-profits funds that have yet to be appropriated between policyholders and shareholders. The Group has opted to account for unallocated surplus wholly as a liability with no allocation to equity. This treatment reflects the fact that shareholders' participation in the cost of bonuses arises only on distribution. Shareholder profits on with-profits business reflect one-ninth of the cost of declared bonus.

For Jackson, applying the MSB as applicable to overseas operations which permits the application of local GAAP in some circumstances, the assets and liabilities of insurance contracts are accounted for under insurance accounting prescribed by US GAAP. For the assets and liabilities of insurance contracts of Asian operations, the local GAAP is applied with adjustments, where necessary, to comply with UK GAAP. For the operations in Taiwan, Vietnam and Japan, countries where local GAAP is not appropriate in the context of the previously applied MSB, accounting for insurance contracts is based on US GAAP. For participating business the liabilities include provisions for the policyholders' interest in realised investment gains and other surpluses that, where appropriate, and in particular for Vietnam, have yet to be declared as bonuses.

The usage of these bases of accounting has varying effects on the way in which product options and guarantees are measured. For UK regulated with-profits funds, options and guarantees are valued on a market consistent basis. The basis is described in note D2(g)(ii). For other operations a market consistent basis is not applied under the accounting basis described in note A4. Details of the guarantees, basis of setting assumptions, and sensitivity to altered assumptions are described in notes D3 and D4.

Valuation and accounting presentation of fair value movements of derivatives and debt securities of Jackson

Under IAS 39, derivatives are required to be carried at fair value. Unless net investment hedge accounting is applied, value movements on derivatives are recognised in the income statement. As previously discussed the Group has chosen to change its presentation of operating profit for its US insurance operations as explained further in note A4(d)(ii). Derivative value movements in respect of equity risk within variable annuity business and other equity related hedging activities are now included outside operating profit as part of short-term fluctuations in investment returns. Accordingly, the value movements on all derivatives held by Jackson are separately identified within the short-term fluctuations in investment returns identified as part of the Group's segment results described below and in note B1.

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A3: CRITICAL ACCOUNTING POLICIES, ESTIMATES AND JUDGEMENTS > CONTINUED

For derivative instruments of Jackson, the Group has considered whether it is appropriate to undertake the necessary operational changes to qualify for hedge accounting so as to achieve matching of value movements in hedging instruments and hedged items in the performance statements. In reaching the decision a number of factors were particularly relevant. These were:

- IAS 39 hedging criteria have been designed primarily in the context of hedging and hedging instruments that are assessable as financial instruments that are either stand-alone or separable from host contracts, rather than, for example, duration characteristics of insurance contracts;
- the high hurdle levels under IAS 39 of ensuring hedge effectiveness at the level of individual hedge transactions;
- the difficulties in applying the macro hedge provisions under IAS 39 (which are more suited to banking arrangements) to Jackson's derivative book;
- the complexity of asset and liability matching of US life insurers such as those with Jackson's product range; and finally
- whether it is possible or desirable, without an unacceptable level of costs and constraint on commercial activity, to achieve the accounting hedge effectiveness required under IAS 39.

Taking account of these considerations the Group has decided that, except for certain minor categories of derivatives, it is not appropriate to seek to achieve hedge accounting under IAS 39. As a result of this decision the total income statement results are more volatile as the movements in the value of Jackson's derivatives are reflected within it.

Under IAS 39, unless carried at amortised cost (subject to impairment provisions where appropriate) under the held-to-maturity category, debt securities are also carried at fair value. The Group has chosen not to classify any financial assets as held-to-maturity. Debt securities of Jackson are designated as available-for-sale with value movements, unless impaired, being recorded as movements within other comprehensive income. Impairments are recorded in the income statement.

Presentation of results before tax

The total tax charge for the Group reflects tax that in addition to relating to shareholders' profits is also attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies. This is explained in more detail in note F5. However, pre-tax profits are determined after transfers to or from unallocated surplus of with-profits funds. These transfers are in turn determined after taking account of tax borne by with-profits funds. Consequently reported profit before the total tax charge is not representative of pre-tax profits attributable to shareholders. In order to provide a measure of pre-tax profits attributable to shareholders the Group has chosen to adopt an income statement presentation of the tax charge and pre-tax results that distinguishes between policyholder and shareholder components.

Segmental analysis of results and earnings attributable to shareholders

The Group uses operating profit based on longer-term investment returns as the segmental measure of its results. The basis of calculation is disclosed in note A4(d).

For shareholder-backed business, with the exception of debt securities held by Jackson and assets classified as loans and receivables, all financial investments and investment property are designated as assets at fair value through profit and loss. Short-term fluctuations in investment returns on such assets held by with-profits funds, do not affect directly reported shareholder results. This is because (i) the unallocated surplus of with-profits funds is accounted for as liabilities and (ii) excess or deficits of income and expenditure of the funds over the required surplus for distribution are transferred to or from unallocated surplus. However, for shareholder-backed businesses the short-term fluctuations affect the result for the year and the Group provides additional analysis of results to provide information on results before and after short-term fluctuations in investment returns.

b Critical accounting estimates and judgements

Investments

Determining the fair value of financial investments when the markets are not active

The Group holds certain financial investments for which the markets are not active. These can include financial investments which are not quoted on active markets and financial investments for which markets are no longer active as a result of market conditions e.g. market illiquidity. When the markets are not active, there is generally no or limited observable market data to account for financial investments at fair value. The determination of whether an active market exists for a financial investment requires management's judgement.

If the market for a financial investment of the Group is not active, the fair value is determined by using valuation techniques. The Group establishes fair value for these financial investments by using quotations from independent third-parties, such as brokers or pricing services or by using internally developed pricing models. Priority is given to publicly available prices from independent sources when available, but overall the source of pricing and/or the valuation technique 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 valuation techniques include the use of 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 and may include a number of assumptions relating to 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 financial investments.

The financial investments measured at fair value are classified into the following three level hierarchy on the basis of the lowest level of inputs that is significant to the fair value measurement of the financial investment concerned:

Level 1: Quoted prices (unadjusted) in active markets for identical assets and liabilities

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

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

At 31 December 2010, £4,573 million (2009: £5,557 million) of the financial investments (net of derivative liabilities) valued at fair value were classified as level 3. Of these £866 million (2009: £1,684 million) are held to back shareholder non-linked business and so changes to these valuations will directly impact shareholders' equity. Further details of the classification of financial instruments are given in note G1.

Determining impairments relating to financial assets

Available-for-sale securities

Financial investments carried on an available-for-sale basis are represented by Jackson's debt securities portfolio. The consideration of evidence of impairment requires management's judgement. In making this determination the factors considered include, for example:

- Whether the decline of the financial investment's fair value is substantial.
  A substantial decline in fair value might be indicative of a credit loss event that would lead to a measurable decrease in the estimated future cash flows.
- The impact of the duration of the security on the calculation of the revised estimated cash flows.
- The duration of a security for maturity helps to inform whether assessments of estimated future cash flows that are higher than market value are reasonable.
- The duration and extent to which the amortised cost exceeds fair value.
  This factor provides an indication of how the contractual cash flows and effective interest rate of a financial asset compares with the implicit market estimate of cash flows and the risk attaching to a 'fair value' measurement. The length of time for which that level of difference has been in place may also provide further evidence as to whether the market assessment implies an impairment loss has arisen.
- The financial condition and prospects of the issuer or other observable conditions that indicate the investment may be impaired.
  If a loss event that will have a detrimental effect on cash flows is identified an impairment loss in the income statement is recognised. The loss recognised is determined as the difference between the book cost and the fair value of the relevant impaired securities. This loss comprises the effect of the expected loss of contractual cash flows and any additional market-price-driven temporary reductions in values.

For Jackson's residential mortgage-backed and other asset-backed securities, all of which are classified as available-for-sale, the model used to analyse cash flows, begins with the current delinquency experience of the underlying collateral pool for the structure, by applying assumptions about how much of the currently delinquent loans will eventually default, and multiplying this by an assumed loss severity. Additional factors are applied to anticipate ageing effect. After applying a cash flow simulation an indication is obtained as to whether or not the security has suffered, or is anticipated to suffer, contractual principal or interest payment shortfall. If a shortfall applies an impairment charge is recorded. The difference between the fair value and book cost for unimpaired securities accounted for as available-for-sale, is accounted for as unrealised gains or losses, with the movements in the accounting period being accounted for in other comprehensive income.

The Group's review of fair value involves several criteria, including economic conditions, credit loss experience, other issuer-specific developments and future cash flows. These assessments are based on the best available information at the time. Factors such as market liquidity, the widening of bid/ask spreads and a change in cash flow assumptions can contribute to future price volatility. If actual experience differs negatively from the assumptions and other considerations used in the consolidated financial statements, unrealised losses currently in equity may be recognised in the income statement in future periods. The preceding note in this section provides explanation on how fair value is determined when the markets for the financial investments are not active. Further, additional details on the impairments of the available-for-sale securities of Jackson are described in notes D3 and G5.

Assets held at amortised cost

Financial assets classified as loans and receivables under IAS 39 are carried at amortised cost using the effective interest rate method. Certain mortgage loans of the UK insurance operations 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 loans and receivables include loans collateralised by mortgages, deposits and loans to policyholders. In estimating future cash flows, the Group looks at the expected cash flows of the assets and applies historical loss experience of assets with similar credit risks that has been adjusted for conditions in the historical loss experience which no longer exist or for conditions that are expected to arise. The estimated future cash flows are discounted using the financial asset's original or variable effective interest rate and exclude credit losses that have not yet been incurred.

The risks inherent in reviewing the impairment of any investment include the risk that market results may differ from expectations; facts and circumstances may change in the future and differ from estimates and assumptions; or the Group may later decide to sell the asset as a result of changed circumstances.

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A3: CRITICAL ACCOUNTING POLICIES, ESTIMATES AND JUDGEMENTS > CONTINUED

Insurance contracts

Product classification

IFRS 4 requires contracts written by insurers to be classified as either 'insurance contracts' or 'investment contracts' depending on the level of insurance risk transferred. Insurance risk is a pre-existing risk, other than financial risk, transferred from the contract holder to the contract issuer. If significant insurance risk is transferred by the contract then it is classified as an insurance contract. Contracts that transfer financial risk but not significant insurance risk are termed investment contracts. Furthermore, some contracts, both insurance and investment, contain discretionary participating features representing the contractual right to receive additional benefits as a supplement to guaranteed benefits:

a that are likely to be a significant portion of the total contract benefits;
b whose amount or timing is contractually at the discretion of the insurer; and
c that are contractually based on asset or fund performance, as discussed in IFRS 4.

Accordingly, insurers must perform a product classification exercise across their portfolio of contracts issued to determine the allocation to these various categories. IFRS 4 permits the continued usage of previously applied GAAP for insurance contracts and investment contracts with discretionary participating features. Except for UK regulated with-profits funds, as described subsequently, this basis has been applied by the Group.

For investment contracts that do not contain discretionary participating features, IAS 39 and, where the contract includes an investment management element, IAS 18, apply measurement principles to assets and liabilities attaching to the contract.

Valuation assumptions

i Contracts of with-profits funds

The Group's insurance contracts and investment contracts with discretionary participating features are primarily with-profits and other protection type policies. For UK regulated with-profits funds, the contract liabilities are valued by reference to the UK Financial Services Authority's (FSA) realistic basis. In aggregate, this basis has the effect of placing a value on the liabilities of UK with-profits contracts, which reflects the amounts expected to be paid based on the current value of investments held by the with-profits funds and current circumstances.

The basis of determining liabilities for the Group's with-profits business has little or no effect on the results attributable to shareholders. This is because movements on liabilities of the with-profits funds are absorbed by the unallocated surplus. Except through indirect effects, or in remote circumstances as described below, changes to liability assumptions are therefore reflected in the carrying value of the unallocated surplus, which is accounted for as a liability rather than shareholders' equity. A detailed explanation of the basis of liability measurement is contained in note D2(g)(ii).

The Group's other with-profits contracts are written in with-profits funds that operate in some of the Group's Asian operations. The liabilities for these contracts and those of Prudential Annuities Limited, which is a subsidiary company of the PAC with-profits funds, are determined differently. For these contracts the liabilities are estimated using actuarial methods based on assumptions relating to premiums, interest rates, investment returns, expenses, mortality and surrenders. The assumptions to which the estimation of these reserves is particularly sensitive are: the interest rate used to discount the provision and the assumed future mortality experience of policyholders.

For liabilities determined using the basis described above for UK regulated with-profits funds, and the other liabilities described in the preceding paragraph, changes in estimates arising from the likely range of possible changes in underlying key assumptions have no direct impact on the reported profit.

This lack of sensitivity reflects the with-profits fund structure, basis of distribution, and the application of previous GAAP to the unallocated surplus of with-profits funds as permitted by IFRS 4. Changes in liabilities of these contracts that are caused by altered estimates are absorbed by the unallocated surplus of the with-profits funds with no direct effect on shareholders' equity. The Company's obligations and more detail on such circumstances are described in note H14.

ii Other contracts

Contracts, other than those of with-profits funds, are written in shareholder-backed operations of the Group. The significant shareholder-backed product groupings and the factors that may significantly affect IFRS results due to experience against assumptions or changes of assumptions vary significantly between business units. For some types of business the effect of changes in assumptions may be significant, whilst for others, due to the nature of the product, assumption setting may be of less significance. The nature of the products and the significance of assumptions are discussed in notes D2, D3 and D4. From the perspective of shareholder results the key sensitivity relates to the assumption for allowance for credit risk for UK annuity business.

Jackson

Jackson offers individual fixed annuities, fixed index annuities, immediate annuities, variable annuities, individual and variable life insurance and institutional products. With the exception of institutional products and an incidental amount of business for annuity certain contracts, which are accounted for as investment contracts under IAS 39, all of Jackson's contracts are accounted for under IFRS 4 as insurance contracts by applying US GAAP, the previous GAAP used before IFRS adoption. The accounting requirements under these standards and the effect of changes in valuation assumptions are considered below for fixed annuity, variable annuity and traditional life insurance contracts.

Fixed annuity contracts, which are investment contracts under US GAAP terminology, are accounted for by applying in the first instance a retrospective deposit method to determine the liability for policyholder benefits. This is then augmented by potentially three additional amounts, namely deferred income, any amounts previously assessed against policyholders that are refundable on termination of the contract, and any premium deficiency, i.e., any probable future loss on the contract. These types of contracts contain considerable interest rate guarantee features. Notwithstanding the accompanying market risk exposure, except in the circumstances of interest rate scenarios where the guarantee rates included in contract terms are higher than crediting rates that can be supported from assets held to cover liabilities, the accounting measurement of Jackson's fixed annuity products is not generally sensitive to interest rate risk. This position derives from the nature of the products and the US GAAP basis of measurement.

Variable annuity contracts written by Jackson may provide for guaranteed minimum death, income, or withdrawal benefit features. In general terms, liabilities for these benefits are accounted for under US GAAP by using estimates of future benefits and fees under best estimate assumptions. For variable annuity business the key assumption is the expected long-term level of equity market returns, which for 2010 and 2009 was 8.4 per cent per annum (after deduction of external fund management fees) determined using a mean reversion methodology. Under the mean reversion methodology, projected returns over the next five years are flexed (subject to capping) so that, combined with the actual rates of return for the current and the previous two years the 8.4 per cent rate is maintained. The projected rates of return are capped at no more than 15 per cent for each of the next five years. Further details are explained in note D3(g).

These returns affect the level of future expected profits through their effects on the fee income with consequential impact on the amortisation of deferred acquisition costs as described below and the required level of provision for guaranteed minimum death benefit claims.

For traditional life insurance contracts, provisions for future policy benefits are determined using the net level premium method and assumptions as of the issue date as to mortality, interest, policy lapses and expenses plus provisions for adverse deviation.

Except to the extent of mortality experience, which primarily affects profits through variations in claim payments and the guaranteed minimum death benefit reserves, the profits of Jackson are relatively insensitive to changes in insurance risk. This reflects the principally spread and fee-based nature of Jackson's business.

Asian operations

The insurance products written in the Group's Asian operations principally cover with-profits business, unit-linked business, and other non-participating business. The results of with-profits business are relatively insensitive to changes in estimates and assumptions that affect the measurement of policyholder liabilities. As for the UK business, this feature arises because unallocated surplus is accounted for by the Group as a liability. The results of Asian unit-linked business are also relatively insensitive to changes in estimates or assumptions.

The remaining non-participating business in Asia has some limited sensitivity to interest rates. Further details are provided in D4(j).

Deferred acquisition costs

Significant costs are incurred in connection with acquiring new insurance business. Except for acquisition costs of with-profits contracts of the UK regulated with-profits funds, which are accounted for under the realistic FSA regime as described in note A4, these costs, which vary with, and are primarily related to, the production of new business, are capitalised and amortised against margins in future revenues on the related insurance policies. The recoverability of the asset is measured and the asset is deemed impaired if the projected future margins are less than the carrying value of the asset. To the extent that the future margins differ from those anticipated, then an adjustment to the carrying value of the deferred acquisition cost asset will be necessary.

The deferral and amortisation of acquisition costs is of most relevance to the Group's results for shareholder-financed long-term business of Jackson and Asian operations. The majority of the UK shareholder-backed business is for individual and group annuity business where the incidence of acquisition costs is negligible.

Jackson

For term business, acquisition costs are deferred and amortised in line with expected premiums. For annuity business, acquisition costs are deferred and amortised in line with expected gross profits on the relevant contracts. For interest-sensitive business, the key assumption is the long-term spread between the earned rate and the rate credited to policyholders, which is based on the annual spread analysis. In addition, expected gross profits depend on mortality assumptions, assumed unit costs and terminations other than deaths (including the related charges), all of which are based on a combination of Jackson's actual industry experience and future expectations. A detailed analysis of actual experience is measured by internally developed mortality studies.

For variable annuity business, the key assumption is the expected long-term level of equity market returns as described above.

The level of acquisition costs carried in the statement of financial position is also sensitive to unrealised valuation movements on debt securities held to back the liabilities and solvency capital. Further details are explained in notes D3(g) and H1.

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A3: CRITICAL ACCOUNTING POLICIES, ESTIMATES AND JUDGEMENTS > CONTINUED

Asian operations
For those territories applying US GAAP, principles similar to those set out in the Jackson paragraph above are applied to the deferral and amortisation of acquisition costs. For other Asian territories, except where the underlying reserving basis makes implicit allowance for the future fees that cover acquisition costs, the deferral and amortisation of acquisition costs is consistent with Modified Statutory Basis where costs associated with the production of new business are amortised in line with the emergence of margins.

Pensions
The Group applies the requirements of IAS 19, 'Employee benefits' and associated interpretations including IFRIC 14 'IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction', to its defined benefit pension schemes. The principal defined benefit pension scheme is the Prudential Staff Pension Scheme (PSPS). For PSPS the terms of the trust deed restrict shareholders' access to any underlying surplus. Accordingly, applying the interpretation of IFRIC 14, any underlying IAS 19 basis surplus is not recognised for IFRS reporting. The financial position for PSPS recorded in the IFRS financial statements reflects the higher of any underlying IAS 19 deficit and any obligation for deficit funding.

The economic participation in the surplus or deficits attaching to the PSPS and the smaller Scottish Amicable Pensions Scheme (SAPS) are shared between the PAC with-profits sub-fund (WPSF) and shareholder operations. The economic interest reflects the source of contributions over the scheme life, which in turn reflects the activity of the members during their employment.

In the case of PSPS, movements in the apportionment of the financial position for PSPS between the WPSF and shareholders' funds in 2010 reflect the 70/30 ratio applied to the base deficit position as at 31 December 2005 but with service cost and contributions for ongoing service apportioned by reference to the cost allocation for activity of current employees. For SAPS the ratio is estimated to be approximately 50/50 between the WPSF and shareholders' funds.

Due to the inclusion of actuarial gains and losses in the income statement rather than being recognised in other comprehensive income, the results of the Group are affected by changes in interest rates for corporate bonds that affect the rate applied to discount projected pension payments, changes in mortality assumptions and changes in inflation assumptions.

Deferred tax
Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all the available evidence, it can be regarded as more likely than not that there will be suitable taxable profits against which the losses can be relieved. The taxation regimes applicable across the Group apply separate rules to trading and capital profits and losses. The distinction between temporary differences that arise from items of either a capital or trading nature may affect the recognition of deferred tax assets. The judgements made, and uncertainties considered, in arriving at deferred tax balances in the financial statements are discussed in note H4.

Goodwill
Goodwill impairment testing requires the exercise of judgement by management as to prospective future cash flows. Further information is disclosed in note H1.

A4: SIGNIFICANT ACCOUNTING POLICIES

a Financial instruments other than financial instruments classified as long-term business contracts
Investment classification
Under IAS 39, subject to specific criteria, financial instruments should be accounted for under one of the following categories: 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. Upon initial recognition, financial investments are measured at fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. These IAS 39 classifications have been changed by IFRS 9 'Financial Investments: Classification and Measurement' which is not required to be adopted until 2013 and is still subject to EU endorsement. This standard has not been adopted by the Group in 2010. The Group holds financial investments on the following bases:

i Financial assets and liabilities at fair value through profit and loss – this comprises assets and liabilities designated by management as fair value through profit and loss on inception and derivatives that are held for trading. These investments are measured at fair value with all changes thereon being recognised in investment income.

ii Financial investments on an available-for-sale basis – this comprises assets that are designated by management and/or do not fall into any of the other categories. Available-for-sale financial assets are initially recognised at fair value plus attributable transaction costs. For available-for-sale debt securities, the difference between their cost and par value is amortised to the income statement using the effective interest rate. Available-for-sale financial assets are subsequently measured at fair value. Interest income is recognised on an effective interest basis in the income statement. Except for foreign exchange gains and losses on debt securities, not in functional currency, which are included in the income statement, unrealised gains and losses are recognised in other comprehensive income (i.e. outside of the income statement). Upon disposal or impairment, accumulated unrealised gains and losses are transferred from other comprehensive income to the income statement as realised gains or losses.

iii Loans and receivables – this comprises non-quoted 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 collateralised by mortgages, deposits, loans to policyholders and other unsecured loans and receivables. These investments are initially recognised at fair value plus transaction costs. Subsequently, these investments are carried at amortised cost using the effective interest method.

As permitted under IAS 39 the Group has designated certain financial assets as fair value through profit and loss as these assets are managed and their performance is evaluated on a fair value basis. These assets represent all of the Group's financial assets other than the majority of loans and receivables and debt securities held by Jackson. Debt securities held by Jackson are accounted for on an available-for-sale basis. The use of the fair value option is consistent with the Group's risk management and investment strategies.

The Group uses the trade date method to account for regular purchases and sales of financial assets.

Use of fair values

The Group uses current bid prices to value its investments with quoted prices. Actively traded investments without quoted prices are valued using prices provided by third parties. If there is no active established market for an investment, the Group applies an appropriate valuation technique such as a discounted cash flow technique. Additional details are provided in note G1.

Impairments

The Group assesses at each statement of financial position date, whether there is objective evidence that a financial asset or group of financial assets not held at fair value through profit and loss is impaired. A financial asset or group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that have occurred after the initial recognition of the asset (a loss event) and that a loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. Objective evidence that a financial asset or group of financial assets is impaired includes observable data that comes to the attention of the Group. For assets designated as available-for-sale, the initial impairment is the cumulative loss which is removed from the available-for-sale reserve within equity and recognised in the income statement. Any subsequent impairment loss is measured as the cumulative loss, less any impairment loss previously recognised.

For loans and receivables carried at amortised cost, the impairment amount is the difference between carrying value and the present value of the expected cash flows discounted at the original effective interest rate.

If, in subsequent periods, an impaired debt security held on an available-for-sale basis or an impaired loan or receivable recovers in value (in part or in full), and this recovery can be objectively related to an event occurring after the impairment, then the previously recognised impairment loss is reversed through the income statement (in part or in full).

Derivatives and hedge accounting

Derivative financial instruments are used to reduce or manage investment, interest rate and currency exposures, to facilitate efficient portfolio management and for investment purposes.

The Group may designate certain derivatives as hedges. This includes fair value hedges, cash flow hedges and hedges of net investments in foreign operations. If the criteria for hedge accounting are met then the following accounting treatments are applied from the date at which the designation is made and the accompanying requisite documentation is in place:

i Hedges of net investments in foreign operations – the effective portion of any change in fair value of derivatives or other financial instruments designated as net investment hedges are recognised in other comprehensive income (i.e. outside of the income statement). The ineffective portion of changes in the fair value of the hedging instrument is recorded in the income statement. The gain or loss on the hedging instrument recognised directly in other comprehensive income, is recognised in the income statement on disposal of the foreign operation.

ii Fair value hedges – movements in the fair value of the hedged item attributable to the hedged risk are recognised in the income statement.

iii Cash flow hedges – the effective portion of changes in the fair value of derivatives designated as cash flow hedges is recognised in other comprehensive income (i.e. outside of the income statement). Movements in fair value relating to the ineffective portion are booked in the income statement. Amounts recognised in other comprehensive income are recorded in the income statement in the periods in which the hedged item affects profit or loss.

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A4: SIGNIFICANT ACCOUNTING POLICIES > CONTINUED

All derivatives that do not meet the relevant hedging criteria are carried at fair value with movements in fair value being recorded in the income statement.

The primary areas of the Group's continuing operations where derivative instruments are held are the UK with-profits funds and annuity business, and Jackson.

For the Group's continuing operations, hedge accounting under IAS 39 is not usually applied. The exceptions, where hedge accounting has been applied in 2010 and 2009, are summarised in note G3.

For UK with-profits funds the derivative programme is undertaken as part of the efficient management of the portfolio as a whole. As noted in section D2 value movements on the with-profits funds investments are reflected in changes in asset-share liabilities to policyholders or the liability for unallocated surplus. Shareholders' profit and equity are not affected directly by value movements on the derivatives held.

For UK annuity business the derivatives are held to contribute to the matching as far as practical, of asset returns and duration with those of liabilities to policyholders. The carrying value of these liabilities is sensitive to the return on the matching financial assets including derivatives held. Except for the extent of minor mismatching, value movements on derivatives held for this purpose do not affect shareholders' profit or equity.

For Jackson an extensive derivative programme is maintained. Value movements on the derivatives held can be very significant in their effect on shareholder results. The Group has chosen generally not to seek to construct the Jackson derivative programme so as to facilitate hedge accounting where theoretically possible, under IAS 39. Further details on this aspect of the Group's financial reporting are described in note A3.

Embedded derivatives

Embedded derivatives are present in host contracts issued by various Group companies, in particular for Jackson. They are embedded within other non-derivative host financial instruments and insurance contracts to create hybrid instruments. Embedded derivatives meeting the definition of an insurance contract are accounted for under IFRS 4. Where economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risks of the host instrument, and where the hybrid instrument is not measured at fair value with the changes in fair value recognised in the income statement, the embedded derivative is bifurcated and carried at fair value as a derivative in accordance with IAS 39.

In addition, the Group applies the requirement of IFRS 4 to not separate and fair value surrender options embedded in host contracts and with-profits investment contracts whose strike price is either a fixed amount or a fixed amount plus interest. Further details on the valuation basis for embedded derivatives attaching to Jackson's life assurance contracts are provided in note D3(g).

Securities lending including repurchase agreements

The Group is party to various securities lending agreements under which securities are loaned to third-parties on a short-term basis. The loaned securities are not derecognised; rather, they continue to be recognised within the appropriate investment classification. The Group's policy is that collateral in excess of 100 per cent of the fair value of securities loaned is required from all securities' borrowers and typically consists of cash, debt securities, equity securities or letters of credit.

In cases where the Group takes possession of the collateral under its securities lending programme, the collateral, and corresponding obligation to return such collateral, are recognised in the consolidated statement of financial position.

Derecognition of financial assets and liabilities

The Group's policy is to derecognise financial assets when it is deemed that substantially all the risks and rewards of ownership have been transferred. The Group also derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire. Where the Group neither transfers nor retains substantially all the risks and rewards of ownership, the Group will derecognise the financial asset where it is deemed that the Group has not retained control of the financial asset.

Where the transfer does not result in the Group transferring the right to receive the cash flows of the financial assets, but does result in the Group assuming a corresponding obligation to pay the cash flows to another recipient, the financial assets are also accordingly derecognised providing all of the following conditions are met:

- the Group has no obligation to pay amounts to the eventual recipients unless it collects the equivalent amounts from the original asset;
- the Group is prohibited by the terms of the transfer contract from selling or pledging the original asset; and
- the Group has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.

The Group derecognises financial liabilities only when the obligation specified in the contract is discharged, cancelled or has expired.

Borrowings

Although initially recognised at fair value, net of transaction costs, borrowings, excluding liabilities of consolidated collateralised debt obligations, are subsequently accounted for on an amortised cost basis using the effective interest method. Under the effective interest method, the difference between the redemption value of the borrowing and the initial proceeds (net of related issue costs) is amortised through the income statement to the date of maturity or for hybrid debt, over the expected life of the instrument.

Financial liabilities designated at fair value through profit and loss

Consistent with the Group's risk management and investment strategy and the nature of the products concerned, the Group has designated under IAS 39 classification certain financial liabilities at fair value through profit and loss as these instruments are managed and their performance evaluated on a fair value basis. These instruments include liabilities related to consolidated collateralised debt obligations and net assets attributable to unit holders of consolidated unit trusts and similar funds.

b Long-term business contracts

Income statement treatment

Premiums and claims

Premium and annuity considerations for conventional with-profits policies and other protection type insurance policies are recognised as revenue when due. Premiums and annuity considerations for linked policies, unitised with-profits and other investment type policies are recognised as revenue when received or, in the case of unitised or unit-linked policies, when units are issued. These amounts exclude UK premium taxes and similar duties where Prudential collects and settles taxes borne by the customer.

Policy fees charged on linked and unitised with-profits policies for mortality, asset management and policy administration are recognised as revenue when related services are provided.

Claims paid include maturities, annuities, surrenders and deaths. Maturity claims are recorded as charges on the policy maturity date. Annuity claims are recorded when each annuity instalment becomes due for payment. Surrenders are charged to the income statement when paid and death claims are recorded when notified.

For investment contracts which do not contain discretionary participating features, the accounting is carried out in accordance with IAS 39 to reflect the deposit nature of the arrangement, with premiums and claims reflected as deposits and withdrawals and taken directly to the statement of financial position as movements in the financial liability balance.

Acquisition costs

With the exception of costs incurred in respect of with-profits contracts valued on a realistic basis, costs of acquiring new insurance business, principally commissions, marketing and advertising costs and certain other costs associated with policy issuance and underwriting that are not reimbursed by policy charges, are specifically identified and capitalised as part of deferred acquisition costs (DAC), which are included as an asset in the statement of financial position. The DAC asset in respect of insurance contracts is amortised against margins in future revenues on the related insurance policies, to the extent that the amounts are recoverable out of the margins. Recoverability of the unamortised DAC asset is assessed at the time of policy issue and reviewed if profit margins have declined.

Under IFRS, investment contracts (excluding those with discretionary participation features) accounted for as financial liabilities in accordance with IAS 39 which also offers investment management services, require the application of IAS 18 for the revenue attached to these services. The Group's investment contracts primarily comprise certain unit-linked savings contracts in the UK and Asia and contracts with fixed and guaranteed terms in the US (such as guaranteed investment contracts and annuity-certains) all of which offer an investment service.

Incremental, directly attributable acquisition costs relating to the investment management element of these contracts are capitalised and amortised in line with the related revenue. If the contracts involve up-front charges, this income is also deferred and amortised through the income statement in line with contractual service provision.

UK regulated with-profits funds

Prudential's long-term business written in the UK comprises predominantly life insurance policies with discretionary participating features under which the policyholders are entitled to participate in the returns of the funds supporting these policies. Business similar to this type is also written in certain of the Group's Asian operations subject to local market and regulatory conditions. Such policies are called with-profits policies. Prudential maintains with-profits funds within the Group's long-term business funds, which segregate the assets and liabilities and accumulate the returns related to that with-profits business. The amounts accumulated in these with-profits funds are available to provide for future policyholder benefit provisions and for bonuses to be distributed to with-profits policyholders. The bonuses, both annual and final, reflect the right of the with-profits policyholders to participate in the financial performance of the with-profits funds. Shareholders' profits with respect to bonuses declared on with-profits business correspond to the shareholders' share of the cost of bonuses as declared by the Board of directors. The shareholders' share currently represents one-ninth of the cost of bonuses declared for with-profits policies.

Annual bonuses are declared and credited each year to with-profits policies. The annual bonuses increase policy benefits and, once credited, become guaranteed. Annual bonuses are charged to the profit and loss account in the year declared. Final bonuses are declared each year and accrued for all policies scheduled to mature and for death benefits expected to be paid during the next financial year. Final bonuses are not guaranteed and are only paid on policies that result from claims through the death of the policyholder or maturity of the policy within the period of declaration or by concession on surrender. No policyholder benefit provisions are recorded for future annual or final bonus declarations.

The policyholders' liabilities of the regulated with-profits funds are accounted for under FRS 27.

Under FRS 27 for the UK with-profits funds:

- no deferred acquisition costs and related deferred tax are recognised; and
- adjusted realistic basis liabilities instead of MSB liabilities are recognised.

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A4: SIGNIFICANT ACCOUNTING POLICIES > CONTINUED

FRS 27 realistic basis liabilities are underpinned by the FSA's Peak 2 basis of reporting. This Peak 2 basis requires the value of liabilities to be calculated as:

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

The WPBR is primarily based on the retrospective calculation of accumulated asset shares but is adjusted to reflect future policyholder benefits and other outgoings.

The FPRL must include a market consistent valuation of costs of guarantees, options and smoothing, less any related charges, and this amount is determined using either a stochastic approach, hedging costs or a series of deterministic projections with attributed probabilities.

The assumptions used in the stochastic models are calibrated to produce risk-free returns on each asset class. Volatilities of, and correlations between, investment returns from different asset classes are as determined by the Group's Portfolio Management Group on a market consistent basis.

The cost of guarantees, options and smoothing is very sensitive to the bonus, market value reduction (MVR) and investment policies the Group employs and therefore the stochastic modelling incorporates a range of management actions that would help to protect the fund in adverse scenarios. Substantial flexibility has been included in the modelled management actions in order to reflect the discretion that the Group retains in adverse investment conditions, thereby avoiding the creation of unreasonable minimum capital requirements. The management actions assumed are consistent with management's policy for with-profits funds and the disclosures made in the publicly available Principles and Practices of Financial Management.

The realistic basis liabilities representing the Peak 2 basis realistic liabilities for with-profits business included in Form 19 of the FSA regulatory returns include the element for the shareholders' share of the future bonuses. For accounting purposes under FRS 27, this latter item is reversed because, consistent with the current basis of financial reporting, shareholder transfers are recognised only on declaration.

Unallocated surplus

The unallocated surplus represents the excess of assets over policyholder liabilities for the Group's with-profits funds. As allowed under IFRS 4, the Group has opted to continue to record unallocated surplus of with-profits funds wholly as a liability. The annual excess (shortfall) of income over expenditure of the with-profits funds, after declaration and attribution of the cost of bonuses to policyholders and shareholders, is transferred to (from) the unallocated surplus each year through a charge (credit) to the income statement. The balance retained in the unallocated surplus represents cumulative income arising on the with-profits business that has not been allocated to policyholders or shareholders. The balance of the unallocated surplus is determined after full provision for deferred tax on unrealised appreciation on investments.

Other insurance contracts (i.e. contracts which contain significant insurance risk as defined under IFRS 4)

For these contracts UK GAAP has been applied, which reflects the MSB. Under this basis the following approach applies:

Other UK insurance contracts

Other UK insurance contracts that contain significant insurance risk include unit-linked, annuity and other non-profit business. For the purposes of local regulations, segregated accounts are established for linked business for which policyholder benefits are wholly or partly determined by reference to specific investments or to an investment-related index. The interest rates used in establishing policyholder benefit provisions for pension annuities in the course of payment are adjusted each year. Mortality rates used in establishing policyholder benefit are based on published mortality tables adjusted to reflect actual experience.

Overseas subsidiaries

The assets and liabilities of insurance contracts of overseas subsidiaries are determined initially using local GAAP bases of accounting with subsequent adjustments where necessary to comply with the Group's accounting policies.

Jackson

The future policyholder benefit provisions for Jackson's conventional protection-type policies are determined using the net level premium method under US GAAP principles and assumptions as of the issue date as to mortality, interest, policy lapses and expenses plus provisions for adverse deviations. For non-conventional protection-type policies, the policyholder benefit provision included within policyholder liabilities in the consolidated statement of financial position is the policyholder account balance.

For the business of Jackson, the determination of the expected emergence of margins, against which the amortisation profile of the DAC asset is established, is dependent on certain key assumptions. For single premium deferred annuity business, the key assumption is the expected long-term spread between the earned rate and the rate credited to policyholders. For variable annuity business, the key assumption is the expected long-term level of equity market returns which, for 2010 and 2009, was 8.4 per cent per annum, implemented using a mean reversion methodology. These returns affect the level of future expected profits through their effects on fee income and the required level of provision for guaranteed minimum death benefit claims.

Jackson accounts for the majority of its investment portfolio on an available-for-sale basis (see investment policies above) whereby unrealised gains and losses are recognised in other comprehensive income. As permitted by IFRS 4, Jackson has used shadow accounting. Under shadow accounting, to the extent that recognition of unrealised gains or losses on available-for-sale securities causes adjustments to the carrying value and amortisation patterns of DAC and deferred income, these adjustments are recognised in other comprehensive income to be consistent with the treatment of the gains or losses on the securities. More precisely, shadow DAC adjustments reflect the change in DAC that would have arisen if the assets held in the statement of financial position had been sold, crystallising unrealised gains or losses, and the proceeds reinvested at the yields currently available in the market.

Asian operations

Except for the operations in Taiwan, Vietnam and Japan, the future policyholder benefit provisions for Asian businesses are determined in accordance with methods prescribed by local GAAP adjusted to comply, where necessary, with UK GAAP. For the Hong Kong business, which is a branch of the PAC, and the Singapore and Malaysian operations, the valuation principles and sensitivities to changes of assumptions of conventional with-profits and other protection-type policies are similar to those described above for equivalent products written by the UK operations. Refinements to the local reserving methodology are generally treated as change in estimates, dependent on the nature of the change. Such a refinement arose in 2009 in respect of Malaysia as explained in note D4(i).

For the operations in Taiwan, Vietnam and Japan, countries where local GAAP is not appropriate in the context of the previously applied MSB, accounting for insurance contracts is based on US GAAP. For these three operations the business written is primarily non-participating and linked business. The future policyholder benefit provisions for non-linked business are determined using the net level premium method, with an allowance for surrenders, maintenance and claim expenses. Rates of interest used in establishing the policyholder benefit provisions vary by operation depending on the circumstances attaching to each block of business. Where appropriate, liabilities for participating business for these three operations include provisions for the policyholders' interest in realised investment gains and other surpluses that have yet to be declared as bonuses.

Although the basis of valuation of Prudential's overseas operations is in accordance with the requirements of the Companies Act 2006 and ABI SORP, the valuation of policyholder benefit provisions for these businesses may differ from that determined on a UK MSB for UK operations with the same features. These differences are permitted under IFRS 4.

Liability adequacy

The Group performs liability adequacy testing on its insurance provisions to ensure that the carrying amounts of provisions (less related DAC and present value of in-force business – see policy on business acquisitions and disposals) is sufficient to cover current estimates of future cash flows. When performing the liability adequacy test, the Group discounts all contractual cash flows and compares this amount to the carrying value of the liability. Any deficiency is immediately charged to the income statement.

Reinsurance

In the normal course of business, the Group 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 consolidated statement of financial position 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.

The treatment of any gains or losses arising on the purchase of reinsurance contracts is dependent on the underlying accounting basis of the entity concerned amongst other things.

Investment contracts (contracts which do not contain significant insurance risk as defined under IFRS 4)

For investment contracts with discretionary participation features, the accounting basis is consistent with the accounting for similar with-profits insurance contracts. Other investment contracts are accounted for on a basis that reflects the hybrid nature of the arrangements whereby part is accounted for as a financial instrument under IAS 39 and the investment management service component is accounted for under IAS 18.

For those investment contracts in the US with fixed and guaranteed terms, the Group uses the amortised cost model to measure the liability. On contract inception, the liability is measured at fair value less incremental, directly attributable acquisition costs. Remeasurement at future reporting dates is on an amortised cost basis utilising an effective interest rate methodology whereby the interest rate utilised discounts to the net carrying amount of the financial liability.

Those investment contracts without fixed and guaranteed terms are designated at fair value through profit and loss because the resulting liabilities are managed and their performance is evaluated on a fair value basis. Fair value is based upon the fair value of the underlying assets of the fund. Where the contract includes a surrender option its carrying value is subject to a minimum carrying value equal to its surrender value.

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A4: SIGNIFICANT ACCOUNTING POLICIES > CONTINUED

c Other assets, liabilities, income and expenditure

Basis of consolidation

The Group consolidates those entities it is deemed to control. The degree of control is determined by the ability of the Group to govern the financial and operating policies of an entity in order to obtain benefits. Consideration is given to other factors such as potential voting rights.

The Group has consolidated special purpose entities (SPEs), such as funds holding collateralised debt obligations (CDOs), where evaluation of the substance of the relationship between the SPE and the Group indicates that the Group is deemed to control the SPE under IFRS.

The Group holds investments in internally and externally managed open-ended investment companies (OEICs) and unit trusts. These are consolidated where the Group's percentage ownership level is 50 per cent or greater. The Group's percentage ownership levels in these entities can fluctuate from day to day according to changes in the Group's and third-party participation in the funds. In instances where the Group's ownership of internally managed funds declines marginally below 50 per cent and, based on historical analysis and future expectations the decline in ownership is expected to be temporary, the funds continue to be consolidated as subsidiaries under IAS 27.

Where the Group exercises significant influence or has the power to exercise significant influence over an entity, generally through ownership of 20 per cent or more of the entity's voting rights, but does not control the entity, then this is considered to be an investment in an associate. With the exception of those referred to below, the Group's investments in associates are recorded at the Group's share of the associates' net assets including any goodwill and intangibles arising upon initial acquisition. The carrying value of investments in associates is adjusted each year for the Group's share of the entities' profit or loss. This does not apply to investments in associates held by the Group's insurance or investment funds including the venture capital business or mutual funds and unit trusts, which as permitted by IAS 28 are carried at fair value through profit and loss.

The Group's investments in joint ventures are recognised using proportional consolidation whereby the Group's share of an entity's individual balances are combined line-by-line with similar items into the Group financial statements.

Other interests in entities, where significant influence is not exercised, are carried as investments at fair value through profit and loss.

The consolidated financial statements of the Group include the assets, liabilities and results of the Company and subsidiary undertakings in which Prudential has a controlling interest, using accounts drawn up to 31 December 2010 except where entities have non-coterminous year ends. In such cases, the information consolidated is based on the accounting period of these entities and is adjusted for material changes up to 31 December. Accordingly, the information consolidated is deemed to cover the same period for all entities throughout the Group. The results of subsidiaries are included in the financial statements from the date control commences to the date control ceases. All inter-company transactions are eliminated on consolidation. Results of asset management activities include those for managing internal funds.

Investment properties

Investments in leasehold and freehold properties not for occupation by the Group, including properties under development for future use as investment properties, are carried at fair value, with changes in fair value included in the income statement. Properties are valued annually either by the Group's qualified surveyors or by taking into consideration the advice of professional external valuers using the Royal Institution of Chartered Surveyors (RICS) guidelines. The RICS guidelines apply separate assumptions to the value of the land, buildings and tenancy associated with each property. Each property is externally valued at least once every three years. The cost of additions and renovations is capitalised and considered when estimating fair value. Fair value is based on active market prices, adjusted, if necessary, for any difference in the nature, location or condition of the specific property. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices in less active markets.

Leases of investment property where the Group has substantially all the risks and rewards of ownership are classified as finance leases (leasehold property). Finance leases are capitalised at the lease's inception at the lower of the fair value of the leased property and the present value of the minimum lease payments. Where a lease has a contingent rent element, the rent is calculated in accordance with individual lease terms and charged as an expense as incurred.

Pension schemes

The Group operates a number of pension schemes around the world. The largest of these schemes is the PSPS, a defined benefit scheme. The Group also operates defined contribution schemes. Defined contribution schemes are schemes where the Company pays contributions into a fund and the Company has no legal or constructive obligation to pay further contributions should the assets of that fund be insufficient to pay the employee benefits relating to employee service in both current and prior periods. Defined benefit schemes are post-employment benefit plans that are not defined contribution schemes.

For the Group's defined benefit schemes, if the present value of the defined benefit obligation exceeds the fair value of the scheme assets, then a liability is recorded in the Group's statement of financial position. By contrast, if the fair value of the assets exceeds the present value of the defined benefit obligation then the surplus will only be recognised if the nature of the arrangements under the trust deed, and funding arrangements between the Trustee and the Company support the availability of refunds or recoverability through agreed reductions in future contributions. In addition, if there is a constructive obligation for the Company to pay deficit funding, this is also recognised.

The Group utilises the projected unit credit method to calculate the defined benefit obligation. Estimated future cash flows are then 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. These calculations are performed by independent actuaries.

The plan assets of the Group's pension schemes exclude several insurance contracts that have been issued by the Group. These assets are excluded from plan assets in determining the pension obligation recognised in the consolidated statement of financial position.

The aggregate of the actuarially determined service costs of the currently employed personnel and the unwind of discount on liabilities at the start of the period, less the expected investment return on scheme assets at the start of the period, is charged to the income statement. Actuarial gains and losses as a result of changes in assumptions or experience variances are also charged or credited to the income statement.

Contributions to the Group's defined contribution schemes are expensed when due. Once paid, the Group has no further payment obligations. Any prepayments are reflected as an asset on the statement of financial position.

Share-based payments

The Group offers share award and option plans for certain key employees and a Save As You Earn (SAYE) plan for all UK and certain overseas employees. The arrangements for distribution to employees of shares held in trust relating to share award plans and for entitlement to dividends depend upon the particular terms of each plan. Shares held in trust relating to these plans are conditionally gifted to employees.

The compensation expense charged to the income statement is primarily based upon the fair value of the options granted, the vesting period and the vesting conditions. Vesting conditions exclude the ability of an employee to voluntarily exit a scheme and such exits are treated as an acceleration of vesting and hence a shortening of the period over which the expense is charged. The Group revises its estimate of the number of options likely to be exercised at each statement of financial position date and adjusts the charge to the income statement accordingly. Where the share-based payment depends upon vesting outcomes attaching to market-based performance conditions, additional modelling is performed to estimate the fair value of the awards. No subsequent adjustment is then made to the fair value charge for awards that do not vest on account of these performance conditions not being met.

The Company has established trusts to facilitate the delivery of Prudential plc shares under employee incentive plans and savings-related share option schemes. None of the trusts that hold shares for employee incentive and savings plans continue to hold these shares once they are issued to employees. The cost to the Company of acquiring these treasury shares held in trusts is shown as a deduction from shareholders' equity.

Tax

The Group's UK subsidiaries each file separate tax returns. Jackson and other foreign subsidiaries, where permitted, file consolidated income tax returns. In accordance with UK tax legislation, where one domestic UK company is a 75 per cent owned subsidiary of another UK company or both are 75 per cent owned subsidiaries of a common parent, the companies are considered to be within the same UK tax group. For companies within the same tax group, trading profits and losses arising in the same accounting period may be offset for purposes of determining current and deferred taxes.

Current tax expense is charged or credited to operations based upon amounts estimated to be payable or recoverable as a result of taxable operations for the current year. To the extent that losses of an individual UK company are not offset in any one year, they can be carried back for one year or carried forward indefinitely to be offset against profits arising from the same company.

Deferred taxes are provided under the liability method for all relevant temporary differences, being the difference between the carrying amount of an asset or liability in the statement of financial position and its value for tax purposes. IAS 12, 'Income Taxes' does not require all temporary differences to be provided for, in particular, the Group does not provide for deferred tax on undistributed earnings of subsidiaries where the Group is able to control the timing of the distribution and the temporary difference created is not expected to reverse in the foreseeable future. The tax effects of losses available for carry forward are recognised as an asset. Deferred tax assets are only recognised when it is more likely than not, that future taxable profits will be available against which these losses can be utilised. Deferred tax related to charges or credits taken to other comprehensive income is also credited or charged to other comprehensive income and is subsequently recognised in the income statement together with the deferred gain or loss.

The tax charge for long-term business includes tax expense on with-profits funds attributable to both the policyholders and the shareholders. Different tax rules apply under UK law depending upon whether the business is life insurance or pension business. Tax on the life insurance business is based on investment returns less expenses attributable to that business. Tax on the pension business is based on the shareholders' profits or losses attributable to that business. The shareholders' portion of the long-term business is taxed at the shareholders' rate with the remaining portion taxed at rates applicable to the policyholders.

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A4: SIGNIFICANT ACCOUNTING POLICIES > CONTINUED

Deferred tax is measured at the tax rates that are expected to apply to the period when the asset is realised or the liability settled, based on tax rates (and laws) that have been enacted or are substantively enacted at the end of the reporting period.

Basis of presentation of tax charges

Tax charges in the income statement reflect the aggregate of the shareholder tax on the long-term business result and on the Group's other results.

Under UK Listing Authority rules, profit before tax is required to be presented. This requirement, coupled with the fact that IFRS does not contemplate tax charges which are attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies, necessitates the reporting of total tax charges within the presented results. The result before all taxes (i.e. 'profit before tax' as shown in the income statement) represents income net of post-tax transfers to unallocated surplus of with-profits funds, before tax attributable to policyholders and unallocated surplus of with-profits funds, unit-linked policies and shareholders. Separately within the income statement, 'profit before tax attributable to shareholders' is shown after deduction of taxes attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies. Tax charges on this measure of profit reflect the tax charges attributable to shareholders. In determining the tax charges attributable to shareholders, the Group has applied a methodology consistent with that previously applied under UK GAAP reflecting the broad principles underlying the tax legislation of life assurance companies.

Property, plant and equipment

All property, plant and equipment such as owner occupied property, computer equipment and furniture and fixtures, are carried at depreciated cost. Costs including expenditure directly attributable to the acquisition of the assets are capitalised. Depreciation is calculated and charged on a straight-line basis over an asset's estimated useful life. The residual values and useful lives are reviewed at each statement of financial position date. If the carrying amount of an asset is greater than its recoverable amount then its carrying value is written down to that recoverable amount.

Leasehold improvements to owner occupied property are depreciated over the shorter of the economic life and the life of the lease. Assets held under finance leases are capitalised at their fair value.

Business acquisitions and disposals

Business acquisitions are accounted for by applying the purchase method of accounting, which adjusts the net assets of the acquired company to fair value at the date of purchase. The excess of the acquisition consideration over the fair value of the assets and liabilities of the acquired entity is recorded as goodwill. Expenses related to acquiring new subsidiaries are expensed in the period in which they are incurred. Should the fair value of the identifiable assets and liabilities of the entity exceed the acquisition consideration then this amount is recognised immediately in the income statement. Income and expenses of acquired entities are included in the income statement from the date of acquisition. Income and expenses of entities sold during the period are included in the income statement up to the date of disposal. The gain or loss on disposal is calculated as the difference between sale proceeds, net of selling costs, less the net assets of the entity at the date of disposal.

For life insurance company acquisitions, the adjusted net assets include an identifiable intangible asset for the present value of in-force business which represents the profits that are expected to emerge from the acquired insurance business. The present value of in-force business is calculated using best estimate actuarial assumptions for interest, mortality, persistency and expenses and is amortised over the anticipated lives of the related contracts in the portfolio. The net carrying amount of insurance liabilities acquired less the value of in-force business, represents the fair value of the insurance liabilities acquired. An intangible asset may also be recognised in respect of acquired investment management contracts representing the fair value of contractual rights acquired under these contracts.

Goodwill

Goodwill arising on acquisitions of subsidiaries and businesses is capitalised and carried on the Group statement of financial position as an intangible asset at initial value less any accumulated impairment losses. Goodwill impairment testing is conducted annually and when there is an indication of impairment. For the purposes of impairment testing, goodwill is allocated to cash generating units. These cash generating units reflect the smallest group of assets that includes the goodwill and generates cash flows that are largely independent of the cash inflows from other groups of assets. If the carrying amount of the cash generating unit exceeds its recoverable amount then the goodwill is considered impaired. Impairment losses are recognised immediately in the income statement and may not be reversed in future periods.

Acquired intangible assets

Intangible assets acquired on the purchase of a subsidiary or portfolio of contracts are fair valued at acquisition and carried at cost less amortisation and any accumulated impairment losses. Amortisation calculated is charged on a straight-line basis over the estimated useful life of the assets. The residual values and useful lives are reviewed at each statement of financial position date.

Cash and cash equivalents
Cash and cash equivalents consist of cash at bank and in hand, deposits held at call with banks, treasury bills and other short-term highly liquid investments with less than 90 days maturity from the date of acquisition.

Rights of offset
Assets and liabilities in the consolidated financial statements are only reported on a net basis when there is a legally enforceable right to offset and there is an intention to settle on a net basis.

Segments
Under IFRS 8, the Group determines and presents operating segments based on the information that is internally provided to the Group Executive Committee ('GEC'), which is the Group's chief operating decision maker.

An operating segment is a component of the Group that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components. An operating segment's operating results are reviewed regularly by the GEC to make decisions about resources to be allocated to the segment and assess its performance, and for which discrete financial information is available.

The operating segments identified by the Group reflect the Group's organisational structure, which is by both geography (Asia, US and UK) and by product line (insurance operations and asset management).

Insurance operations principally comprise of products that contain both significant and insignificant elements of insurance risk. The products are managed together and there is no distinction between these two categories other than for accounting purposes. This segment also includes the commission earned on general insurance business and investment subsidiaries held for supporting the Group's insurance operations.

Asset management comprises both internal and third-party asset management services, inclusive of portfolio and mutual fund management, where the Group acts as an advisor, and broker-dealer activities. The nature of the products and the managing of the business differ from the risks inherent in the insurance operations segments, and the regulatory environment of the asset management industry differs from that of the insurance operations segments.

The Group's operating segments as determined in accordance with IFRS 8, are as follows:

Insurance operations
- Asia
- US (Jackson)
- UK

Asset management operations
- M&G
- Asian asset management
- US broker dealer and asset management (including Curian)

Prudential Capital has been incorporated into the M&G operating segment for the purposes of segment reporting. The Group's operating segments are also its reportable segments.

The performance measure of operating segments utilised by the Company is IFRS operating profit attributable to shareholders based on longer-term investment returns. This measure excludes the recurrent items of short-term fluctuations in investment returns and the shareholders' share of actuarial and other gains and losses on defined benefit pension schemes. In addition, for 2010 this measure excluded costs associated with the terminated AIA transaction and gain arising upon the dilution of the Group's holding in PruHealth. For 2009 it excluded the non-recurrent cost of hedging the Group IGD capital surplus included within short-term fluctuations in investment returns and the loss on sale and the results of the Taiwan agency business during the period of ownership. In 2010 the Company amended its presentation of operating profit for its US insurance operations to exclude the net equity hedge accounting effect previously included relating principally to its variable annuity business as explained below in note A4(d). These amounts are included in short-term fluctuations in investment returns. Prior year comparatives have been amended accordingly. There is no change to total profit for continuing operations before tax attributable to shareholders arising from this altered treatment. Operating earnings per share is based on operating profit based on longer-term investment returns, after tax and non-controlling interests. Further details on the determination of the performance measure of 'operating profit based on longer-term investment returns' is provided below in note A4 (d).

Segment results that are reported to the GEC include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Unallocated items are mainly in relation to the Group Head Office and Asia Regional Head Office.

Shareholders' dividends
Interim dividends are recorded in the period in which they are paid. Final dividends are recorded in the period in which they are approved by shareholders.

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A4: SIGNIFICANT ACCOUNTING POLICIES > CONTINUED

Share capital

Where there is no obligation to transfer assets, shares are classified as equity. The difference between the proceeds received on issue of the shares, net of share issue costs, and the nominal value of the shares issued, is credited to share premium. Where the Company purchases shares for the purposes of employee incentive plans, the consideration paid, net of issue costs, is deducted from retained earnings. Upon issue or sale any consideration received is credited to retained earnings net of related costs.

Foreign exchange

The Group's consolidated financial statements are presented in pounds sterling, the Group's presentation currency. Accordingly, the results and financial position of foreign subsidiaries must be translated into the presentation currency of the Group from their functional currencies, i.e. the currency of the primary economic environment in which the entity operates. All assets and liabilities of foreign subsidiaries are converted at year end exchange rates whilst all income and expenses are converted at average exchange rates where this is a reasonable approximation of the rates prevailing on transaction dates. The impact of these currency translations is recorded as a separate component in the Statement of comprehensive income.

Foreign currency borrowings that are used to provide a hedge against Group equity investments in overseas subsidiaries are translated at year end exchange rates and movements recognised in other comprehensive income. Other foreign currency monetary items are translated at year end exchange rates with changes recognised in the income statement.

Foreign currency transactions are translated at the spot rate prevailing at the time.

d Operating profit based on longer-term investment returns

The Group provides supplementary analysis of profit before tax attributable to shareholders that distinguishes operating profit based on longer-term investment returns from other constituent elements of the total profit.

The Group uses operating profit based on longer-term investment returns to measure the performance of its operational segments. For the purposes of measuring operating profit, investment returns on shareholder-financed business are based on the expected longer-term rates of return. This reflects the particular features of long-term insurance business where assets and liabilities are held for the long-term and for which the accounting basis for insurance liabilities under current IFRS is not generally conducive to demonstrating trends in underlying performance for life businesses exclusive of changes in market conditions. In determining profit on this basis the following key elements are applied to the results of the Group's shareholder-financed operations.

The approach to determining profit on this basis was altered in 2010 from that previously applied in 2009 in respect of the net equity hedge accounting effect for variable and fixed index annuity US life business. Comparative results have been adjusted accordingly. The approach to determining operating profit based on longer-term investment returns reflected in segment results shown in note B1 is as follows:

i Debt and equity securities

Longer-term investment returns comprise income and longer-term capital returns. For debt securities the longer-term capital returns comprise two elements. These are a risk margin reserve (RMR) based charge for expected defaults, which is determined by reference to the credit quality of the portfolio, and amortisation of interest-related realised gains and losses to operating results based on longer-term investment returns to the date when sold bonds would have otherwise matured. The shareholder-backed operation for which the RMR charge is most significant is Jackson National Life.

For 2010 and 2009 Jackson has used the ratings resulting from the regulatory ratings detail issued by the National Association of Insurance Commissioners (NAIC) for residential mortgage-backed securities (RMBS) to determine the average annual RMR. In addition, in 2010, NAIC extended the new ratings framework to commercial mortgage-backed securities (CMBS), which Jackson has used for 2010. These were developed by external third parties; PIMCO (for RMBS) and BlackRock Solutions (for CMBS), and are considered by management more relevant information for the MBS securities concerned than using ratings by Nationally Recognised Statistical Rating Organisations (NRSRO). For other securities Jackson uses ratings by NRSRO.

ii US variable and fixed index annuity business

(i) Current treatment

The following value movements for Jackson's variable and fixed index annuity business are excluded from operating profit based on longer-term investment returns:

- Fair value movements for equity-based derivatives;
- Fair value movements for embedded derivatives for Guaranteed Minimum Withdrawal Benefit (GMWB) 'not for life' and fixed index annuity business, and Guaranteed Minimum Income Benefit (GMIB) reinsurance;
- Movements in accounts carrying value of GMDB and GMWB 'for life' liabilities;
- Fee assessment, and claim payments, in respect of guarantee liabilities; and
- Related changes to amortisation of deferred acquisition costs for each of the above items.

(ii) Change of treatment in 2010

For previous reporting of the 2009 results, all of the above items were included in operating profit based on longer-term investment returns with the intention of broadly matching the impacts with two exceptions. The exceptions were for the effect of GMIB reinsurance and movements in carrying values of free standing derivatives and embedded derivatives arising from changes in the level of observed implied equity volatility and changes in the discount rate applied from year to year. Both of these items remain in short-term fluctuations in investment returns in 2010.

Previously, for the purposes of determining operating profit based on longer-term investment returns, the charge for these features was determined using historical longer-term equity volatility levels and long-term average AA corporate bond rate curves with the movement relating to the change in difference in long-term and current rates being included in short-term fluctuations (as shown in note B1).

However, despite this use of longer-term equity volatility assumption levels and AA corporate bond rate curves, accounting volatility arose within the operating profit based on longer-term investment returns that was not representative of the underlying economic result. This feature arose due to the movement in the change in the accounting values of the derivatives and Jackson's liabilities for variable and fixed indexed annuity guarantees included in the operating profit. Under IFRS, liabilities for GMDB and 'for life' GMWB are not fair valued. Instead, they are accounted for under IFRS using 'grandfathered' US GAAP in accordance with FASB ASC Subtopic 944-80, Financial Services – Insurance – Separate Accounts (formerly SOP 03-1). This accounting basis produces a distorting accounting effect on the operating profit that is not representative of the true economics of Jackson's hedging programme. Over the long term the impact of this accounting distortion should cumulatively net out to a broadly neutral effect, but in the short term the operating profit can be highly volatile. The recent growth in Jackson's variable annuity business had resulted in this short-term effect having a greater impact on the Group operating profit than in prior years. Further, these accounting mismatches are magnified in periods of significant market movements. These factors have prompted a reassessment of the presentation of operating profit based on longer-term investment returns.

The following items have been reclassified from operating profit to short-term fluctuations in investment returns:

- The fair value movement in free standing hedging derivatives, excluding the impact of the difference between longer-term and current period implied equity volatility levels;
- The movement in liabilities for those embedded derivative liabilities which are fair valued in accordance with IFRS, primarily GMWB 'not for life' and fixed index annuity business, excluding the impacts of the differences between longer-term and current period equity volatility and incorporating 10-year average yield curves, in lieu of current period yield curves;
- Movements in IFRS basis guarantee liabilities for GMWB 'for life', being those policies where a minimum annual withdrawal is permitted for the duration of the policyholders' life subject to certain conditions, and GMDB business for which, under the US GAAP rules applied under IFRS, the reserving methodology under US GAAP principles generally gives rise to a muted impact of current period market movements;
- Fee assessment, and claims payments, in respect of guarantee liabilities; and
- Related changes to the amortisation of deferred acquisition costs for each of the above items.

The change reflects management's IFRS 8 segment measure. Within the supplementary analysis of profit, the change is presentational only. It has no impact on profit before tax or shareholders' equity. The impact of this change is as follows:

	2010 £m			2009 £m		
	Previous basis	**Change**	**Revised basis**	**Previous basis**	**Change**	**Revised basis**
Operating profit based on longer-term investment returns						
Jackson	466	367	833	459	159	618
Rest of Group	1,108	–	1,108	946	–	946
Total	1,574	367	1,941	1,405	159	1,564
Short-term fluctuations in investment returns on shareholder-backed business	244	(367)	(123)	36	(159)	(123)
Shareholders' share of actuarial and other gains and loss on defined benefit pension schemes	(10)	–	(10)	(74)	–	(74)
Costs of terminated AIA transaction	(377)	–	(377)	–	–	–
Gain on dilution of holding in PruHealth	30	–	30	–	–	–
Loss on sale and results of Taiwan agency business	–	–	–	(621)	–	(621)
Profit from continuing operations before tax attributable to shareholders	1,461	–	1,461	746	–	746

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A4: SIGNIFICANT ACCOUNTING POLICIES > CONTINUED

US operations – Embedded derivatives for variable annuity guarantee features
The Guaranteed Minimum Income Benefit (GMIB) liability, which is fully reinsured, subject to a deductible and annual claim limits, is accounted for in accordance with FASB ASC Subtopic 944-80 Financial Services – Insurance – Separate Accounts (formerly SOP 03-1) under IFRS using 'grandfathered' US GAAP. As the corresponding reinsurance asset is net settled, it is considered to be a derivative under IAS 39 and the asset is therefore recognised at fair value. As the GMIB benefit is economically reinsured the mark to market element of the reinsurance asset is included as a component of short-term fluctuations in investment returns.

iii Derivative value movements
Derivative value movements are excluded from operating results based on longer-term investment returns. Non-equity based derivatives are primarily held by Jackson as part of a broadly-based hedging programme for features of Jackson's bond portfolio (for which value movements are booked in the statement of comprehensive income rather than the income statement) and product liabilities (for which US GAAP accounting as grandfathered under IFRS 4 does not reflect the economic features being hedged).

Value movements for Jackson's equity-based derivatives and variable and fixed index annuity product embedded derivatives were in prior periods included in operating profits based on longer-term investment returns. In 2010 these value movements, which are variable in nature, have been included in short-term fluctuations and 2009 comparatives have been adjusted accordingly.

There are two exceptions to the basis described above in sections (a) to (c) for determining operating results based on longer-term investment returns. These are for:

- Unit-linked and US variable annuity business. For such business the policyholder unit liabilities are directly reflective of the asset value movements. Accordingly all asset value movements are recorded in the operating results based on longer-term investment returns.
- Assets covering non-participating business liabilities that are interest rate sensitive. For UK annuity business policyholder liabilities are determined by reference to current interest rates. The value movements of the assets covering liabilities are closely correlated with the related change in liabilities. Accordingly asset value movements are recorded within the operating results based on longer-term investment returns. Policyholder liabilities include a margin for credit risk. Variations between actual and best estimate expected impairments are recorded as a component of short-term fluctuations in investment returns.

iv Other liabilities to policyholders and embedded derivatives for product guarantees
Under IFRS, the degree to which the carrying values of liabilities to policyholders are sensitive to current market conditions varies between territories depending upon the nature of the 'grandfathered' measurement basis. In general, in those instances where the liabilities are particularly sensitive to routine changes in market conditions, the accounting basis is such that the impact of market movements on the assets and liabilities is broadly equivalent in the income statement, and operating profit based on longer-term investments returns is not distorted. In these circumstances, there is no need for the movement in the liability to be bifurcated between the elements that relate to longer-term market conditions and short-term effects.

However, some types of business movements in liabilities do require bifurcation to ensure that at the net level (i.e. after allocated investment return and change for policyholder benefits) the operating result reflects longer-term market returns.
Examples where such bifurcation is necessary are:

a Asia
Vietnamese participating business
For the participating business in Vietnam the liabilities include policyholders' interest in investment appreciation and other surplus. Bonuses paid in a reporting period and accrued policyholders' interest in investment appreciation and other surpluses primarily reflect the level of realised investment gains above contract specific hurdle levels. For this business, operating profit based on longer-term investment returns includes the aggregate of longer-term returns on the relevant investments, a credit or charge equal to movements on the liability for the policyholders' interest in realised investment gains (net of any recovery of prior deficits on the participating pool), less amortisation over five years of current and prior movements on such credits or charges.

The overall purpose of these adjustments is to ensure that investment returns included in operating results equal longer-term returns but that in any one reporting period movements on liabilities to policyholders caused by investment returns are substantially matched in the presentation of the supplementary analysis of profit before tax attributable to policyholders.

Non-participating business
Liabilities are bifurcated so that the total movement in the carrying value of liabilities is split between that which is included in operating results based on longer-term investment returns, and the residual element for the effect of using year end rates is included in short-term fluctuations and in the income statement.

Guaranteed Minimum Death Benefit (GMDB) product features

For unhedged GMDB liabilities accounted for under IFRS using 'grandfathered' US GAAP, such as in the Japanese business, the change in carrying value is determined under FASB ASC Subtopic 944-80 Financial Services – Insurance – Separate Accounts (formerly SOP 03-1), which partially reflects changes in market conditions. Under the Company's segmental basis of reporting the operating profit reflects the change in liability based on longer-term market conditions with the difference between the charge to the operating result and the movement reflected in the total result included in short-term fluctuations in investment returns.

b UK shareholder-backed annuity business

With one exception, the operating result based on longer-term investment returns reflects the impact of all value movements on policyholder liabilities for annuity business in PRIL and the PAC non-profit sub-fund.

The exception is for the impact on credit risk provisioning of actual downgrades during the period. As this feature arises due to short-term market conditions, the effect of downgrades, if any, in a particular period, on the overall provisions for credit risk is included in the category of short-term fluctuations in investment returns.

The effects of other changes to credit risk provisioning are included in the operating result, as is the net effect of changes to the valuation rate of interest due to portfolio rebalancing to align more closely with management benchmark.

e Fund management and other non-insurance businesses

For these businesses, the particular features applicable for life assurance noted above do not apply. For these businesses it is inappropriate to include returns in the operating result on the basis described above. Instead, it is appropriate to generally include realised gains and losses (including impairments) in the operating result with unrealised gains and losses being included in short-term fluctuations. For this purpose impairments are calculated as the credit loss determined by comparing the projected cash flows discounted at the original effective interest rate to the carrying value. In some instances it may also be appropriate to amortise realised gains and losses on derivatives and other financial instruments to operating results over a time period that reflects the underlying economic substance of the arrangements.

A5: NEW ACCOUNTING PRONOUNCEMENTS

New accounting pronouncements

The following standards, interpretations and amendments have either been adopted for the first time in 2010 or have been issued but are not yet effective in 2010, including those which have not yet been adopted in the EU. This is not intended to be a complete list as only those standards, interpretations and amendments that are anticipated to have an impact upon the Group's financial statements have been discussed.

Accounting pronouncements adopted in 2010

Revised IFRS 3, 'Business combinations' and Amendments to IAS 27, 'Consolidated and separate financial statements' and IAS 31, 'Interests in joint ventures'

The Group has applied the revised IFRS 3 and amended IAS 27 and IAS 31 from 1 January 2010. The revised IFRS 3 and amended IAS 27 and IAS 31 are the outcomes of the second phase of the IASB's and the US Financial Accounting Standards Board's (FASB) joint business combination project. The change in accounting policy as a result of the adoption of these standards has been applied prospectively. No restatement to 2009 comparatives is required. The more significant changes from the revised IFRS 3 include:

- the immediate expensing of acquisition-related costs rather than inclusion in goodwill;
- recognition and measurement at fair value of contingent consideration classified as financial instruments at acquisition date with subsequent changes to income; and
- additional items or adjustments to items recognised in the business combination are permitted to be applied retrospectively during the measurement period to reflect new information obtained about facts and circumstances that existed as of the acquisition date. The measurement period ends as soon as the acquirer receives the necessary information or learns that more information is not obtainable but is subject to an overall limit for one year.

The amendments to IAS 27 reflect changes to the accounting for non-controlling interests (known as non-controlling interests prior to the amendments). From 1 January 2010, transactions that increase or decrease non-controlling interests without a change of control are accounted as equity transactions and therefore no goodwill is recognised. As a consequence any gains or losses are reported directly in equity and not in the income statement.

The amendments to IAS 31 reflect changes to the accounting for changes in joint control over an entity. From 1 January 2010, when a jointly controlled entity becomes an associate of an investor, the investor shall measure at fair value any investment the investor retains in the former jointly controlled entity. The investor shall recognise in profit or loss any difference between:

(a) the fair value of any retained investment and any proceeds from disposing of the part interest in the jointly controlled entity; and
(b) the carrying amount of an investment at the date when joint control is lost.

A: BACKGROUND AND ACCOUNTING POLICIES CONTINUED

A5: NEW ACCOUNTING PRONOUNCEMENTS > CONTINUED

Previously, no explicit guidance was provided.

The adoption of revised IFRS 3 and amended IAS 27 and IAS 31 has resulted in presentational and disclosure changes in the Group's financial statements, and affected the accounting for the acquisition of United Overseas Bank (UOB) Life Assurance Limited in Singapore. The disclosure on this acquisition is provided in note I1. As a result of the adoption of the revised IFRS 3, the Group has expensed the UOB Life acquisition-related costs incurred of £2 million which would otherwise have been included within goodwill. The Group has also recognised a gain of £30 million related to the change of treatment of PruHealth from a joint venture to an associate, in line with the revisions to IAS 31 set out above as described in note I2(a).

Improvements to IFRSs (2009)

The 2009 annual improvements include minor changes to 12 IFRSs. Amongst others, these include changes to IAS 17 'Leases' on the treatment of lease of land with an indefinite economic life and to IAS 36 'Impairment of assets' on the largest unit to which goodwill should be allocated being the operating segment level as defined by IFRS 8. The Group has reviewed and adopted these changes in 2010 with no significant impact on the Group's results and financial position.

Amendments to IFRS 2 – Group cash-settled share-based payment transactions

In June 2009, the IASB issued further amendments to IFRS 2 which sets out the accounting requirements for share-based payments. These amendments clarified existing guidance, in particular by specifying that an entity that receives goods or services in a share-based payment arrangement must account for those goods or services no matter which entity in the group settles the transaction and no matter whether the transaction is settled in shares or cash. There was no impact on the Group's financial statements upon adoption of this standard.

Amendment to IAS 39, 'Financial instruments: Recognition and measurement' – Eligible Hedged Items

This amendment to IAS 39 clarifies how the principles that determine whether a hedged risk or portion of cash flows is eligible for designation should be applied in particular situations. The adoption of this amendment had no impact on the Group's designated IAS 39 hedges.

Accounting pronouncements endorsed by the EU but not yet effective

The following accounting pronouncements potentially relevant to the Group have been issued and endorsed for use in the EU but are not mandatory for adoption for the 31 December 2010 year end.

Amendments to IAS 24, 'Related party disclosures'

The main revisions which will apply from 2011 relate to exemption for government-related entities and are therefore not applicable to the Group. The amendment also clarifies and simplifies the definition of a related party albeit the nature of the change is minor. The adoption of these revisions is not expected to have any impact on the Group's related party disclosures.

Amendment to IFRIC, '14 Prepayment of a minimum funding requirement'

This amendment will apply from 2011 and removes an unintended consequence of IFRIC 14 relating to voluntary pension pre-payments when there is a minimum funding requirement. IFRIC 14 was amended to require an asset to be recognised for any surplus arising from voluntary pre-payment of minimum funding contributions in respect of future service. The adoption of this amendment is not expected to have an impact on the Group's financial statements.

IFRIC 19, 'Extinguishing financial liabilities with equity instruments'

In November 2009, the IFRIC issued guidance on how to account for the extinguishment of a financial liability by the issue of equity instruments. This interpretation is effective for accounting periods beginning on or after 1 July 2010. This interpretation is not expected to have a material effect on the Group's financial statements.

Improvements to IFRSs (2010)

The changes from this annual improvement which were issued in May 2010 and mostly effective from 2011 include clarification of financial instruments disclosures and of the statement of changes in equity. The Group is in the process of evaluating the implications of these changes.

Accounting pronouncements not yet endorsed by the EU

The following accounting pronouncements potentially relevant to the Group have been issued but not yet endorsed for use in the EU.

IFRS 9, 'Financial Instruments: Classification and measurement'

In November 2009, the IASB issued a new standard which altered the classification and measurement of financial instruments. Under the new standard only two possible classifications arise, rather than the four existing classifications currently available under IAS 39, and will result in all financial assets being valued at amortised cost or fair value through profit and loss.

In October 2010, the IASB issued requirements on the accounting for financial liabilities. These requirements will be added to IFRS 9 and maintain the existing amortised cost measurement for most liabilities and will require changes in fair value due to changes in the entity's own credit risk to be recognised in the other comprehensive income (OCI) section of the comprehensive income statement, rather than within profit or loss for liabilities measured at fair value.

IFRS 9 applies to financial statements for annual periods beginning on or after 1 January 2013. Entities are permitted to apply the new requirements in earlier periods, however, if they do, they must also apply the requirements in IFRS 9 that relate to financial assets.

The standard is not mandatory until 1 January 2013 and is yet to be endorsed by the European Union. The Group is still assessing the full impact of this standard.

Amendments to IFRS 7, 'Financial instruments: Disclosures – Transfers of financial assets'

The amendments, which were issued in October 2010 and effective for annual periods beginning on or after 1 January 2012, introduce new disclosure requirements about transfers of financial assets. These include disclosures for financial assets that are not derecognised in their entirety and financial assets that are derecognised in their entity but for which the entity retains continuing involvement.
The Group is evaluating the implications of the amendments but they are not expected to have a significant impact on the Group's disclosures.

Amendments to IAS 12, 'Income taxes'

On 20 December 2010, the IASB published amendments to IAS 12 Deferred Tax: Recovery of Underlying Assets following the exposure draft issued on 10 September 2010. The amendments are effective for annual periods beginning on or after 1 January 2012.
The amendments require the measurement of deferred tax assets and liabilities arising from investment properties and plant, property and equipment valued at fair value on the presumption that the carrying amount of the asset will be, normally, recovered through sale.
These amendments are not expected to have a material effect on the Group's financial statements.

B: SUMMARY OF RESULTS

B1: SEGMENT DISCLOSURE – INCOME STATEMENT

The determination of the operating segments and performance measure of the operating segments of the Group are as detailed in note A4. Further segmentation of the income segment is provided in note F1 of these financial statements.

	2010 £m	2009 £m
ASIAN OPERATIONS		
Insurance operations:[note ii]		
Underlying results before exceptional credit	536	353
Exceptional credit for Malaysia operations[D4(i)]	–	63
Total Asian insurance operations	536	416
Development expenses	(4)	(6)
Total Asian insurance operations after development expenses	532	410
Asian asset management	72	55
Total Asian operations	604	465
US OPERATIONS		
Jackson (US insurance operations)[notes ii,iv]	833	618
Broker-dealer and asset management[note iv]	22	4
Total US operations	855	622
UK OPERATIONS		
UK insurance operations:[note ii]		
Long-term business	673	606
General insurance commission[note v]	46	51
Total UK insurance operations	719	657
M&G	284	238
Total UK operations	1,003	895
TOTAL SEGMENT PROFIT	2,462	1,982
OTHER INCOME AND EXPENDITURE		
Investment return and other income	30	22
Interest payable on core structural borrowings	(257)	(209)
Corporate expenditure	(220)	(203)
Charge for share-based payments for Prudential schemes[note viii]	(3)	(5)
Total	(450)	(395)
Solvency II implementation costs	(45)	–
Restructuring costs[note ix]	(26)	(23)
Operating profit based on longer-term investment returns[note i]	1,941	1,564
Short-term fluctuations in investment returns on Shareholder-backed business[note vi]	(123)	(123)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes[note vii]	(10)	(74)
Costs of terminated AIA transaction[note x]	(377)	–
Gain on dilution of holding in PruHealth[I2(a)]	30	–
Loss on sale and results for Taiwan agency business[note iii]	–	(621)
PROFIT FROM CONTINUING OPERATIONS BEFORE TAX ATTRIBUTABLE TO SHAREHOLDERS	1,461	746

Notes

i Operating profit based on longer-term investment returns.
Operating profit based on longer-term investment returns is a supplemental measure of results and is the basis on which management regularly review the performance of the Group's segments as defined by IFRS 8. For the purposes of measuring operating profit, investment returns on shareholder-financed business are based on expected long-term rates of return as discussed in note A4. The expected long-term rates of return are intended to reflect historical real rates of return and, where appropriate, current inflation expectations adjusted for consensus economic and investment forecasts. The most significant operation that requires adjustment for the difference between actual and long-term investment returns is Jackson. The amounts included in operating results for long-term capital returns for Jackson's debt securities comprise two

components. These are a risk margin reserve based charge for long-term expected defaults, which is determined by reference to the credit quality of the portfolio, and amortisation of interest-related realised gains and losses to operating results based on longer-term results to the date when sold bonds would otherwise have matured. Consistent with the policy of including longer-term investment returns in the measure of operating profit, movements in policyholder liabilities are also, where appropriate, delineated between amounts included in operating profits and movements arising from short-term market conditions, which are recorded in short-term fluctuations in investment returns. The presentation of operating profit based on longer-term investment returns has been revised in 2010 and the 2009 comparatives have been amended accordingly (see note (iv)).

ii Effect of changes to assumptions, estimates and bases of determining life assurance liabilities.
The results of the Group's long-term business operations are affected by changes to assumptions, estimates and bases of preparation. These are described in notes D2(i), D3(i) and D4(i).

iii Sale of Taiwan agency business.
In order to facilitate comparisons of operating profit based on longer-term investment returns that reflect the Group's retained operations, the results attributable to the Taiwan business for which the sale process was completed in June 2009 are included separately within the segmental analysis of profit for 2009.

iv Jackson operating results based on longer-term investment returns.
The Group has amended the presentation of operating profit for its US insurance operations to remove net equity hedge accounting effect (incorporating related amortisation of deferred acquisition costs) and include it in short-term fluctuations. The 2009 comparatives have been amended accordingly. The effect of this change is explained note A4(d)(ii).
IFRS basis operating profits for US operations include the following amounts (net of related change in amortisation of deferred acquisition costs, where applicable) so as to derive longer-term investment returns.

	2010 £m	**2009** £m
Debt securities:		
Amortisation of interest related realised gains and losses	63	47
Risk margin reserve charge for longer-term credit related losses (see below)	(55)	(60)
Equity type investments:		
Longer-term returns	(8)	69

The risk margin reserve (RMR) charge for longer-term credit related losses included in operating profit based on longer-term investment returns for 2010 is based on an average annual RMR of 26 basis points (2009: 27 basis points) on average book values of US $44.2 billion for the year as shown below.

	2010				**2009**			
Moody's rating category (or equivalent under NAIC ratings of MBS)	**Average book value** (US $m)	**RMR** %	**Annual expected losses** US $m	**Annual expected losses** £m	**Average book value** (US $m)	**RMR** %	**Annual expected losses** US $m	**Annual expected losses** £m
A3 or higher	20,622	0.06	(12)	(8)	19,509	0.03	(5)	(3)
Baa1, 2, 3	20,785	0.26	(53)	(34)	21,072	0.23	(47)	(30)
Ba1, 2, 3	1,935	1.04	(20)	(13)	2,035	1.13	(23)	(15)
B1, 2, 3	500	2.99	(15)	(10)	594	2.86	(17)	(11)
Below B3	321	3.88	(13)	(8)	691	3.91	(27)	(17)
Total	44,163	0.26	(113)	(73)	43,901	0.27	(119)	(76)
Related change to amortisation of deferred acquisition costs (see below)			28	18			25	16
Risk margin reserve charge to operating profit for longer-term credit related losses			(85)	(55)			(94)	(60)

For the period ended 31 December 2010, Jackson has continued the practice commenced in the second half of 2009 in relation to RMBS and for 2010 for CMBS to determine the risk margin charge included in operating profit based on longer-term investment returns using the regulatory rating as determined by third parties; PIMCO (for RMBS) and BlackRock Solutions (for CMBS) on behalf of the National Association of Insurance Commissioners (NAIC). See note A4(d) for further information.

The longer-term rates of return for equity-type investments are currently based on spreads over 10 year US treasury rates of 400 to 600 basis points. The longer-term rates of return for equity-type investments ranged from 6.5 per cent to 7.9 per cent at 31 December 2010 and 6.7 per cent to 7.4 per cent at 31 December 2009 depending on the type of investments.

Consistent with the basis of measurement of insurance assets and liabilities for Jackson's IFRS results, the charges and credits to operating profits based on longer-term investment returns are partially offset by related changes to amortisation of deferred acquisition costs.

v UK operations transferred its general insurance business to Churchill in 2002, with general insurance commission representing the commission receivable net of expenses for Prudential-branded general insurance products as part of this arrangement.

B: SUMMARY OF RESULTS CONTINUED

B1: SEGMENT DISCLOSURE - INCOME STATEMENT > CONTINUED

vi Short-term fluctuations in investment returns on shareholder-backed business.

	2010 £m	2009 £m
Insurance operations:		
Asia	114	31
US	(378)	(132)
UK	116	108
Other operations:		
IGD hedge costs	–	(235)
Other	25	105
	25	(130)
Total	(123)	(123)

General overview of defaults
The Group incurred defaults of £nil in 2010 (2009: £11 million) on its debt securities portfolio. The defaults of £11 million in 2009 were experienced by the UK Shareholder-backed annuity business.

Asian insurance operations
The fluctuations for Asian insurance operations in 2010 of £114 million primarily reflect unrealised gains on the debt securities held by shareholders' funds, as well as a £30 million unrealised gain on the Group's 8.66 per cent stake in China Life Insurance Company of Taiwan. For 2009, the gain of £31 million primarily relate to strong market performance in Taiwan and Japan partially offset by the fall in the Vietnamese bond markets.

US insurance operations
The short-term fluctuations in investment returns for US insurance operations for the year comprise the following items:

	2010 £m	2009 £m
Short-term fluctuations related to debt securities:		
Charges in the year		
Losses on sales of impaired and deteriorating bonds	(99)	(6)
Bond write downs	(124)	(630)
Recoveries/reversals	10	5
Total charges in the year*	(213)	(631)
Less: risk margin charge included in operating profit based on longer-term investment returns[B1(iv)]	73	76
	(140)	(555)
Interest related realised gains (losses):		
Arising in the year	224	125
Less: amortisation gains and losses arising in current and prior years to operating profit based on longer-term investment returns	(82)	(59)
	142	66
Related change to amortisation of deferred acquisition costs	(3)	75
Total short-term fluctuations related to debt securities	(1)	(414)
Derivatives (other than equity related): market value movements (net of related change to amortisation of deferred acquisition costs)†	(15)	385
Net equity hedge results based on longer-term equity volatility and interest rates (net of related change to amortisation of deferred acquisition costs)‡	(367)	(159)
Equity related derivatives: volatility and interest rate normalisation (net of related change to amortisation of deferred acquisition costs)#	2	85
Equity type investments: actual less longer-term return (net of related change to amortisation of deferred acquisition costs)[B1(iv)]	3	(59)
Other items (net of related change to amortisation of deferred acquisition costs)	–	30
Total	(378)	(132)

* The charges on debt securities of Jackson incurred in 2010 and 2009 of £213 million and £631 million respectively, comprise the following:

	Defaults £m	Bond write downs £m	Losses on sale of impaired and deteriorating bonds £m	Recoveries/ reversals £m	2010 Total £m	2009 Total £m
Residential mortgage-backed securities						
Prime (including agency)	–	21	35	–	56	268
Alt-A	–	35	20	(1)	54	182
Sub-prime	–	15	(2)	–	13	49
Total residential mortgage-backed securities	–	71	53	(1)	123	499
Corporate debt securities	–	1	40	(4)	37	107
Other	–	52	6	(5)	53	25
Total	–	124	99	(10)	213	631

Within other bond write downs of £52 million (2009: £30 million), £40 million (2009: £30 million) relate to Piedmont securities. Piedmont is an investment vehicle investing in certain asset-backed and mortgage-backed securities in the US.

† The loss of £15 million (2009: gain of £385 million) is for the value movement for non-equity freestanding derivatives held to manage the fixed annuity and other general account business. Under IAS 39, unless hedge accounting is applied, value movements on derivatives are recognised in the income statement.

For the derivatives programme attaching to the fixed annuity and other general account business the Group has continued its approach of not seeking to apply hedge accounting under IAS 39. This decision reflects the inherent constraints of IAS 39 for hedge accounting investments and life assurance assets and liabilities under 'grandfathered' US GAAP under IFRS 4.

‡ The Group has amended its presentation of equity-based derivatives and associated guarantee liabilities to remove the net equity hedge accounting effect (incorporating related amortisation of deferred acquisition costs) from operating profit based on longer-term investment returns and include it in short-term fluctuations. The 2009 comparatives have been amended accordingly. The effect of this change is explained in note A4(d)(ii).

Prior to the change in the presentation of operating profit of the US insurance operations as explained in note A4(d)(ii), the effect of the difference in the value movements for freestanding derivatives and embedded derivatives arising from changes between longer-term and actual levels of implied equity volatility and end of period AA corporate bond yield curves was reflected in short-term fluctuations in investment return. This normalisation reflects the use of longer-term implied equity volatility levels, and also, for embedded derivatives 10 year average AA corporate bond yield curves, in the value movement included in net equity hedge accounting effect and is unaffected by the change in the presentation of the net equity hedge accounting effect.

This volatility and interest rate normalisation of value movements for freestanding and embedded derivatives gave rise to a £2 million gain (2009: £85 million). The net equity hedge accounting effect based on longer-term equity volatility and interest rate is as described above in note ‡.

In addition to the items discussed above, for US insurance operations, included within the statement of comprehensive income, is an increase in net unrealised gains on debt securities classified as available-for-sale of £1,221 million (2009: reduction in net unrealised losses of £2,669 million). Temporary market value movements do not reflect defaults or impairments. Additional details on the movement in the value of the Jackson portfolio are included in note D3.

UK insurance operations

The short-term fluctuations gain for UK insurance operations of £116 million (2009: £108 million) reflected principally asset value movements, principally for shareholder-backed annuity business.

IGD hedge costs

During the severe equity market conditions experienced in the first quarter of 2009 coupled with historically high equity volatility the Group entered into exceptional short-dated hedging contracts to protect against potential tail-events on the IGD capital position, in addition to the regular operational hedging programmes. The hedge contracts expired in 2009 and have not been renewed.

Other

Short-term fluctuations of other operations, in addition to the previously discussed IGD hedge costs, arise from:

	2010 £m	2009 £m
Unrealised value movements on swaps held centrally to manage Group assets and liabilities	(25)	28
Unrealised value movements on Prudential Capital's bond portfolio	48	66
Unrealised value movements on investments held by other operations	2	11
	25	105

B: SUMMARY OF RESULTS CONTINUED

B1: SEGMENT DISCLOSURE – INCOME STATEMENT > CONTINUED

vii Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes

	2010 £m	2009 £m
ACTUARIAL GAINS AND LOSSES		
Actual less expected return on scheme assets	31	23
Experience (losses) gains on scheme liabilities	(5)	17
Losses on changes of assumptions for scheme liabilities	(41)	(147)
	(15)	(107)
Less: amount attributable to the PAC with-profits sub-fund	5	47
	(10)	(60)
OTHER GAINS AND LOSSES		
Movement in the provision for deficit funding of PSPS	–	(48)
Less: amount attributable to the PAC with-profits sub-fund	–	34
	–	(14)
Total	(10)	(74)

The actuarial gains and losses shown in the table above relate to the Scottish Amicable and M&G. The amounts did not include actuarial gains and losses for the Prudential Staff Pension Scheme (PSPS) for which the Group has not recognised its interest in the scheme's underlying surplus.

The losses of £41 million on change of assumptions comprise mainly the effect of a decrease in the risk discount rate partially offset by the effect of decrease in inflation rates.

Other gains and losses in 2009 related to the change in the provision for deficit funding obligation for PSPS. There was no change in 2010.

Further details on the Group's defined benefit pension schemes are shown in note I3.

viii Share-based payments

The charge for share-based payments for Prudential schemes is for the SAYE and Group performance-related schemes.

ix Restructuring costs are incurred in the UK as part of EEV covered business (£26 million) and as part of central operations of £nil (EEV non-covered business) (2009: £16 million and £7 million respectively).

x The following costs were incurred in relation to the proposed, and subsequently terminated transaction, to purchase AIA Group Limited and related rights issue.

	2010 £m
AIG termination break fee	153
Underwriting fees	58
Costs associated with foreign exchange hedging	100
Adviser fees and other	66
TOTAL COSTS BEFORE TAX	377
Associated tax relief	(93)
Total costs after tax	284

Of the £377 million total costs before tax, the £100 million associated with foreign exchange hedging has been recorded within 'Investment return' and the other £277 million has been recorded as 'Other expenditure' within 'Acquisition costs and other expenditure' in the consolidated income statement.

B2: EARNINGS PER SHARE

Basic earnings per share is calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year, excluding those held in employee share trusts and consolidated unit-trusts and OEICs, which are treated as cancelled.

For diluted earnings per share, the weighted average number of shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares. The Group's only class of dilutive potential ordinary shares are those share options granted to employees where the exercise price is less than the average market price of the Company's ordinary shares during the year. No adjustment is made if the impact is anti-dilutive overall.

Earnings per share are calculated based on earnings attributable to ordinary shareholders, after related tax and non-controlling interests.

	2010					
	Before tax B1 £m	Tax F5 £m	Non-controlling interests £m	Net of tax and non-controlling interests £m	Basic earnings per share Pence	Diluted earnings per share Pence
Based on operating profit based on longer-term investment returns, excluding exceptional tax credit	1,941	(371)	(5)	1,565	62.0p	61.9p
Exceptional tax credit*	–	158	–	158	6.3p	6.3p
Based on operating profit based on longer-term investment returns	1,941	(213)	(5)	1,723	68.3p	68.2p
Short-term fluctuations in investment returns on shareholder-backed business	(123)	92	–	(31)	(1.2p)	(1.2p)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	(10)	3	–	(7)	(0.3p)	(0.3p)
Costs of terminated AIA transaction	(377)	93	–	(284)	(11.3p)	(11.3p)
Gain on dilution of holding in PruHealth	30	–	–	30	1.2p	1.2p
Based on profit for the year from continuing operations including exceptional tax credit	1,461	(25)	(5)	1,431	56.7p	56.6p

* The tax charge attributable to shareholders' return includes an exceptional tax credit of £158 million which primarily relates to the impact of settlement agreed with the UK tax authorities.

	2009(1)					
	Before tax B1 £m	Tax F5 £m	Non-controlling interests £m	Net of tax and non-controlling interests £m	Basic earnings per share Pence	Diluted earnings per share Pence
Based on operating profit based on longer-term investment returns	1,564	(374)	(2)	1,188	47.5p	47.4p
Short-term fluctuations in investment returns on shareholder-backed business	(123)	280	1	158	6.3p	6.3p
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	(74)	21	–	(53)	(2.1p)	(2.1p)
Adjustment from loss on sale and result of Taiwan agency business	(621)	18	–	(603)	(24.1p)	(24.0p)
Based on profit for the year from continuing operations	746	(55)	(1)	690	27.6p	27.6p
Adjustments for post-tax results of discontinued operations	(14)	–	–	(14)	(0.6p)	(0.6p)
Based on profit for the year	732	(55)	(1)	676	27.0p	27.0p

Note

(1) The Group has amended the presentation of IFRS operating profit for its US operations to remove net equity hedge accounting effect (incorporating related amortisation of deferred acquisition costs) and include it in short-term fluctuations. The 2009 comparatives have been amended accordingly.

B: SUMMARY OF RESULTS CONTINUED

B2: EARNINGS PER SHARE > CONTINUED

Number of shares

A reconciliation of the weighted average number of ordinary shares used for calculating basic and diluted earnings per share is set out as below:

	2010 £m	2009 £m
Weighted average shares for calculation of basic earnings per share	2,524	2,501
Shares under option at end of year	13	12
Number of shares that would have been issued at fair value on assumed option exercise	(8)	(7)
Weighted average shares for calculation of diluted earnings per share	2,529	2,506

B3: DIVIDENDS

	2010 £m	2009 £m
Dividends declared and paid in reporting period		
Parent company:		
Interim dividend (2010: 6.61p, 2009: 6.29p per share)	168	159
Second interim/Final dividend for prior period (2010: 13.56p, 2009: 12.91p per share)	343	322
Total	511	481

As a result of shares issued in lieu of dividends of £62 million (2009: £137 million), dividends paid in cash, as set out in the consolidated cash flow statement, were £449 million (2009: £344 million).

	2010 £m	2009 £m
Parent company dividends relating to reporting period:		
Interim dividend (2010: 6.61p, 2009: 6.29p per share)	168	159
Final/second interim dividend (2010: 17.24p, 2009: 13.56p per share)	439	343
Total	607	502

Interim dividends are recorded in the period in which they are paid. Final dividends are recorded in the period in which they are approved by shareholders. The second interim dividend of 13.56 pence per ordinary share for the year ended 31 December 2009 was paid to eligible shareholders on 27 May 2010 and the 2010 interim dividend of 6.61 pence per ordinary share was paid to eligible shareholders on 23 September 2010.

Following the Board's decision to rebase the dividend upwards and subject to shareholders' approval, the 2010 final dividend of 17.24 pence per ordinary share will be paid on 26 May 2011 in sterling to shareholders on the principal and Irish branch registers at 6.00pm BST on Friday, 1 April 2011 (the 'Record Date'), and in Hong Kong dollars to shareholders on the Hong Kong branch register at 4.30pm Hong Kong time on the Record Date ('HK Shareholders'). Holders of US American Depositary Receipts ('US Shareholders') will be paid their dividend in US dollars on or about five days after the payment date of the dividend to shareholders on the principal register. The dividend will be paid on or about 2 June 2011 in Singapore dollars to shareholders with shares standing to the credit of their securities accounts with The Central Depository (Pte.) Limited ('CDP') at 5.00pm Singapore time on the Record Date ('SG Shareholders'). The dividend payable to the HK Shareholders will be translated at the exchange rate ruling at the close of business on 8 March 2011. The exchange rate at which the dividend payable to the SG Shareholders will be translated will be determined by CDP. The dividend will distribute an estimated £439 million of shareholders' funds.

The scrip dividend alternative is not being offered in respect of this dividend. In its place shareholders will be offered a Dividend Reinvestment Plan (DRIP).

B4: EXCHANGE TRANSLATION

Exchange movement recognised in other comprehensive income

	2010 £m	2009 £m
Asian operations	164	(189)
US operations	88	(244)
Unallocated to a segment (central funds)	(35)	227
	217	(206)

The movements for Asian and US operations reflect the application of year end exchange rates to the assets and liabilities and average exchange rates to the income statement on translation of these operations into the presentation currency of the Group. The movement unallocated to a segment mainly reflects the translation of currency borrowings and forward contracts which have been designated as a net investment hedge against the currency risk of the net investment in Jackson.
The exchange rates applied were:

Local currency: £	Closing rate at 31 Dec 2010	Average for 2010	Closing rate at 31 Dec 2009	Average for 2009	Opening rate at 1 Jan 2009
Hong Kong	12.17	12.01	12.52	12.14	11.14
Indonesia	14,106.51	14,033.41	15,171.52	16,173.28	15,799.22
Malaysia	4.83	4.97	5.53	5.51	5.02
Singapore	2.01	2.11	2.27	2.27	2.07
India	70.01	70.66	75.15	75.70	70.05
Vietnam	30,526.26	29,587.63	29,832.74	27,892.39	25,205.87
US	1.57	1.55	1.61	1.57	1.44

B5: NEW BUSINESS

Insurance products and investment products note i

	Insurance products gross premiums		Investment products gross inflows note ii		Total	
	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m
Asian operations	2,514	2,019	80,597	71,176	83,111	73,195
US operations	11,439	8,909	–	6	11,439	8,915
UK operations	5,910	5,014	26,372	24,875	32,282	29,889
Group total	19,863	15,942	106,969	96,057	126,832	111,999

B: SUMMARY OF RESULTS CONTINUED

B5: NEW BUSINESS > CONTINUED

Insurance products – new business premiums and contributions note i

	Single		Regular		Annual Equivalents	
	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m
GROUP INSURANCE OPERATIONS						
Asia – ex Japan	1,104	785	1,391	1,131	1,501	1,209
US	11,417	8,885	22	24	1,164	912
UK	5,656	4,768	254	246	820	723
GROUP TOTAL – EX JAPAN	18,177	14,438	1,667	1,401	3,485	2,844
Japan(iv)	13	57	6	46	7	52
GROUP TOTAL	18,190	14,495	1,673	1,447	3,492	2,896
ASIAN INSURANCE OPERATIONS						
Hong Kong	107	94	276	232	287	241
Indonesia	141	41	269	186	283	190
Malaysia	58	63	198	140	204	146
Philippines	64	14	17	10	23	11
Singapore	318	297	143	98	175	128
Thailand	15	14	25	14	26	16
Vietnam	1	1	41	35	41	35
SE ASIA OPERATIONS INC. HONG KONG	704	524	969	715	1,039	767
China (Group's 50% interest)	103	72	48	38	58	45
India (Group's 26% interest)	85	47	180	163	188	168
Korea	66	38	89	118	96	122
Taiwan(iii)	146	104	105	97	120	107
TOTAL ASIA OPERATIONS – EX JAPAN	1,104	785	1,391	1,131	1,501	1,209
US INSURANCE OPERATIONS						
Fixed Annuities	836	1,053	–	–	84	105
Fixed Index Annuities	1,089	1,433	–	–	109	143
Life	11	10	22	24	23	25
Variable Annuities	9,481	6,389	–	–	948	639
TOTAL US INSURANCE OPERATIONS	11,417	8,885	22	24	1,164	912
UK & EUROPE INSURANCE OPERATIONS(vi)						
Direct and Partnership Annuities	593	590	–	–	59	59
Intermediated Annuities	221	242	–	–	22	24
Internal Vesting Annuities	1,235	1,357	–	–	124	136
TOTAL INDIVIDUAL ANNUITIES	2,049	2,189	–	–	205	219
Corporate Pensions	228	192	198	191	221	210
On-shore Bonds	1,660	1,444	–	–	166	145
Other Products	774	881	56	55	133	143
Wholesale	945	62	–	–	95	6
TOTAL UK & EUROPE INSURANCE OPS	5,656	4,768	254	246	820	723
GROUP TOTAL – EX JAPAN	18,177	14,438	1,667	1,401	3,485	2,844

Investment products – funds under management notes ii and iv

	2010 £m				
	1 Jan 2010	Market gross inflows	Redemptions	Market exchange translation and other movements	31 Dec 2010
Asian operations	19,474	80,597	(80,812)	2,789	22,048
US operations	–	–	–	–	–
UK operations	70,306	26,372	(17,267)	9,915	89,326
GROUP TOTAL	89,780	106,969	(98,079)	12,704	111,374

	2009 £m				
	1 Jan 2009	Market gross inflows	Redemptions	Market exchange translation and other movements	31 Dec 2009
Asian operations	15,232	71,176	(69,177)	2,243	19,474
US operations	50	6	(66)	10	–
UK operations	46,997	24,875	(11,397)	9,831	70,306
GROUP TOTAL	62,279	96,057	(80,640)	12,084	89,780

Notes

i The tables shown above are provided as an indicative volume measure of transactions undertaken in the reporting period that have the potential to generate profits for shareholders. The amounts shown are not, and not intended to be, reflective of premium income recorded in the IFRS income statement.

Annual Premium Equivalents (APEs) are calculated as the aggregate of regular new business amounts and one-tenth of single new business amounts. New business premiums for regular premium products are shown on an annualised basis. Department of Work and Pensions (DWP) rebate business is classified as single recurrent business. Internal vesting business is classified as new business where the contracts include an open market option.

The format of the tables shown above is consistent with the distinction between insurance and investment products as applied for previous financial reporting periods. With the exception of some US institutional business, products categorised as 'insurance' refer to those classified as contracts of long-term insurance business for regulatory reporting purposes, i.e. falling within one of the classes of insurance specified in Part II of Schedule 1 to the Regulated Activities Order under FSA regulations.

The details shown above for insurance products include contributions for contracts that are classified under IFRS 4 'Insurance Contracts' as not containing significant insurance risk. These products are described as investment contracts or other financial instruments under IFRS. Contracts included in this category are primarily certain unit-linked and similar contracts written in UK insurance operations and Guaranteed Investment Contracts and similar funding agreements written in US operations.

ii Investment products referred to in the table for funds under management above are unit trust, mutual funds and similar types of retail fund management arrangements. These are unrelated to insurance products that are classified as 'investment contracts' under IFRS 4, as described in the preceding paragraph, although similar IFRS recognition and measurement principles apply to the acquisition costs and fees attaching to this type of business.

iii The tables above include new business for the Taiwan bank distribution operation. New business of the Taiwan Agency business, which was sold in June 2009 (as explained in note I2(b) is excluded from the tables.

iv New business sales for the Group's Japanese insurance subsidiary, which ceased selling new business with effect from 15 February 2010, have been presented separately from the remainder of the Group.

v New business and market gross inflows and redemptions have been translated at the average exchange rate for the year applicable. Funds under management at points in time are translated at the exchange rate applicable at those dates.

vi The Prudential's European operation is based in Ireland and sells products into Jersey, Guernsey, Isle of Man, Gibraltar, Cyprus, Malta, Belgium, Spain and UK.

B: SUMMARY OF RESULTS CONTINUED

B6: GROUP STATEMENT OF FINANCIAL POSITION

To explain more comprehensively the assets, liabilities and capital of the Group's businesses it is appropriate to provide an analysis of the Group's statement of financial position by operating segment and type of business. The tables below aggregate the three asset management segments for ease of presentation and hence should be read in conjunction with the associated tables on asset management in note E2.

a Group statement of financial position by operating segment

i Position at 31 December 2010

	2010 £m							
	Insurance operations							
BY OPERATING SEGMENT	UK D2	US D3	Asia D4	Total insurance operations	Asset management operations E2	Unallocated to a segment (central operations)	Intra-group eliminations	31 Dec 2010 Group total
ASSETS								
Intangible assets attributable to shareholders:								
Goodwill	–	–	236	236	1,230	–	–	1,466
Deferred acquisition costs and other intangible assets	118	3,543	939	4,600	9	–	–	4,609
Total[H1]	118	3,543	1,175	4,836	1,239	–	–	6,075
Intangible assets attributable to with-profits funds:								
In respect of acquired subsidiaries for venture fund and other investment purposes	166	–	–	166	–	–	–	166
Deferred acquisition costs and other intangible assets	13	–	97	110	–	–	–	110
Total[H2]	179	–	97	276	–	–	–	276
Total	297	3,543	1,272	5,112	1,239	–	–	6,351
Deferred tax assets[H4]	214	1,391	98	1,703	123	362	–	2,188
Other non-investment and non-cash assets[H3-H6]	4,633	1,241	811	6,685	999	4,159	(5,761)	6,082
Investment of long-term business and other operations:								
Investment properties	11,212	26	9	11,247	–	–	–	11,247
Investments accounted for using the equity method	69	–	2	71	–	–	–	71
Financial investments:								
Loans[note d]	2,302	4,201	1,340	7,843	1,418	–	–	9,261
Equity securities and portfolio holdings in unit trusts	40,519	31,501	14,464	86,484	151	–	–	86,635
Debt securities[note d]	74,304	26,366	14,108	114,778	1,574	–	–	116,352
Other investments	3,998	1,199	382	5,579	59	141	–	5,779
Deposits	9,022	212	638	9,872	80	–	–	9,952
Total investments[G1,H7,H8,note c]	141,426	63,505	30,943	235,874	3,282	141	–	239,297
Properties held for sale[H9]	254	3	–	257	–	–	–	257
Cash and cash equivalents[H10]	2,839	232	1,601	4,672	1,436	523	–	6,631
TOTAL ASSETS	149,663	69,915	34,725	254,303	7,079	5,185	(5,761)	260,806

Note

(i) Further segmental analysis:
The non-current assets of the Group comprise goodwill, intangible assets other than DAC and present value of acquired in-force business and property, plant and equipment included within 'other non-investment and non-cash assets'. Items defined as financial instruments or related to insurance contracts are excluded. Of the Group's total non-current assets at 31 December 2010 of £2,454 million (2009: £1,965 million), £1,708 million (2009: £1,444 million) was held in the UK by the UK insurance operations, M&G and central operations, £131 million (2009: £112 million) was held in the US and £615 million (2009: £409 million) was held in Asia.
No individual country in Asia held non-current assets at the end of the year which exceeded 10 per cent of the Group total.

BY OPERATING SEGMENT	2010 £m							
	Insurance operations			Total insurance opera-tions	Asset manage-ment opera-tions E2	Unallo-cated to a segment (central opera-tions)	Intra-group elimina-tions	31 Dec 2010 Group total
	UK D2	US D3	Asia D4					
EQUITY AND LIABILITIES								
Equity								
Shareholders' equity[H11]	2,148	3,815	2,149	8,112	1,787	(1,868)	–	8,031
Non-controlling interests	35	–	5	40	4	–	–	44
Total equity	2,183	3,815	2,154	8,152	1,791	(1,868)	–	8,075
Liabilities								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Insurance contract liabilities[H12]	84,152	58,641	28,498	171,291	–	–	–	171,291
Investment contract liabilities with discretionary participation features[G1]	25,613	–	119	25,732	–	–	–	25,732
Investment contract liabilities without discretionary participation features[G1]	15,765	1,882	57	17,704	–	–	–	17,704
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds)[D2(g)ii,H12]	10,187	–	66	10,253	–	–	–	10,253
Total policyholder liabilities and unallocated surplus of with-profits funds[note e]	135,717	60,523	28,740	224,980	–	–	–	224,980
Core structural borrowings of shareholder-financed operations:[H13]								
Subordinated debt	–	–	–	–	–	2,718	–	2,718
Other	–	159	–	159	250	549	–	958
Total	–	159	–	159	250	3,267	–	3,676
Operational borrowings attributable to shareholder-financed operations[G1,H13]	162	90	189	441	3	2,560	–	3,004
Borrowings attributable to with-profits operations[H13]	1,522	–	–	1,522	–	–	–	1,522
Other non-insurance liabilities:[G1,H4,H14,H15]								
Obligations under funding, securities lending and sale and repurchase agreements	2,398	1,801	–	4,199	–	–	–	4,199
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	1,755	33	1,126	2,914	458	–	–	3,372
Deferred tax liabilities	1,738	1,776	495	4,009	5	210	–	4,224
Current tax liabilities	399	34	70	503	33	295	–	831
Accruals and deferred income	340	–	109	449	244	14	–	707
Other creditors	1,939	511	1,122	3,572	4,039	471	(5,761)	2,321
Provisions	442	19	61	522	157	50	–	729
Derivative liabilities	792	799	222	1,813	78	146	–	2,037
Other liabilities	276	355	437	1,068	21	40	–	1,129
Total	10,079	5,328	3,642	19,049	5,035	1,226	(5,761)	19,549
Total liabilities	147,480	66,100	32,571	246,151	5,288	7,053	(5,761)	252,731
TOTAL EQUITY AND LIABILITIES	149,663	69,915	34,725	254,303	7,079	5,185	(5,761)	260,806

B: SUMMARY OF RESULTS CONTINUED

B6: GROUP STATEMENT OF FINANCIAL POSITION > CONTINUED

ii Position at 31 December 2009

BY OPERATING SEGMENT	2009 £m							
	Insurance operations							
	UK D2	US D3	Asia D4	Total insurance operations	Asset management operations E2	Unallocated to a segment (central operations)	Intra-group eliminations	31 Dec 2009 Group total
ASSETS								
Intangible assets attributable to shareholders:								
Goodwill	–	–	80	80	1,230	–	–	1,310
Deferred acquisition costs and other intangible assets	127	3,092	822	4,041	8	–	–	4,049
Total[H1]	127	3,092	902	4,121	1,238	–	–	5,359
Intangible assets attributable to with-profits funds:								
In respect of acquired subsidiaries for venture fund and other investment purposes	124	–	–	124	–	–	–	124
Deferred acquisition costs and other intangible assets	9	–	97	106	–	–	–	106
Total[H2]	133	–	97	230	–	–	–	230
Total	260	3,092	999	4,351	1,238	–	–	5,589
Deferred tax assets[H4]	292	1,944	132	2,368	132	208	–	2,708
Other non-investment and non-cash assets[H3-H6]	3,074	1,404	880	5,358	718	4,393	(5,044)	5,425
Investment of long-term business and other operations:								
Investment properties	10,861	33	11	10,905	–	–	–	10,905
Investments accounted for using the equity method	4	–	2	6	–	–	–	6
Financial investments:								
Loans[note d]	1,815	4,319	1,207	7,341	1,413	–	–	8,754
Equity securities and portfolio holdings in unit trusts	37,051	20,984	11,182	69,217	137	–	–	69,354
Debt securities[note d]	67,772	22,831	9,984	100,587	1,164	–	–	101,751
Other investments	3,630	955	258	4,843	113	176	–	5,132
Deposits	11,557	454	746	12,757	63	–	–	12,820
Total investments[G1,H7,H8,note c]	132,690	49,576	23,390	205,656	2,890	176	–	208,722
Properties held for sale[H9]	–	3	–	3	–	–	–	3
Cash and cash equivalents[H10]	2,265	340	837	3,442	970	895	–	5,307
TOTAL ASSETS	138,581	56,359	26,238	221,178	5,948	5,672	(5,044)	227,754

BY OPERATING SEGMENT	2009 £m							
	Insurance operations			Total insurance operations	Asset management operations E2	Unallocated to a segment (central operations)	Intra group eliminations	31 Dec 2009 Group total
	UK D2	US D3	Asia D4					
EQUITY AND LIABILITIES								
Equity								
Shareholders' equity[H11]	1,939	3,011	1,462	6,412	1,659	(1,800)	–	6,271
Non-controlling interests	28	–	1	29	3	–	–	32
Total equity	1,967	3,011	1,463	6,441	1,662	(1,800)	–	6,303
Liabilities								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Insurance contract liabilities[H12]	77,655	46,346	21,712	145,713	–	–	–	145,713
Investment contract liabilities with discretionary participation features[G1]	24,780	–	100	24,880	–	–	–	24,880
Investment contract liabilities without discretionary participation features[G1]	13,794	1,965	46	15,805	–	–	–	15,805
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds)[D2(g)ii,H12]	9,966	–	53	10,019	–	–	–	10,019
Total policyholder liabilities and unallocated surplus of with-profits funds[note e]	126,195	48,311	21,911	196,417	–	–	–	196,417
Core structural borrowings of shareholder-financed operations:[H13]								
Subordinated debt	–	–	–	–	–	2,691	–	2,691
Other	–	154	–	154	–	549	–	703
Total	–	154	–	154	–	3,240	–	3,394
Operational borrowings attributable to shareholder-financed operations[G1,H13]	158	203	210	571	142	2,038	–	2,751
Borrowings attributable to with-profits operations[H13]	1,284	–	–	1,284	–	–	–	1,284
Other non-insurance liabilities:[G1,H4,H14,H15]								
Obligations under funding, securities lending and sale and repurchase agreements	2,108	1,374	–	3,482	–	–	–	3,482
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	2,534	47	818	3,399	410	–	–	3,809
Deferred tax liabilities	1,606	1,858	384	3,848	5	19	–	3,872
Current tax liabilities	426	89	85	600	35	580	–	1,215
Accruals and deferred income	271	–	105	376	209	9	–	594
Other creditors	726	532	760	2,018	3,292	1,346	(5,044)	1,612
Provisions	406	10	50	466	127	50	–	643
Derivative liabilities	709	461	146	1,316	49	136	–	1,501
Other liabilities	191	309	306	806	17	54	–	877
Total	8,977	4,680	2,654	16,311	4,144	2,194	(5,044)	17,605
Total liabilities	136,614	53,348	24,775	214,737	4,286	7,472	(5,044)	221,451
TOTAL EQUITY AND LIABILITIES	138,581	56,359	26,238	221,178	5,948	5,672	(5,044)	227,754

B: SUMMARY OF RESULTS CONTINUED

B6: GROUP STATEMENT OF FINANCIAL POSITION > CONTINUED

b Group statement of financial position by business type

BY BUSINESS TYPE	2010 £m							2009 £m
		Shareholder-backed business						
	Participating funds	Unit-linked and variable annuity	Non-linked business	Asset management operations E2	Unallocated to a segment (central operations)	Intra-group elimination	31 Dec 2010 Group total	31 Dec 2009 Group total
Assets								
Intangible assets attributable to shareholders:								
Goodwill	–	–	236	1,230	–	–	1,466	1,310
Deferred acquisition costs and other intangible assets	–	–	4,600	9	–	–	4,609	4,049
Total[H1]	–	–	4,836	1,239	–	–	6,075	5,359
Intangible assets attributable to with-profits funds:								
In respect of acquired subsidiaries for venture fund and other investment purposes	166	–	–	–	–	–	166	124
Deferred acquisition costs and other intangible assets	110	–	–	–	–	–	110	106
Total[H2]	276	–	–	–	–	–	276	230
Total	276	–	4,836	1,239	–	–	6,351	5,589
Deferred tax assets[H4]	109	–	1,594	123	362	–	2,188	2,708
Other non-investment and non-cash assets[H3-H6]	2,749	651	3,285	999	4,159	(5,761)	6,082	5,425
Investment of long-term business and other operations:								
Investment properties	8,993	745	1,509	–	–	–	11,247	10,905
Investments accounted for using the equity method	–	–	71	–	–	–	71	6
Financial investments:								
Loans[note d]	2,144	–	5,699	1,418	–	–	9,261	8,754
Equity securities and portfolio holdings in unit trusts	31,371	54,274	839	151	–	–	86,635	69,354
Debt securities[note d]	53,261	9,054	52,463	1,574	–	–	116,352	101,751
Other investments	3,887	131	1,561	59	141	–	5,779	5,132
Deposits	7,272	749	1,851	80	–	–	9,952	12,820
Total investments[G1,H7,H8, note c]	106,928	64,953	63,993	3,282	141	–	239,297	208,722
Properties held for sale[H9]	254	–	3	–	–	–	257	3
Cash and cash equivalents[H10]	1,915	1,490	1,267	1,436	523	–	6,631	5,307
TOTAL ASSETS	112,231	67,094	74,978	7,079	5,185	(5,761)	260,806	227,754

BY BUSINESS TYPE	2010 £m							2009 £m
		Shareholder-backed business						
	Participating funds	Unit-linked and variable annuity	Non-linked business	Asset management operations E2	Unallocated to a segment (central operations)	Intra-group elimination	31 Dec 2010 Group total	31 Dec 2009 Group total
EQUITY AND LIABILITIES								
Equity								
Shareholders' equity[H11]	–	–	8,112	1,787	(1,868)	–	8,031	6,271
Non-controlling interests	35	–	5	4	–	–	44	32
Total equity	35	–	8,117	1,791	(1,868)	–	8,075	6,303
Liabilities								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Contract liabilities (including amounts in respect of contracts classified as investment contracts under IFRS 4)	92,544	65,598	56,585	–	–	–	214,727	186,398
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds)[D2g(ii),H12]	10,253	–	–	–	–	–	10,253	10,019
Total policyholder liabilities and unallocated surplus of with-profits funds[note e]	102,797	65,598	56,585	–	–	–	224,980	196,417
Core structural borrowings of shareholder-financed operations:[H13]								
Subordinated debt	–	–	–	–	2,718	–	2,718	2,691
Other	–	–	159	250	549	–	958	703
Total	–	–	159	250	3,267	–	3,676	3,394
Operational borrowings attributable to shareholder-financed operations[G1,H13]	–	–	441	3	2,560	–	3,004	2,751
Borrowings attributable to with-profits operations[G1,H13]	1,522	–	–	–	–	–	1,522	1,284
Deferred tax liabilities	1,576	25	2,408	5	210	–	4,224	3,872
Other non-insurance liabilities	6,301	1,471	7,268	5,030	1,016	(5,761)	15,325	13,733
Total liabilities	112,196	67,094	66,861	5,288	7,053	(5,761)	252,731	221,451
TOTAL EQUITY AND LIABILITIES	112,231	67,094	74,978	7,079	5,185	(5,761)	260,806	227,754

B: SUMMARY OF RESULTS CONTINUED

B6: GROUP STATEMENT OF FINANCIAL POSITION > CONTINUED

c Reconciliation of movement in investments

A reconciliation of the Group's directly held investments from the beginning of the year to the end of the year is as follows:

	Insurance operations			Total insurance operations	Asset Management	Unallocated to a segment	Group total
	UK £m	US £m	Asia £m	£m	£m	£m	£m
AT 31 DECEMBER 2008/1 JANUARY 2009							
Total investments (including derivative assets)	121,862	46,171	21,809	189,842	3,303	289	193,434
Less: investments held by consolidated investment funds	(609)	–	(1,101)	(1,710)	–	–	(1,710)
Less: derivative liabilities[G3]	(3,401)	(863)	(32)	(4,296)	(292)	(244)	(4,832)
Directly held investments, net of derivative liabilities	117,852	45,308	20,676	183,836	3,011	45	186,892
Net cash inflow (outflow) from operating activities	1,432	2,755	3,028	7,215	(148)	(52)	7,015
Disposal of Taiwan agency business	–	–	(3,261)	(3,261)	–	–	(3,261)
Realised gains (losses) in the year	108	(529)	(243)	(664)	34	4	(626)
Unrealised gains and losses and exchange movements in the year	10,623	1,581	2,326	14,530	(56)	43	14,517
Reclassification of property under development	131	–	–	131	–	–	131
Movement in the year of directly held investments, net of derivative liabilities	12,294	3,807	1,850	17,951	(170)	(5)	17,776
AT 31 DECEMBER 2009/1 JANUARY 2010							
Total investments (including derivative assets)	132,690	49,576	23,390	205,656	2,890	176	208,722
Less: investments held by consolidated investment funds	(1,835)	–	(718)	(2,553)	–	–	(2,553)
Less: derivative liabilities[G3]	(709)	(461)	(146)	(1,316)	(49)	(136)	(1,501)
Directly held investments, net of derivative liabilities	130,146	49,115	22,526	201,787	2,841	40	204,668
Net cash inflow from operating activities	1,329	7,306	2,167	10,802	329	120	11,251
Realised gains (losses) in the year	2,233	21	984	3,238	11	(148)	3,101
Unrealised gains and losses and exchange movements in the year	5,958	6,264	3,301	15,523	23	(17)	15,529
Dilution of PruHealth investment	56	–	–	56	–	–	56
Acquisition of UOB Life Assurance Ltd	–	–	1,004	1,004	–	–	1,004
Movement in the year of directly held investments, net of derivative liabilities	9,576	13,591	7,456	30,623	363	(45)	30,941
AT 31 DECEMBER 2010							
Total investments (including derivative assets)	141,426	63,505	30,943	235,874	3,282	141	239,297
Less: investments held by consolidated investment funds	(912)	–	(739)	(1,651)	–	–	(1,651)
Less: derivative liabilities[G3]	(792)	(799)	(222)	(1,813)	(78)	(146)	(2,037)
Directly held investments, net of derivative liabilities	139,722	62,706	29,982	232,410	3,204	(5)	235,609

* The above reconciliation analyses the movement of directly held investments net of derivative liabilities. The deduction of derivative liabilities reflects the fact that these are considered an integral part of the Group's investment portfolio and the exclusion from investments is merely a matter of required balance sheet presentation. The analysis excludes investments held in the balance sheet as a result of the consolidation of Open-Ended Investment Companies (OEICs) and unit trusts, as the Group's exposure is merely to its share of the value of the fund as a whole rather than to the underlying investments and other assets and liabilities.

d Debt securities and loans

i Information on the credit risks of debt securities

	2010 £m						2009 £m
	Insurance operations			Total insurance operations	Asset Manage-ment	Group total	Group total
	UK	US	Asia				
S&P – AAA	18,833	4,187	2,934	25,954	884	26,838	22,106
S&P – AA+ to AA-	6,885	801	2,138	9,824	143	9,967	9,060
S&P – A+ to A-	21,508	5,156	2,843	29,507	452	29,959	26,849
S&P – BBB+ to BBB-	12,848	8,202	913	21,963	70	22,033	20,581
S&P – Other	3,403	866	1,773	6,042	6	6,048	4,479
	63,477	19,212	10,601	93,290	1,555	94,845	83,075
Moody's – Aaa	765	34	65	864	–	864	870
Moody's – Aa1 to Aa3	360	32	115	507	14	521	687
Moody's – A1 to A3	632	36	130	798	–	798	1,144
Moody's – Baa1 to Baa3	949	73	95	1,117	2	1,119	919
Moody's – Other	233	135	49	417	–	417	411
	2,939	310	454	3,703	16	3,719	4,031
Implicit ratings of MBS based on NAIC valuations (see below)							
– NAIC 1	–	3,083	–	3,083	–	3,083	747
– NAIC 2	–	181	–	181	–	181	105
– NAIC 3-6	–	232	–	232	–	232	473
	–	3,496	–	3,496	–	3,496	1,325
Fitch	630	176	49	855	–	855	1,342
Other	7,258	3,172	3,004	13,434	3	13,437	11,978
Total debt securities	74,304	26,366	14,108	114,778	1,574	116,352	101,751

In the table above, with the exception of residential mortgage-backed securities within Jackson, Standard & Poor's (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. During 2009, the National Association of Insurance Commissioners in the US revised the regulatory ratings process for more than 20,000 residential mortgage-backed securities. In addition, in 2010, NAIC applied the revised ratings process for commercial mortgage-backed securities. The table above includes these securities, held by Jackson, using the regulatory ratings levels established by an external third party (PIMCO). Notes D2(d), D3(d), D4(d) and E2 provide further details on the credit risks of debt securities by segment.

B: SUMMARY OF RESULTS CONTINUED

B6: GROUP STATEMENT OF FINANCIAL POSITION > CONTINUED

ii Group exposure to holdings in asset-backed securities

The Group's exposure to holdings in asset-backed securities which comprise residential mortgage-backed securities (RMBS), commercial mortgage backed securities (CMBS), CDO funds and other asset-backed securities (ABS), at 31 December 2010 is as follows:

	2010 £m	2009 £m
SHAREHOLDER-BACKED OPERATIONS:		
UK insurance operations[note i]	1,181	2,044
US insurance operations[note ii]	6,135	6,376
Asian insurance operations[note iii]	113	59
Other operations[note iv]	437	326
	7,866	8,805
WITH-PROFITS OPERATIONS:		
UK insurance operations[note i]	5,237	6,451
Asian insurance operations[note iii]	435	378
	5,672	6,829
TOTAL	13,538	15,634

i UK insurance operations

The UK insurance operations' exposure to asset-backed securities at 31 December 2010 comprises:

	2010 £m	2009 £m
Shareholder-backed business (2010: 51% AAA, 23% AA)	1,181	2,044
With-profits operations (2010: 52% AAA, 13% AA)	5,237	6,451
Total	6,418	8,495

All of the £1,181 million (2009: £2,044 million) exposure of the shareholder-backed business relates to the UK market, primarily to investments held by PRIL. £3,685 million of the £5,237 million (2009: £4,695 million of the £6,451 million) exposure of the with-profits operations relates to exposure to the UK market while the remaining £1,552 million (2009: £1,756 million) relates to exposure to the US market.

ii US insurance operations

The US insurance operations' exposure to asset-backed securities at 31 December 2010 comprises:

	2010 £m	2009 £m
RMBS*:		
Sub-prime (2010: 40% AAA, 11% AA)	224	194
Alt-A (2010: 15% AAA, 6% AA)	415	443
Prime including agency (2010: 79% AAA, 2% AA)	2,145	2,679
CMBS* (2010: 36% AAA, 15% AA)	2,375	2,104
CDO funds (2010: 4% AAA, 4% AA),† including £1 million exposure to sub-prime	162	79
Other ABS (2010: 26% AAA, 20% AA), including £37 million exposure to sub-prime	814	877
Total	6,135	6,376

* RMBS ratings refer to the rating implicit within NAIC risk-based capital valuation (see note d(i)). For 2010, CMBS ratings refer to the NAIC rating.
† Including the Group's economic interest in Piedmont and other consolidated CDO funds.
Further details on Jackson's RMBS sub-prime and Alt-A securities are given in note D3(d).

iii Asian insurance operations
The Asian insurance operations' exposure to asset-backed securities is primarily held by the with-profits operations. The £435 million (2009: £378 million) asset-backed securities exposure of the Asian with-profits operations comprises:

	2010 £m	2009 £m
CMBS	251	91
CDO funds and other ABS	184	287
Total	435	378

The £435 million (2009: £378 million) includes £341 million (2009: £228 million) held by investment funds consolidated under IFRS in recognition of the control arrangements for those funds and includes an amount not owned by the Group with a corresponding liability of £7 million (2009: £61 million) on the statement of financial position for net asset value attributable to external unit-holders in respect of these funds, which are non-recourse to the Group. Of the £435 million, 43 per cent (2009: £378 million, 72 per cent) are investments graded by Standard & Poor's.

iv Other operations
Other operations' exposure to asset-backed securities at 31 December 2010 is held by Prudential Capital and comprises:

	2010 £m	2009 £m
RMBS: Prime (2010: 96% AAA, 4% AA)	197	91
CMBS (2010: 30% AAA, 23% AA)	184	193
CDO funds and other ABS – all without sub-prime exposure (2010: 98% AAA)	56	42
Total	437	326

iii Loans
Information on the credit quality of the portfolio of loans, which almost wholly is for amounts which are neither past due or impaired is shown in notes D2, D3, D4 and E2. Details of allowances for loans, losses and amounts past due are shown in notes G1 and G2. No additional analysis is provided of the element of loans and receivables that were neither past due nor impaired from those of the total portfolio on the grounds of the immateriality of the difference between the neither past due nor impaired element and the total portfolio.

B: SUMMARY OF RESULTS
CONTINUED

B6: GROUP STATEMENT OF FINANCIAL POSITION > CONTINUED

e Reconciliation of movement in policyholder liabilities and unallocated surplus of with-profits funds
A reconciliation of the total policyholder liabilities and unallocated surplus of with-profits funds of the Group from the beginning of the year to the end of the year is as follows:

	Insurance operations			
	UK £m	US £m	Asia £m	Total £m
AT 1 JANUARY 2009	115,961	45,361	21,069	182,391
Premiums	6,867	9,177	3,807	19,851
Surrenders	(3,971)	(3,255)	(1,201)	(8,427)
Maturities/Deaths	(7,239)	(733)	(342)	(8,314)
Net flows	(4,343)	5,189	2,264	3,110
Shareholders' transfers post-tax	(202)	–	(20)	(222)
Changes in reserving basis in Malaysia	–	–	(63)	(63)
Assumption changes (shareholder-backed business)	(46)	–	(4)	(50)
Investment-related items and other movements	14,118	2,986	4,242	21,346
Foreign exchange translation differences	707	(5,225)	(2,069)	(6,587)
Disposal of Taiwan agency business	–	–	(3,508)	(3,508)
AT 31 DECEMBER 2009/1 JANUARY 2010	126,195	48,311	21,911	196,417
Comprising				
– Policyholder liability	116,229	48,311	21,858	186,398
– Unallocated surplus of with-profits funds	9,966	–	53	10,019
Premiums	7,890	11,735	4,308	23,933
Surrenders	(3,779)	(3,598)	(2,241)	(9,618)
Maturities/Deaths	(7,303)	(769)	(498)	(8,570)
Net flows	(3,192)	7,368	1,569	5,745
Shareholders' transfers post-tax	(223)	–	(24)	(247)
Assumption changes (shareholder-backed business)	(46)	–	19	(27)
Investment-related items and other movements	13,218	3,464	2,216	18,898
Foreign exchange translation differences	(208)	1,380	2,081	3,253
Dilution of holding in PruHealth investment	(27)	–	–	(27)
Acquisition of UOB Life Assurance Limited	–	–	968	968
AT 31 DECEMBER 2010	135,717	60,523	28,740	224,980
Comprising				
– Policyholder liability	125,530	60,523	28,674	214,727
– Unallocated surplus of with-profits funds	10,187	–	66	10,253
Average policyholder liability balances*				
2010	120,880	54,417	25,750	201,047
2009	111,969	46,837	19,630	178,436

* Adjusted for acquisition and disposals in the period and excluding unallocated surplus of with-profits funds.

The items above represent the amount attributable to changes in policyholder liabilities and unallocated surplus of with-profits funds as a result of each of the components listed.

Premiums, surrenders and maturities/deaths represent the amounts impacting policyholder liabilities and may not represent the total cash paid/received (for example, premiums are net of any deductions to cover acquisition costs and claims represent the policyholder liabilities released).

C: GROUP RISK MANAGEMENT

a: OVERVIEW

As a provider of financial services, including insurance, the management of risk lies at the heart of the Group's business. 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 internal control processes are detailed in the Group Governance Manual. This is supported by the Group Risk Framework, which provides an overview of the Group-wide philosophy and approach to risk management. Where appropriate, more detailed policies and procedures have been developed at Group and/or business unit levels. These include Group-wide mandatory policies on certain operational risks, including: health, safety, fraud, money laundering, bribery, business continuity, information security and operational security, and policies on certain financial risks. Additional guidelines are provided for some aspects of actuarial and financial activity.

Prudential's risk governance framework requires that all of the Group's businesses and functions establish processes for identifying, evaluating and managing the key risks faced by the Group. The risk governance framework is based on the concept of 'three lines of defence': Risk management; risk oversight and independent assurance. Primary responsibility for strategy, performance management and risk control lies with the Board, which has established the Group Risk Committee to assist in providing leadership, direction and oversight, and with the Group Chief Executive and the chief executive of each business unit. Risk oversight is provided by Group-level risk committees, chaired by the Group Chief Risk Officer or the Chief Financial Officer. Independent assurance on the Group's internal control and risk management systems is provided by the Group Audit Committee, supported by the Group-wide Internal Audit.

The Group's risk reporting framework forms an important part of the Group's business planning process. Business units review their risks as part of the annual preparation of their business plans and review opportunities and risks against business objectives regularly with Group executive management.

Additional information on the Group's risk framework is included in the risk and capital management section of the Group's business review.

The management of the risk attached to the Group's financial instruments and insurance liabilities, together with the inter-relationship with the management of capital may be summarised in the following sections.

b: GROUP RISK APPETITE

The Group risk appetite framework sets out the Group's appetite for risk exposures as well as the approach to risk management and return optimisation. The Group defines and monitors aggregate risk limits for its earnings volatility and its capital requirements based on financial and non-financial stresses.

i Earnings volatility:

The objectives of the limits are to ensure that (a) the volatility of earnings is consistent with stakeholder expectations, (b) the Group has adequate earnings (and cash flows) to service debt, expected dividends and to withstand unexpected shocks, and (c) earnings (and cash flows) are managed properly across geographies and are consistent with the Group's funding strategies. The two measures applied to monitor the volatility of the Group's earnings are International Financial Reporting Standards (IFRS) operating profit based on longer-term investment returns and European Embedded Value (EEV) operating profit based on longer-term investment returns although IFRS and EEV total profits are also considered.

ii Capital requirements:

The limits aim to ensure that (a) the Group meets its internal economic capital requirements, (b) the Group achieves its desired target rating to meet its business objectives, and (c) supervisory intervention is avoided. The two measures applied by the Group are the EU Insurance Groups Directive (IGD) capital requirements and internal economic capital requirements. In addition, the Group also monitors capital requirements on a local statutory basis.

Business units must establish suitable market, credit, insurance and liquidity limits that maintain financial risk exposures within the defined Group risk appetite.

The Group's risk appetite framework forms an integral part of its annual business planning cycle. The Group Risk function monitors the Group's risk profile against the agreed limits. Using submissions from business units, Group Risk calculates the Group's aggregated position (allowing for diversification effects between business units) relative to the limits implied by the risk appetite statements.

Market risk is managed such that as conditions evolve the risk profile is maintained within risk appetite. In addition to business unit operational limits on credit risk, the Group sets counterparty risk limits at Group level. The limits on the total Group-wide exposures to a single counterparty are specified within different credit rating 'categories'. Group Risk and the Group Credit Risk Committee monitor the Group's actual exposures against these limits on at least a monthly basis, escalating matters to Group Executive Risk Committee as appropriate.

C: GROUP RISK MANAGEMENT CONTINUED

c: RISK MITIGATION AND HEDGING

The Group manages its actual risk profile against its tolerance of risk. To do this, the Group maintains risk registers that include details of the identified risks and of the controls and mitigating actions employed in managing them. Any mitigation strategies involving large transactions, such as a material derivative transaction, are subject to scrutiny at Group level before implementation.

The Group uses a range of risk management and mitigation strategies. The most important of these include: adjusting asset portfolios to reduce investment risks (such as duration mismatches or overweight counterparty exposures); using derivatives to hedge market risks; implementing reinsurance programmes to limit insurance risk; implementing corporate insurance programmes to limit the impact of operational risks; and revising business plans where appropriate.

i Use of derivatives

In the UK business, equity exposure is incurred in the with-profits fund, and it includes a large inherited estate. The inherited estate itself is partially protected against falls in equity markets by a derivative hedging portfolio.

In the US, to protect the shareholders against the volatility introduced by embedded options, Jackson uses both a comprehensive hedging programme and reinsurance. Jackson makes use of the natural offsets that exist between the variable annuity guarantees and the fixed index annuity book, and then uses a combination of OTC options and futures to hedge the residual risk, allowing for significant market shocks and limiting the amount of capital at risk. Internal positions are generally netted before any external hedge positions are considered. Jackson manages fixed annuity interest rate exposure through a combination of interest rate swaps and interest rate options, to protect capital against rates rising quickly and through the contractual ability to reset crediting rates annually.

Prudential principally operates in the UK, the US, and in 13 countries in Asia. The geographical diversity of the Group's business means that Prudential is inevitably subject to the risk of exchange rate fluctuations. The Group does not generally seek to hedge foreign currency revenues, as these are substantially retained locally to support the growth of the Group's business and meet local regulatory and market requirements. However, in cases where a surplus arising in an overseas operation supports Group capital or shareholders' interest, this exposure is hedged if it is economically optimal to do so. Currency borrowings, swaps and other derivatives are used to manage exposures.

Further details of the Group's use of derivatives are explained in note G3.

ii Asset/liability management

Prudential manages its assets and liabilities locally, in accordance with local regulatory requirements and reflecting the differing types of liabilities of each business unit. Stochastic asset/liability modelling is carried out locally by business units to perform dynamic solvency testing and assess capital requirements. Reserve adequacy testing under a range of scenarios and dynamic solvency analysis is carried out, including under certain scenarios mandated by the US, the UK and Asian regulators.

A stochastic approach models the inter-relationship between asset and liability movements, taking into account asset correlation and policyholder behaviour, under a large number of possible scenarios. These scenarios are projected forward over a period of time, typically 25 years, and the liabilities and solvency position of the fund are calculated in each scenario in each future year. This allows the identification of which extreme scenarios will have the most adverse effects and what the best estimate outcome may be. The fund's policy on management actions, including bonus and investment policy, is then set in order that they are consistent with the available capital and the targeted risk of default. This differs from a deterministic model, which would only consider the results from one carefully selected scenario.

For businesses that are most sensitive to interest rate changes, such as immediate annuity business, Prudential uses cash flow analysis to create a portfolio of fixed income securities whose value changes in line with the value of liabilities when interest rates change. This type of analysis helps protect profits and the capital position from changing interest rates. In the UK, the cash flow analysis is used in Prudential's annuity business while, in the US, it is used for its interest-sensitive and fixed index annuities and stable value products such as Guaranteed Investment Contracts (GICs). Perfect matching is not possible, for example because of the nature of the liabilities (which might include guaranteed surrender values) and options for prepayment contained in the assets or the unavailability of assets with a sufficiently long duration.

For businesses that are most sensitive to equity price changes, Prudential uses stochastic modelling and scenario testing to look at the expected future returns on its investments under different scenarios that best reflect the large diversity in returns that equities can produce. This allows Prudential to devise an investment and with-profits policyholder bonus strategy that, on the model assumptions, allows it to optimise returns to its policyholders and shareholders over time, while maintaining appropriate financial strength. Prudential uses this method extensively in connection with its UK with-profits business.

All of Prudential's investments are held either for risk management or investment purposes. This is because almost all of the investments support policyholder or customer liabilities of one form or another. Any assets that Prudential holds centrally that are not supporting customer liabilities are predominantly invested in short-term fixed income and fixed maturity securities.

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

d: RISK EXPOSURES

The Group publishes separately within 'Additional Information' of its Group Annual Report a section on key risk factors, which discusses inherent risks in the business and trading environment.

i Market risks

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.

Equity and interest rate risk

Prudential faces equity risk and interest rate risk because most of its assets are investments that are either equity type 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 Prudential's shareholders depends on the extent to which its customers share the investment risk through the structure of Prudential's products.

The split of Prudential'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 Prudential has available. The nature of some liabilities allows Prudential to invest a substantial portion of its investment funds in equity and property investments that Prudential believes produce greater returns over the long term. On the other hand Prudential has some liabilities that contain guaranteed returns and allow instant access (for example, interest-sensitive fixed annuities and immediate annuities), which generally will be supported by fixed income investments.

Foreign exchange risk

Prudential faces foreign exchange risk, primarily because its presentation currency is pounds sterling, whereas approximately 73 per cent of Prudential's operating profit from continuing operations based on longer-term investment returns, as described in note B1, for the year ended 31 December 2010, came from US and Asian operations. The exposure relating to the translation of reported earnings is not separately managed although its impact is reduced by interest payments on foreign currency borrowings and by the adoption of average exchange rates for the translation of foreign currency revenues.

Approximately 79 per cent of the Group's IFRS basis shareholders' equity at 31 December 2010 arose in Prudential's US and Asian operations (2009: approximately 77 per cent). To mitigate the exposure of the US component there are US$2.3 billion of borrowings held centrally, which are formally designated as net investment hedges at 31 December 2010. Net of the currency position arising from these borrowings some 61 per cent of the Group's shareholders' funds are represented by net assets in currencies other than sterling.

Additional details on the market risks' exposures of the UK, US and Asian insurance operations are provided in notes D2, D3 and D4, respectively.

ii Credit risk

Credit risk is the risk of loss if another party fails to meet its obligations, or fails to do so in a timely fashion. Credit risk is the Group's most significant financial risk.

Some of Prudential's businesses, in particular Jackson, the PAC with-profits fund and Prudential's UK pension annuity business hold 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 Prudential determines the crediting rates, deposit rates and premium rates for the products that will be supported by these assets. The key shareholder business exposed to credit risks is Jackson. 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. Prudential is also exposed to credit-related losses in the event of non-performance by counterparties.

Further analysis of the credit quality of debt securities held by the Group is shown in note B6. Additional details on the credit quality of the debt security portfolios of UK, US and Asian insurance operations are shown in notes D2, D3 and D4, respectively.

iii Liquidity risk

Liquidity risk is the risk that a business, though solvent on a balance sheet basis, either does not have the financial resources to meet its obligations as they fall due or can secure them only at excessive cost. The assets of insurers are in general relatively liquid, whilst liabilities to policyholders are mainly illiquid. Accordingly, for insurers, the focus of managing liquidity risk concentrates on parent capital and liquidity measures. Prudential regularly monitors and analyses its liquidity position at the Group level and performs stress tests of this position. The liquidity of the Group is monitored on a monthly basis by comparing the predicted cash needs of the Group centre, to meet corporate and financing costs (net of expected dividends from the business units), to the liquid resources available to it. These liquid resources include cash held and cash that could be raised through internal resources (for example by reporting unencumbered bonds). Base case and stress scenarios are reported monthly to the Balance Sheet and Capital Management Committee. The main stress is the assumption that the external financing markets are completely closed to Prudential, so no new external funding can be obtained, and existing funding cannot be rolled over. In addition, Group liquidity risk reports are prepared regularly. In summary, these address the sufficiency of external back-up lines, internal sources of liquidity, and monitor how external liabilities and other commitments over the next 12 months compare with internal and external sources. Currently, the parent company has significant internal resources of liquidity which are sufficient to meet all of its foreseeable future needs without having to utilise external funding. The Group maintains £2.1 billion of undrawn syndicated and bilateral committed banking facilities, maturing between 2011 and 2015.

C: GROUP RISK MANAGEMENT CONTINUED

d: RISK EXPOSURES > CONTINUED

iv Insurance risk

Insurance risk is the inherent uncertainty as to the occurrence, amount and timing of insurance liabilities. This includes adverse mortality, morbidity and persistency experience.

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

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

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

v Non-financial risks – operational, business environment and strategic risk

Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people or systems, or from external events. This includes legal and regulatory compliance risk. Business environment risk may arise from exposure to forces in the external environment that could significantly change the fundamentals that drive the business's overall objectives and strategy. Strategic risk may arise from ineffective, inefficient or inadequate senior management processes for the development and implementation of business strategy in relation to the business environment and the Group's capabilities.

Prudential is exposed to operational, business environment and strategic risk in the course of running its businesses. Prudential processes a large number of complex transactions across numerous and diverse products, and is subject to a number of different legal and regulatory, including tax, regimes. Prudential also has a significant number of third-party relationships that are important to the distribution and processing of its products, both as market counterparties and as business partners. This results in reliance upon the operational performance of these outsourcing partners.

The Group uses the qualitative and quantitative analysis of operational risk exposures material to the Group to support business decision making and lessons learned activities; the ongoing improvement of the control environment; the informing of overall levels of capital held; and determination of the adequacy of Prudential's corporate insurance programme.

With regard to business environment risk, the Group has a wide-ranging programme of active and constructive engagement with governments, policymakers and regulators in our key markets and with relevant international institutions, undertaken both directly and indirectly via trade associations. The Group has procedures in place to monitor and track political and regulatory developments. Where appropriate, the Group provides submissions and technical input to officials and others, either via submissions to formal consultations or through interactions with officials.

With regard to strategic risk, business units and the Group Head Office are required to adopt a forward-looking approach to risk management by performing risk assessments as part of the annual strategic planning process. This supports the identification of potential threats and the initiatives needed to address them, as well as competitive opportunities. The impact on the underlying business unit and/or Group-wide risk profile is also considered to ensure that strategic initiatives are within the Group's risk appetite.

e: REGULATORY CAPITAL REQUIREMENTS

Regulatory capital requirements apply at an individual company level for the Group's life assurance and asset management business. These are described in sections D5 and E3 respectively.

In addition, the Group as a whole is subject to the capital adequacy requirements of the European Union (EU) Insurance Groups Directive (IGD) as implemented by the FSA in the UK. The IGD pertains to groups whose activities are primarily concentrated in the insurance sector. The IGD capital adequacy requirements involves aggregating surplus capital held in our regulated subsidiaries, from which Group borrowings, except those subordinated debt issues that qualify as capital, are deducted. No credit for the benefit of diversification is permitted under this approach. The test is passed when this aggregate number is positive: a negative result at any point in time is a notifiable breach of UK regulatory requirements.

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

The FSA has established a structure for determining how much hybrid debt can count as capital which is similar to that used for banks. It categorises capital as Tier 1 (equity and preference shares), Upper Tier 2 and Lower Tier 2. Up to 15 per cent of Tier 1 capital can be in the form of hybrid debt and is called 'Innovative Tier 1'. At 31 December 2010 the Group held £1,463 million (2009: £1,422 million) of Innovative Tier 1 capital in the form of perpetual securities, £nil (2009: £nil) of Upper Tier 2 and £1,255 million (2009: £1,269 million) of Lower Tier 2 capital. In addition, Jackson held £159 million of surplus notes at the end of the financial year 2010 (2009: £154 million) which, although the US does not have a similar capital categorisation under its regulatory framework, are akin to the FSA's Lower Tier 2 Capital and have been disclosed as such in note H13. Further details on Group borrowings are shown in note H13.

At 31 December 2009, Prudential met the requirements of the IGD with £3.4 billion of surplus capital before allowing for the 2009 final dividend. In addition, during 2010, Prudential met the requirements of the FSA under the IGD. The IGD position as at 31 December 2010 will be submitted to the FSA by 30 April 2011 and at the time of preparation of these financial statements the surplus capital under the test was estimated to be around £4.3 billion before allowing for the 2010 final dividend giving a solvency ratio of circa 305 per cent. The main components of the increase in IGD surplus during 2010 are:

- Net capital generation mainly through operating earnings (in-force releases less investment in new business) of £1.7 billion;
- Release of tax provisions of £0.2 billion;
- Foreign exchange movements of positive £0.1 billion;
- Offset by dividend payments, external financing costs and other central costs, costs incurred in relation to the terminated AIA transaction and inadmissible assets arising on the purchase of UOB's life assurance subsidiary in Singapore.

Prudential's approach to capital allocation takes into account a range of factors, especially risk adjusted returns on capital, the impact of alternative capital measurement bases (accounting, regulatory, economic and ratings agency assessments), tax efficiency, and wider strategic objectives.

Prudential optimises capital allocation across the Group by using a consistent set of capital performance metrics across all business units to ensure meaningful comparison. Capital utilisation, return on capital and new business value creation are measured at a product level. The use of these capital performance metrics is embedded into our decision-making processes for product design and product pricing.

Prudential's capital performance metrics are based on economic capital, which provides a view of our capital requirements across the Group, allowing for realistic diversification benefits. Economic capital also provides valuable insights into our risk profile and is used both for risk measurement and capital management.

D: LIFE ASSURANCE BUSINESSES

D1: GROUP OVERVIEW

a Products and classification for IFRS reporting

The measurement basis of assets and liabilities of long-term business contracts is dependent upon the classification of the contracts under IFRS. Under IFRS 4, contracts are initially classified as being either 'insurance' contracts, if the level of insurance risk in the contracts is significant, or 'investment' contracts, if the risk is insignificant.

Insurance contracts

Insurance contracts are permitted to be accounted for under previously applied GAAP. The Group has chosen to adopt this approach. However, as an improvement to accounting policy, permitted by IFRS 4, the Group has applied the measurement principles for with-profits contracts of UK regulated entities and disclosures of the UK Standard FRS 27 from 1 January 2005. An explanation of the provisions under FRS 27 is provided in note D2.

Under the previously applied GAAP, UK GAAP, the assets and liabilities of contracts are reported in accordance with the MSB of reporting as set out in the ABI SORP.

The insurance contracts of the Group's shareholder-backed business fall broadly into the following categories:

- UK insurance operations
  – bulk and individual annuity business, written primarily by Prudential Retirement Income Limited and other categories of non-participating UK business;
- Jackson
  – fixed and variable annuity business and life insurance; and
- Prudential Corporation Asia
  – non-participating term, whole life, and unit-linked policies, together with accident and health policies.

Investment contracts

Investment contracts are further delineated under IFRS 4 between those with and without discretionary participation features. For those contracts with discretionary participation features, IFRS 4 also permits the continued application of previously applied GAAP. The Group has adopted this approach, again subject to the FRS 27 improvement.

For investment contracts that do not contain discretionary participation features, IAS 39 and, where the contract includes an investment management element, IAS 18, apply measurement principles to assets and liabilities attaching to the contract that may diverge from those previously applied.

Contracts of the Group, which are classified as investment contracts that do not contain discretionary participation features, can be summarised as:

- UK
  – certain unit-linked savings and similar contracts;
- Jackson
  – GICs and funding agreements
  – minor amounts of 'annuity certain' contracts; and
- Prudential Corporation Asia
  – minor amounts for a number of small categories of business.

The accounting for the investment contracts of UK insurance operations and Jackson's GICs and funding agreements are considered in turn below:

i Certain UK unit-linked savings and similar contracts

Deferred acquisition costs

Acquisition costs are deferred to the extent that it is appropriate to recognise an asset that represents the entity's contractual right to benefit from providing investment management services and are amortised as the entity recognises the related revenue. IAS 18 further reduces the costs potentially capable of deferral to incremental costs only. Deferred acquisition costs are amortised to the income statement in line with service provision.

Deferred income reserves

These are required to be established under IAS 18 with amortisation over the expected life of the contract. The majority of the relevant UK contracts are single premium with the initial deferred income reflecting the 'front-end load' i.e. the difference between the premium paid and the amount credited to the unit fund. Deferred income is amortised to the income statement in line with service provision. The amortisation profile is either on a straight-line basis or, if more appropriate, a further deferral of income recognition is applied.

Sterling reserves

Prudent provisions established for possible future expenses not covered by future margins at a policy level reflecting the regulatory approach in the UK are not permitted for those contracts with insignificant insurance risk that are classified as investment contracts.

ii Jackson – GICs and funding arrangements

Under a traditional GIC, the policyholder makes a lump sum deposit. The interest rate paid is fixed and established when the contract is issued. Funding agreements are of a similar nature but the interest rate may be floating, based on a rate linked to an external index. The US GAAP accounting requirements for such contracts are very similar to those under IFRS on the amortised cost model for liability measurement.

b Concentration of risk

i Business accepted

The Group's exposure to life assurance risks is well diversified. This is achieved through the geographical spread of the Group's operations and, within those operations, through a broad mix of product types.

As part of the risk management framework, the Group regularly monitors concentration of risk using a variety of risk monitoring tools including:

- Scenario testing and sensitivity analysis of the Group capital and profitability metrics involving IGD, Group economic capital, EEV and IFRS help identify concentrations of risks by risk types, products and business units, as well as the benefits of diversification of risks.

An example of the diversification benefits for Prudential is that adverse scenarios do not affect all business units in the same way, providing natural hedges within the Group. For example, the Group's US business is sensitive to increasing interest rates, whereas, in contrast, several business units in Asia benefit from increasing rates. Conversely, these Asian business units are sensitive towards low interest rates, whereas certain products in the US benefit from falling interest rates. The economic capital framework also takes into account situations where factors are correlated, for example the extent of correlation between UK and US economies.

- Business units are also required to disclose to the Group risk function all material risks, along with information on their severity and likelihood, and mitigating actions taken or planned.

Credit risk remains one of the largest risk exposures. This reflects the relative size of exposure in Jackson and the UK shareholder annuities business. The Group manages concentration of credit risks by setting limits on the maximum exposure to each counterparty based on their credit ratings.

ii Ceded business

The Group cedes certain business to other insurance companies. Although the ceding of insurance does not relieve the Group of liability to its policyholders, the Group participates in such agreements for the purpose of managing its loss exposure. The Group evaluates the financial condition of its reinsurers and monitors concentration of credit risk from similar geographic regions, activities or economic characteristics of the reinsurers to minimise its exposure from reinsurer insolvencies. Reinsurance recoverable insurance assets are not a significant component of the Group's statement of financial position and accordingly, exposure to concentrations of reinsurance risk is not significant to the Group. At 31 December 2010, 97 per cent (2009: 98 per cent) of the reinsurance recoverable insurance assets were ceded by the Group's UK and US operations, of which 90 per cent (2009: 92 per cent) of the balance were from reinsurers with Standard & Poor's rating A- and above.

c Guarantees

Notes D2(e), D3(e) and D4(e) provide details of guarantee features of the Group's life assurance products. In the UK, guarantees of the with-profits products are valued for accounting purposes on a market consistent basis for 2010 as described in section D2(g)(ii). The UK business also has products with guaranteed annuity option features, mostly within SAIF, as described in section D2(e). There is little exposure to financial options and guarantees in the shareholder-backed business of the UK operations. The US business annuity products have a variety of option and guarantee features as described in section D3(e). Jackson's derivative programme seeks to manage the exposures as described in section D3(f). The Group's exposure to guarantees was significantly reduced during 2009 as a result of the disposal of the Taiwan agency business.

d Sensitivity of EEV basis profit and equity for market and other risks

The Group prepares supplementary EEV basis financial statements for half yearly and annual publication. These statements include sensitivity disclosures which are part of the market risk information provided to key management. The 2010 EEV sensitivity disclosures are shown in note 15 of the EEV basis supplementary information in this Annual Report.

D: LIFE ASSURANCE BUSINESSES
CONTINUED

D1: GROUP OVERVIEW > CONTINUED

e Sensitivity of IFRS basis profit or loss and equity to market and other risks

i Overview of risks by business unit

The financial and insurance assets and liabilities attaching to the Group's life assurance business are, to varying degrees, subject to market and insurance risk and other changes of experience assumptions that may have a material effect on IFRS basis 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 three types of risk, namely:

- Currency risk: due to changes in foreign exchange rates;
- interest rate risk: due to changes in market interest rates; and
- other price risk: due to fluctuations in market prices (other than those arising from interest rate risk or currency risk).

Policyholder liabilities relating to the Group's life assurance businesses are also sensitive to the effects of other changes in experience, or expected future experience, such as for mortality, other insurance risk and lapse risk.

In addition, the profitability of the Group's life assurance businesses and, as described in Section E, asset management business, is indirectly affected by the performance of the assets covering policyholder liabilities and related capital.

Three key points are to be noted, namely:

- The Group's with-profits and unit-linked funds absorb most market risk attaching to the funds' investments. Except for second order effects, for example on asset management fees and shareholders' share of cost of bonuses for with-profits business, shareholder results are not directly affected by market value movements on the assets of these funds;
- The Group's shareholder results are most sensitive to market risks for assets of shareholder-backed business; and
- The main exposures of the Group's IFRS basis results to market risk for life assurance operations on investments of shareholder-backed business are for debt securities.

The most significant items for which the IFRS basis shareholders' profit or loss and equity for the Group's life assurance business is sensitive to these variables are shown in the following tables. The distinction between direct and indirect exposure is not intended to indicate the relative size of the sensitivity.

	Market and credit risk			
Type of business	**Investments/derivatives**	**Liabilities/unallocated surplus**	**Other exposure**	**Insurance and lapse risk**
UK insurance operations (see also section D2(j))				
With-profits business (including Prudential Annuities Limited)	Net neutral direct exposure	(Indirect exposure only)	Investment performance subject to smoothing through declared bonuses	Persistency risk to future shareholder transfers
SAIF sub-fund	Net neutral direct exposure	(Indirect exposure only)	Asset management fees earned by M&G	
Unit-linked business	Net neutral direct exposure	(Indirect exposure only)	Investment performance through asset management fees	Persistency risk
Shareholder-backed annuity business	Asset/liability mismatch risk Credit risk Interest rate risk for assets in excess of liabilities i.e. representing shareholder capital			Mortality experience and assumptions for longevity

	Market and credit risk			
Type of business	Investments/derivatives	Liabilities/unallocated surplus	Other exposure	Insurance and lapse risk
US insurance operations (see also section D3(j))				
All business	Currency risk			Persistency risk
Variable annuity business	Net effect of market risk arising from incidence of guarantee features and variability of asset management fees offset by derivative hedging programme			
Fixed index annuity business	Derivative hedge programme to the extent not fully hedged against liability and fund performance	Incidence of equity participation features		
Fixed index annuities, Fixed annuities and GIC business	Credit risk Interest rate risk These risks are reflected in volatile profit or loss and shareholders' equity for derivative value movements and impairment losses, and, in addition, for shareholders' equity for value movements on fixed income securities classified as 'available fo sale' under IAS 39		Spread difference between earned rate and rate credited to policyholders	Lapse risk but the effects of extreme events are mitigated by the use of swaption contracts
Asian insurance operations (see also section D4(j))				
All business	Currency risk			Mortality and morbidity risk Persistency risk
With-profits business	Net neutral direct exposure (Indirect exposure only)		Investment performance subject to smoothing through declared bonuses	
Unit-linked business	Net neutral direct exposure (Indirect exposure only)		Investment performance through asset management fees	
Non-participating business	Interest rate and price risk	Long-term interest rates		.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D1: GROUP OVERVIEW > CONTINUED

ii IFRS shareholder results – Exposures for market and other risk

Key Group exposures

Detailed analyses of sensitivity of IFRS basis profit or loss and equity to market and other risks are provided in notes D2(j), D3(j), D4(j) and E4. The sensitivity analyses provided show the effect on IFRS basis profit or loss and equity to changes in the relevant risk variables, all of which are reasonably possible at the relevant balance sheet date.

The IFRS operating profit based on longer-term investment returns for UK insurance operations has high potential sensitivity for changes to longevity assumptions affecting the carrying value of liabilities to policyholders for shareholder-backed annuity business. In addition, at the total IFRS profit level the result is sensitive to temporary value movements on assets backing IFRS equity.

For Jackson at the level of operating profit based on longer-term investment returns, the results are sensitive to market conditions to the extent of income earned on spread-based products not mitigated by the interest derivative programmes and second order equity-based exposure in respect of variable annuity asset management fees. Further information is given below under the US operations section of market and credit risk.

Jackson's derivative programme is used to substantially mitigate equity market risk attaching to its equity-based products and interest rate risk associated with its spread-based products. Movements in interest rates and credit spreads materially affect the carrying value of derivatives which are used to manage the liabilities to policyholders and backing investment assets of fixed annuity and other general account business. Combined with the use of US GAAP measurement (as grandfathered under IFRS 4) for the asset and liabilities for the insurance contract liabilities, which is largely insensitive to current period market movements, the Jackson total profit (i.e. including short-term fluctuations in investment returns) is very sensitive to market movements. In addition to these effects the Jackson IFRS equity is sensitive to the impact of interest rate and credit spread movements on the value of fixed income securities. Movements in unrealised appreciation on these securities are included as movement in equity (i.e. outside the income statement). See note D3(j) for details of the hedging.

For Asian operations, the operating profit based on longer-term investment returns is mainly affected by the impact of market levels on unit-linked business persistency, and other insurance risk.

At the total IFRS profit level the Asian result is affected by short-term value movements on the asset portfolio for non-linked shareholder-backed business.

M&G profits are affected primarily by movements in the growth in funds under management and by the effect of any impairment on the loan book and fair value movements on debt securities held by Prudential Capital.

Market and credit risk

UK insurance operations

With-profits business

- With-profits business
  Shareholder results of UK 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 PAC with-profits fund are subject to market risk. However, changes in their carrying value, net of related changes to asset-share liabilities of with-profit contracts, affect the level of unallocated surplus of the fund. As unallocated surplus is accounted for as a liability under IFRS, movements in its value do not affect shareholders' profit or equity.
  The shareholder results of the UK 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.
- Prudential Annuities Limited (PAL)
  PAL writes annuity business, but as PAL is owned by the PAC with-profits sub-fund, changes in the carrying value of PAL's assets and liabilities are reflected in the liability for unallocated surplus which as described above, do not affect shareholder results.
- Scottish Amicable Insurance Fund (SAIF)
  SAIF is a ring-fenced fund in which, apart from asset management fees, shareholders have no interest. Accordingly, the Group's IFRS profit and equity are insensitive to the direct effects of market risk attaching to SAIF's assets and liabilities.

Shareholder-backed business

The factors that may significantly affect the IFRS results of UK shareholder-backed business are the mortality experience and assumptions and credit risk attaching to the annuity business of Prudential Retirement Income Limited and the PAC non-profit sub-fund.

- Prudential Retirement Income Limited (PRIL)
  The assets covering PRIL's liabilities are principally debt securities and other investments that are held to match the expected duration and payment characteristics of the policyholder liabilities. These liabilities are valued for IFRS reporting purposes by applying discount rates that reflect the market rates of return attaching to the covering assets.
  Except to the extent of any asset/liability duration mismatch which is reviewed regularly, and exposure to credit risk, the sensitivity of the Group's results to market risk for movements in the carrying value of PRIL's liabilities and covering assets is broadly neutral on a net basis.
  The main market risk sensitivity for PRIL arises from interest rate risk on the debt securities which substantially represent IFRS equity. This equity comprises the net assets held within the long-term fund of the Company that cover regulatory basis liabilities that are not recognised for IFRS reporting purposes, for example contingency reserves, and shareholder capital held outside the long-term fund.
  The principal items affecting the IFRS results for PRIL are mortality experience and assumptions, and credit risk.

- PAC non-profit sub-fund
  The PAC 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. However, for the annuity business the same considerations as described above for PRIL apply, whilst the liabilities of the unit-linked business change in line with the matching linked assets. Other liabilities of the PAC non-profit sub-fund are broadly insensitive to market risk.

- Other shareholder-backed unit-linked business
  Due to the matching of policyholder liabilities to attaching asset value movements, the UK unit-linked business is not directly affected by market or credit risk. The principal factor affecting the IFRS results is investment performance through asset management fees.

US insurance operations (Jackson)

The IFRS basis results of Jackson are highly sensitive to market risk on the assets covering liabilities other than variable annuity business segregated in the separate accounts.

Invested assets covering liabilities (other than the separate accounts) and related capital comprise principally debt securities classified as available-for-sale. Value movements for these securities are reflected as movements in shareholders' equity through the statement of comprehensive income. Other invested assets and derivatives are carried at fair value with the value movements reflected in the income statement.

By contrast, the IFRS insurance liabilities for business written by Jackson, by the application of grandfathered GAAP under IFRS 4, are measured on US GAAP bases which with the exception of certain items covered by the equity hedging programme, are generally insensitive to temporary changes in market conditions or the short-term returns on the attaching asset portfolios.

These differences in carrying value of debt securities, other invested assets, derivatives and insurance liabilities give rise to potentially significant volatility in the IFRS income statement and shareholders' equity. As with other shareholder-backed business the profit or loss for Jackson is presented in the Group's segmental analysis of profit as described in note B1, by distinguishing the result for the year between an operating result based on longer-term investment returns and short-term fluctuations in investment returns. In this way the most significant direct effect of market changes that have taken place to the Jackson result are separately identified.

Excluding these short-term effects, the factors that most significantly affect the Jackson IFRS operating result based on long-term investment returns are:

- Variable annuity business – the spread differential between the earned rate and the rate credited to policyholders on the general account funds and the effect of market movements on fees earned on separate account funds;
- Fixed annuity business – the spread differential between the earned rate and the rate credited to policyholders; and
- Fixed index annuity business – the spread differential between the earned rate and the rate credited to policyholders.

In addition, the total profit for Jackson is affected by the level of impairment losses on the debt securities portfolio, net effect of market risk arising from the incidence and valuation of guarantee features, guaranteed benefit payments and equity index participation features, offset by variability of benefit related fees and equity derivative hedging performance, short-term value movements on derivatives held to manage the fixed annuity and other general account business, and other temporary value movements on portfolio investments classified as fair value through profit and loss.

The Group has amended its presentation of operating profit for its US insurance operations to remove the net equity hedge accounting effect and include it in short-term fluctuations as explained further in note A4(d)(ii). Following this change the operating profit based on longer-term investment returns of the US insurance operations of £833 million for 2010 (2009: £618 million) excludes £367 million (2009: £159 million) negative net equity hedge accounting effects, net of related change to amortisation of deferred acquisition costs. The presentation of results for 2009 has been amended accordingly.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D1: GROUP OVERVIEW > CONTINUED

Asian insurance operations
For Asian with-profits business the same features apply as described above for UK with-profits business. Similarly, as for other parts of the Group, for unit-linked business the main factor affecting IFRS basis results is investment performance through asset management fees.

The sensitivity of the IFRS basis results of the Group's Asian operations to market risk is primarily restricted to the non-participating business.

This sensitivity is primarily reflected through the volatility of asset returns coupled with the fact that the accounting carrying value of liabilities to policyholders are only partially sensitive to changed market conditions. As for UK shareholder-backed operations and Jackson, the IFRS profit is distinguished in the Group's segmental analysis so as to distinguish operating profits based on longer-term investment returns and short-term fluctuations in investment returns.

Insurance and lapse risk
The features described above cover the main sensitivities of IFRS profit and loss and equity for market, insurance and credit risk. Lapse and longevity risk may also be a key determination of IFRS basis results with variable impacts.

In the UK, adverse persistency experience can affect the level of profitability from with-profits and unit-linked business. For with-profits business in any given year, the amount represented by the shareholders' share of cost of bonus may only be marginally affected. However, altered persistency trends may affect future expected shareholder transfers.

By contrast, Group IFRS operating profit is particularly sensitive to longevity outlook that results in changes of assumption for the UK shareholder-backed annuity business.

Jackson is sensitive to lapse risk. However, Jackson uses certain swaption derivatives to ameliorate the effect of a sharp rise in interest rates, which would be the most likely cause of a sudden change in policyholder behaviour.

In Asia, adverse persistency experience can impact the IFRS profitability of certain business written in the region. This risk is managed at a business unit level through monthly monitoring of experience and the implementation of management actions as necessary. These actions could include product enhancements, increased management focus on premium collection as well as other customer retention efforts. The potential financial impact of lapses is often mitigated through the specific features of the products, e.g. surrender charges.

iii Impact of diversification on risk exposure
The Group enjoys significant diversification benefits. This arises because not all risk scenarios will happen at the same time and across all geographic regions. The Group tests the sensitivities of results to different correlation factors such as:

Correlation across geographic regions
- Financial risk factors
- Non-financial risk factor

Correlation across risk factors
- Longevity risk
- Expenses
- Persistency
- Other risks

The effect of Group diversification is to significantly reduce the aggregate standalone volatility risk to IFRS operating profit based on longer-term investment returns. The effect is almost wholly explained by the correlations across risk types, in particular longevity risk.

f Duration of liabilities
Under the terms of the Group's contracts, as for life assurance contracts generally, the contractual maturity date is the earlier of the end of the contract term, death, other insurable events or surrender. The Group has therefore chosen to provide details of liability duration that reflect the actuarially determined best estimate of the likely incidence of these factors on contract duration. Details are shown in sections D2(k), D3(k) and D4(k).

In the years 2006 to 2010, claims paid on the Group's life assurance contracts including those classified as investment contracts under IFRS 4 ranged from £15 billion to £18 billion. Indicatively, it is to be expected that, of the Group's policyholder liabilities (excluding unallocated surplus) at 31 December 2010 of £214.7 billion, the amounts likely to be paid in 2011 will be of a similar magnitude.

D2: UK INSURANCE OPERATIONS

a Summary statement of financial position

In order to reflect the different types of UK business and fund structure, the statement of financial position of the UK insurance operations may be analysed by the assets and liabilities of the Scottish Amicable Insurance Fund (SAIF), the PAC with-profits sub-fund (WPSF), unit-linked assets and liabilities and annuity (principally PRIL) and other business. The assets and liabilities of these funds and subsidiaries are shown in the table below.

£94.8 billion of the £141.4 billion of investments are held by SAIF and the PAC WPSF. Shareholders are exposed only indirectly to value movements on these assets.

		PAC with-profits sub-fund note i			Other funds and subsidiaries			UK insurance operations	
	Scottish Amicable Insurance Fund note ii £m	Excluding Prudential Annuities Limited £m	Prudential Annuities Limited note iii £m	Total note iv £m	Unit-linked assets and liabilities £m	Annuity and other long-term business £m	Total £m	2010 Total £m	2009 Total £m
ASSETS									
Intangible assets attributable to shareholders:									
Deferred acquisition costs and other intangible assets	–	–	–	–	–	118	118	118	127
	–	–	–	–	–	118	118	118	127
Intangible assets attributable to PAC with-profits fund:									
In respect of acquired subsidiaries for venture fund and other investment purposes	–	166	–	166	–	–	–	166	124
Deferred acquisition costs	–	13	–	13	–	–	–	13	9
	–	179	–	179	–	–	–	179	133
Total	–	179	–	179	–	118	118	297	260
Deferred tax assets	2	93	14	107	–	105	105	214	292
Other non-investment and non-cash assets	412	1,810	322	2,132	557	1,532	2,089	4,633	3,074
Investments of long-term business and other operations:									
Investment properties[note viii]	673	7,589	731	8,320	745	1,474	2,219	11,212	10,861
Investments accounted for using the equity method	–	–	–	–	–	69	69	69	4
Financial investments:									
Loans[note v]	153	979	138	1,117	–	1,032	1,032	2,302	1,815
Equity securities and portfolio holdings in unit trusts	3,105	23,716	229	23,945	13,434	35	13,469	40,519	37,051
Debt securities[note D2c]	4,704	29,013	12,785	41,798	6,045	21,757	27,802	74,304	67,772
Other investments[note vi]	276	3,241	178	3,419	73	230	303	3,998	3,630
Deposits	793	6,038	435	6,473	498	1,258	1,756	9,022	11,557
Total investments[note b]	9,704	70,576	14,496	85,072	20,795	25,855	46,650	141,426	132,690
Properties held for sale	–	254	–	254	–	–	–	254	–
Cash and cash equivalents	170	1,127	82	1,209	1,153	307	1,460	2,839	2,265
TOTAL ASSETS	10,288	74,039	14,914	88,953	22,505	27,917	50,422	149,663	138,581

D: LIFE ASSURANCE BUSINESSES CONTINUED

D2: UK INSURANCE OPERATIONS > CONTINUED

	PAC with-profits sub-fund note i				Other funds and subsidiaries			UK insurance operations	
	Scottish Amicable Insurance Fund note ii £m	Excluding Prudential Annuities Limited £m	Prudential Annuities Limited note iii £m	Total note iv £m	Unit-linked assets and liabilities £m	Annuity and other long-term business £m	Total £m	2010 Total £m	2009 Total £m
EQUITY AND LIABILITIES									
Equity									
Shareholders' equity	–	–	–	–	–	2,148	2,148	2,148	1,939
Non-controlling interests	–	35	–	35	–	–	–	35	28
Total equity	–	35	–	35	–	2,148	2,148	2,183	1,967
Liabilities									
Policyholder liabilities and unallocated surplus of with-profits funds:									
Contract liabilities (including amounts in respect of contracts classified as investment contracts under IFRS 4)	9,759	59,545	12,282	71,827	21,671	22,273	43,944	125,530	116,229
Unallocated surplus of with-profits funds (reflecting application of 'realistic' provisions for UK regulated with-profits funds)note vii	–	8,363	1,824	10,187	–	–	–	10,187	9,966
Total	9,759	67,908	14,106	82,014	21,671	22,273	43,944	135,717	126,195
Operational borrowings attributable to shareholder-financed operations	–	–	–	–	–	162	162	162	158
Borrowings attributable to with-profits funds	118	1,404	–	1,404	–	–	–	1,522	1,284
Deferred tax liabilities	80	903	252	1,155	–	503	503	1,738	1,606
Other non-insurance liabilities	331	3,789	556	4,345	834	2,831	3,665	8,341	7,371
Total liabilities	10,288	74,004	14,914	88,918	22,505	25,769	48,274	147,480	136,614
TOTAL EQUITY AND LIABILITIES	10,288	74,039	14,914	88,953	22,505	27,917	50,422	149,663	138,581

Notes

i For the purposes of this table and subsequent explanation, references to the PAC WPSF also include, for convenience, the amounts attaching to the Defined Charges Participating Sub-fund, which comprises 3.5 per cent of the total assets of WPSF and includes the with-profits annuity business transferred to Prudential from the Equitable Life Assurance Society on 1 December 2007 (with assets of approximately £1.7 billion). Profits to shareholders on this with-profits annuity business emerge on a 'charges less expenses' basis and policyholders are entitled to 100 per cent of the investment earnings.

ii SAIF is a separate sub-fund within the PAC long-term business fund.

iii Wholly-owned subsidiary of the PAC WPSF that writes annuity business.

iv Excluding policyholder liabilities of the Hong Kong branch of PAC.

v The loans of the Group's UK insurance operations of £2,302 million (2009: £1,815 million) comprise loans held by the PAC WPSF of £1,270 million (2009: £1,106 million) and loans held by shareholder-backed business of £1,032 million (2009: £709 million).

The loans held by the PAC WPSF comprise mortgage loans of £256 million, policy loans of £21 million and other loans of £993 million (2009: £145 million, £24 million and £937 million respectively). The mortgage loans are collateralised by properties. Other loans held by the PAC with-profits fund are all commercial loans and comprise mainly syndicated loans.

The loans held by the UK shareholder-backed business comprise mortgage loans collateralised by properties of £1,027 million (2009: £702 million) and other loans of £5 million (2009: £7 million).

vi Other investments comprise:

	2010 £m	2009 £m
Derivative assets*(note G3)	926	910
Partnerships in investment pools and other†	3,072	2,720
	3,998	3,630

* In the UK, Prudential uses derivatives to reduce equity and credit risk, interest rate and currency exposures, and to facilitate efficient portfolio management. After derivative liabilities of £792 million (2009: £709 million), which are also included in the statement of financial position, the overall derivative position was a net asset of £134 million (2009: £201 million).

† Partnerships in investment pools and other comprise mainly investments held by the PAC with-profits fund. These investments are primarily venture fund investments and investment in property funds and limited partnerships.

vii Unallocated surplus of with-profits funds

Prudential's long-term business written in the UK comprises predominantly life insurance policies under which the policyholders are entitled to participate in the returns of the funds supporting these policies. Business similar to this type is also written in certain of the Group's Asian operations, subject to local market and regulatory conditions. Such policies are called with-profits policies. Prudential maintains with-profits funds within the Group's long-term business funds, which segregate the assets and liabilities and accumulate the returns related to that with-profits business. The amounts accumulated in these with-profits funds are available to provide for future policyholder benefit provisions and for bonuses to be distributed to with-profits policyholders. The bonuses, both annual and final, reflect the right of the with-profits policyholders to participate in the financial performance of the with-profits funds. Shareholders' profits with respect to bonuses declared on with-profits business correspond to the shareholders' share of the cost of bonuses as declared by the PAC Board of directors. The shareholders' share currently represents one-ninth of the cost of bonuses declared for with-profits policies.

The unallocated surplus represents the excess of assets over policyholder liabilities for the Group's with-profits funds. As allowed under IFRS 4, the Group has opted to continue to record unallocated surplus of with-profits funds wholly as a liability. The annual excess (shortfall) of income over expenditure of the with-profits funds, after declaration and attribution of the cost of bonuses to policyholders and shareholders, is transferred to (from) the unallocated surplus each year through a charge (credit) to the income statement. The balance retained in the unallocated surplus represents cumulative income arising on the with-profits business that has not been allocated to policyholders or shareholders. The balance of the unallocated surplus is determined after full provision for deferred tax on unrealised appreciation on investments.

viii Investment properties

At 31 December 2010, the Group's UK insurance operations had £11,212 million (2009: £10,861 million) of investment properties. The following table shows the property portfolio by type of investment. The properties are shown at market value below in accordance with the policies described in note A4.

	2010		2009	
	£m	%	£m	%
Office buildings	4,617	41.2	4,820	44.4
Shopping centres/commercial	3,777	33.7	3,699	34.0
Retail warehouses/industrial	2,184	19.5	1,780	16.4
Development	402	3.6	20	0.2
Other	232	2.0	542	5.0
Total	11,212	100.0	10,861	100.0

Approximately 46.2 per cent (2009: 42.4 per cent) of the UK held investment property is located in London and Southeast England including Buckinghamshire, Berkshire, East and West Sussex, Hampshire, Isle of Wight, Kent, Oxfordshire and Surrey, with 36.7 per cent (2009: 39.8 per cent) located throughout the rest of the UK and the remaining 17.1 per cent (2009: 17.8 per cent) located overseas.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D2: UK INSURANCE OPERATIONS > CONTINUED

b Reconciliation of movement in investments

A reconciliation of the total investments of UK insurance operations from the beginning of the year to the end of the year is as follows:

		PAC with-profits sub-fund			Other funds and subsidiaries		
	Scottish Amicable Insurance Fund £m	Excluding Prudential Annuities Limited £m	Prudential Annuities Limited £m	Total £m	Unit-linked assets and liabilities £m	Annuity and other long-term business £m	UK insurance operations Total £m
AT 1 JANUARY 2009							
Total investments (including derivative assets)	10,438	62,814	13,329	76,143	15,571	19,710	121,862
Less: Investments held by consolidated investment funds	–	(145)	–	(145)	(424)	(40)	(609)
Less: Derivative liabilities	(414)	(2,331)	(280)	(2,611)	(14)	(362)	(3,401)
Directly held investments, net of derivative liabilities	10,024	60,338	13,049	73,387	15,133	19,308	117,852
Net cash inflow (outflow) from operating activities	(1,226)	507	(30)	477	258	1,923	1,432
Realised gains (losses) in the year	165	554	(20)	534	(285)	(306)	108
Unrealised gains and losses and exchange movements in the year	848	4,935	610	5,545	2,586	1,644	10,623
Reclassification of property under development	–	131	–	131	–	–	131
Movement in the year of directly held investments, net of derivative liabilities	(213)	6,127	560	6,687	2,559	3,261	12,294
AT 31 DECEMBER 2009/1 JANUARY 2010							
Total investments (including derivative assets)	9,848	67,832	13,794	81,626	18,421	22,795	132,690
Less: Investments held by consolidated investment funds	–	(1,050)	(19)	(1,069)	(729)	(37)	(1,835)
Less: Derivative liabilities[note G3]	(37)	(317)	(166)	(483)	–	(189)	(709)
Directly held investments, net of derivative liabilities	9,811	66,465	13,609	80,074	17,692	22,569	130,146
Net cash inflow (outflow) from operating activities	(762)	(838)	(21)	(859)	1,000	1,950	1,329
Realised gains in the year	368	1,502	73	1,575	267	23	2,233
Unrealised gains and losses and exchange movements in the year	249	2,963	608	3,571	1,131	1,007	5,958
Dilution of PruHealth investment	–	–	–	–	–	56	56
Movement in the year of directly held investments, net of derivative liabilities	(145)	3,627	660	4,287	2,398	3,036	9,576
AT 31 DECEMBER 2010							
Total investments (including derivative assets)	9,704	70,576	14,496	85,072	20,795	25,855	141,426
Less: Investments held by consolidated investment funds	–	(140)	(22)	(162)	(705)	(45)	(912)
Less: Derivative liabilities[note G3]	(38)	(344)	(205)	(549)	–	(205)	(792)
Directly held investments, net of derivative liabilities	9,666	70,092	14,269	84,361	20,090	25,605	139,722

c Reconciliation of movement in policyholder liabilities and unallocated surplus of with-profits funds

A reconciliation of the total policyholder liabilities and unallocated surplus of with-profits funds of UK insurance operations from the beginning of the year to the end of the year is as follows:

		Other shareholder-backed funds and subsidiaries		
	SAIF and PAC with-profits sub-fund £m	Unit-linked liabilities £m	Annuity and other long-term business £m	UK insurance operations Total £m
AT 1 JANUARY 2009	82,108	16,318	17,535	115,961
Premiums	3,271	1,860	1,736	6,867
Surrenders	(2,394)	(1,535)	(42)	(3,971)
Maturities/Deaths	(5,147)	(670)	(1,422)	(7,239)
Net flows[note a]	(4,270)	(345)	272	(4,343)
Shareholders transfers post-tax	(202)	–	–	(202)
Switches	(270)	270	–	–
Assumption changes (shareholder-backed business)[note D2i, note c]	–	–	(46)	(46)
Investment-related items and other movements[note b]	9,365	2,849	1,904	14,118
Foreign exchange translation differences	764	(57)	–	707
AT 31 DECEMBER 2009/1 JANUARY 2010	87,495	19,035	19,665	126,195
Comprising:				
– Policyholder liabilities	77,529	19,035	19,665	116,229
– Unallocated surplus of with-profits funds	9,966	–	–	9,966
Premiums	3,311	2,301	2,278	7,890
Surrenders	(2,453)	(1,272)	(54)	(3,779)
Maturities/Deaths	(5,079)	(726)	(1,498)	(7,303)
Net flows[note a]	(4,221)	303	726	(3,192)
Shareholders transfers post-tax	(223)	–	–	(223)
Switches	(236)	236	–	–
Assumption changes (shareholder-backed business)[note D2i, note c]	–	–	(46)	(46)
Investment-related items and other movements[note b]	9,165	2,097	1,956	13,218
Dilution of holding in PruHealth	–	–	(27)	(27)
Foreign exchange translation differences	(207)	–	(1)	(208)
AT 31 DECEMBER 2010	91,773	21,671	22,273	135,717
Comprising:				
– Policyholder liabilities	81,586	21,671	22,273	125,530
– Unallocated surplus of with-profits funds	10,187	–	–	10,187
Average policyholder liabilities balances*				
2010	79,558	20,353	20,969	120,880
2009	75,692	17,677	18,600	111,969

* Excluding the unallocated surplus of the with-profits funds and as adjusted for corporate transactions in the period.

Notes

a Net flows of negative £3,192 million have improved from negative £4,343 million in 2009, principally as a result of increased premiums due to bulk annuity transaction in 2010 and improved unit-linked flows.

b Investment-related items and other movements of £13,218 million across fund types reflected the continued strong performance of UK equity markets in 2010, as well as the continued increase in value of debt securities.

c Assumption changes principally represent the net impact of changes to the mortality assumptions and expense assumptions.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D2: UK INSURANCE OPERATIONS > CONTINUED

d Information on credit risk of debt securities

The following table summarises by rating the securities held by UK insurance operations as at 31 December 2010 and 2009:

	PAC with-profits sub-fund				Other funds and subsidiaries			UK insurance operations	
	Scottish Amicable Insurance Fund £m	Excluding Prudential Annuities Limited £m	Prudential Annuities Limited £m	Total £m	Unit-linked assets and liabilities £m	PRIL £m	Other annuity and long-term business £m	2010 Total £m	2009 Total £m
S&P – AAA	1,128	5,741	3,315	9,056	2,459	5,224	966	18,833	16,091
S&P – AA+ to AA-	346	2,045	1,334	3,379	608	2,299	253	6,885	6,472
S&P – A+ to A-	1,211	7,568	3,778	11,346	1,672	6,467	812	21,508	19,693
S&P – BBB+ to BBB-	1,011	6,960	1,153	8,113	836	2,464	424	12,848	12,183
S&P – Other	359	2,662	178	2,840	34	149	21	3,403	2,667
	4,055	24,976	9,758	34,734	5,609	16,603	2,476	63,477	57,106
Moody's – Aaa	78	428	56	484	80	93	30	765	463
Moody's – Aa1 to Aa	9	81	51	132	52	141	26	360	276
Moody's – A1 to A3	27	169	214	383	33	169	20	632	801
Moody's – Baa1 to Baa3	63	358	248	606	92	155	33	949	815
Moody's – Other	16	116	31	147	10	57	3	233	339
	193	1,152	600	1,752	267	615	112	2,939	2,694
Fitch	28	207	118	325	48	208	21	630	1,022
Other	428	2,678	2,309	4,987	121	1,622	100	7,258	6,950
Total debt securities	4,704	29,013	12,785	41,798	6,045	19,048	2,709	74,304	67,772

Where no external ratings are available, internal ratings produced by the Group's asset management operation, which are prepared on the Company's assessment of a comparable basis to external ratings, are used where possible. Of the £7,258 million total debt securities held in 2010 (2009: £6,950 million) which are not externally rated, £2,210 million were internally rated AAA to A-, £3,861 million were internally rated BBB to B- and £1,187 million were rated below B- or unrated (2009: £2,190 million, £3,445 million and £1,315 million respectively). The majority of unrated debt security investments were held in SAIF and the PAC with-profits fund and relate to convertible debt and other investments which are not covered by ratings analysts nor have an internal rating attributed to them. Of the £1,722 million PRIL and other annuity and long-term business investments which are not externally rated, £7 million were internally rated AAA, £92 million AA, £496 million A, £899 million BBB, £82 million BB and £146 million were internally rated B+ and below.

As detailed in note D2(i) below, the primary sensitivity of IFRS basis profit or loss and shareholders' equity relates to non-linked shareholder-backed business which covers 'PRIL' and 'other annuity and long-term business' in the table above.

e Products and guarantees

Prudential's long-term products in the UK consist of life insurance, pension products and pension annuities.

These products are written primarily in:

- One of three separate sub-funds of the PAC long-term fund, namely the with-profits sub-fund, SAIF, and the non-profit sub-fund;
- Prudential Annuities Limited, which is owned by the PAC with-profits sub-fund;
- Prudential Retirement Income Limited, a shareholder-owned subsidiary; or
- Other shareholder-backed subsidiaries writing mainly non-profit unit-linked business.

i With-profits products and PAC with-profits sub-fund

Within the statement of financial position of UK insurance operations at 31 December 2010, as shown in note D2(a), there are policyholder liabilities and unallocated surplus of £82.0 billion (2009: £77.5 billion) that relate to the WPSF. These amounts include the liabilities and capital of Prudential Annuities Limited, a wholly-owned subsidiary of the fund. The WPSF mainly contains with-profits business but it also contains some non-profit business (unit-linked, term assurances and annuities). The WPSF's profits are apportioned 90 per cent to its policyholders and 10 per cent to shareholders as surplus for distribution is determined via the annual actuarial valuation.

The WPSF held a provision of £24 million at 31 December 2010 (2009: £31 million) to honour guarantees on a small amount of guaranteed annuity products. SAIF's exposure to guaranteed annuities is described below.

Beyond the generic guarantees described above, there are very few explicit options or guarantees such as minimum investment returns, surrender values or annuities at retirement and any granted have generally been at very low levels.

With-profits products provide returns to policyholders through bonuses that are 'smoothed'. There are two types of bonuses: 'annual' and 'final'. Annual bonuses are declared once a year, and once credited, are guaranteed in accordance with the terms of the particular product. Unlike annual bonuses, final bonuses are guaranteed only until the next bonus declaration.

The main factors that influence the determination of bonus rates are the return on the investments of the with-profits fund, inflation, taxation, the expenses of the fund chargeable to policyholders and the degree to which investment returns are smoothed. The overall rate of return earned on investments and the expectation of future investment returns are the most important influences on bonus rates.

A high proportion of the assets backing the with-profits business are invested in equities and real estate. If the financial strength of the with-profits business is affected, then a higher proportion of fixed interest or similar assets might be held by the fund.

Further details on the determination of the two types of the bonuses: 'regular' and 'final', the application of significant judgement, key assumptions and the degree of smoothing of investment returns in determining the bonus rates are provided below.

Regular bonus rates

For regular bonuses, the bonus rates are determined for each type of policy primarily by targeting the bonus level at a prudent proportion of the long-term expected future investment return on 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 the date of payment of the premium or date of issue of the policy or 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 PAC Board has regard to the overall strength of the long-term fund when determining the length of time over which it will seek to achieve the amended prudent target bonus level.

In normal investment conditions, PAC expects changes in regular bonus rates to be gradual over time, and these are not expected to exceed one per cent per annum over any year. However, the PAC directors retain the discretion whether or not to declare a regular bonus each year, and there is no limit on the amount by which regular bonus rates can change.

Final bonus rates

A final bonus which is normally declared yearly, may be added when a claim is paid or when units of a unitised product are realised.

The rates of final bonus usually vary by type of policy and by reference to the period, usually a year, in which the policy commences or each premium is paid. These rates are determined by reference to the asset shares for the sample policies but subject to the smoothing approach, explained below.

In general, the same final bonus scale applies to maturity, death and surrender claims except that:

- The total surrender value may be impacted by the application of a Market Value Reduction – MVR – (for accumulating with-profits policies) and is affected by the surrender bases (for conventional with-profits business); and
- For the SAIF and Scottish Amicable Life (SAL), the final bonus rates applicable on surrender may be adjusted to reflect expected future bonus rates.

Application of significant judgement

The application of the above method for determining bonuses requires the PAC Board of directors to apply significant judgement in many respects, including in particular the following:

- Determining what constitutes fair treatment of customers: Prudential is required by UK law and regulation to consider the fair treatment of its customers in setting bonus levels. The concept of determining what constitutes fair treatment, while established by statute, is not defined.
- Smoothing of investment returns: This is an important feature of with-profits products. Determining when particular circumstances, such as a significant rise or fall in market values, warrant variations in the standard bonus smoothing limits that apply in normal circumstances requires the PAC Board to exercise significant judgement.
- Determining at what level to set bonuses to ensure that they are competitive: The overall return to policyholders is an important competitive measure for attracting new business.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D2: UK INSURANCE OPERATIONS > CONTINUED

Key assumptions

As noted above, the overall rate of return on investments and the expectation of future investment returns are the most important influences in bonus rates, subject to the smoothing described below. Prudential determines the assumptions to apply in respect of these factors, including the effects of reasonably likely changes in key assumptions, in the context of the overarching discretionary and smoothing framework that applies to its with-profits business as described above. As such, it is not possible to specifically quantify the effects of each of these assumptions or of reasonably likely changes in these assumptions.

Prudential's approach, in applying significant judgement and discretion in relation to determining bonus rates, is consistent conceptually with the approach adopted by other firms that manage a with-profits business. It is also consistent with the requirements of UK law, which require all UK firms that carry out a with-profits business to define, and make publicly available, the Principles and Practices of Financial Management (PPFM) that are applied in the management of their with-profits funds.

Accordingly, Prudential's PPFM contains an explanation of how it determines regular and final bonus rates within the discretionary framework that applies to all with-profits policies, subject to the general legislative requirements applicable. The purpose of Prudential's PPFM is therefore to:

- explain the nature and extent of the discretion available;
- show how competing or conflicting interests or expectations of:
  – different groups and generations of policyholders; and
  – policyholders and shareholders are managed so that all policyholders and shareholders are treated fairly; and
- provide a knowledgeable observer (e.g. a financial adviser) with an understanding of the material risks and rewards from starting and continuing to invest in a with-profits policy with Prudential.

Furthermore, in accordance with industry-wide regulatory requirements, the PAC Board has appointed:

- an Actuarial Function Holder who provides the PAC Board with all actuarial advice;
- a With-Profits Actuary whose specific duty is to advise the PAC Board on the reasonableness and proportionality of the manner in which its discretion has been exercised in applying the PPFM and the manner in which any conflicting interests have been addressed; and
- a With-Profits Committee of independent individuals, which assesses the degree of compliance with the PPFM and the manner in which conflicting rights have been addressed.

Smoothing of investment return

In determining bonus rates for the UK with-profits policies, smoothing is applied to the allocation of the overall earnings of the UK with-profits fund of which the investment return is a significant element. The smoothing approach differs between accumulating and conventional with-profits policies to reflect the different contract features. In normal circumstances, Prudential does not expect most payout 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 payout values between different policies. Greater flexibility may be required in certain circumstances, for example following a significant rise or fall in market values, and in such situations the PAC Board may decide to vary the standard bonus smoothing limits in order to protect the overall interests of policyholders.

The degree of smoothing is illustrated numerically by comparing in the following table the relatively 'smoothed' level of policyholder bonuses declared as part of the surplus for distribution with the more volatile movement in investment return and other items of income and expenditure of the UK component of the PAC with-profits fund for each year presented.

	2010 £m	2009 £m
Net income of the fund:		
Investment return	8,815	10,461
Claims incurred	(6,390)	(6,253)
Movement in policyholder liabilities	(4,301)	(3,692)
Add back policyholder bonuses for the year (as shown below)	2,019	1,827
Claims incurred and movement in policyholder liabilities (including charge for provision for asset shares and excluding policyholder bonuses)	(8,672)	(8,118)
Earned premiums, net of reinsurance	3,148	3,063
Other income	9	(2)
Acquisition costs and other expenditure	(600)	(842)
Tax (charge)	(528)	(640)
Net income of the fund before movement in unallocated surplus	2,172	3,922
Movement in unallocated surplus	70	(1,893)
Surplus for distribution	2,242	2,029
Surplus for distribution allocated as follows:		
– 90% policyholders bonus (as shown above)	2,019	1,827
– 10% shareholders' transfers	223	202
	2,242	2,029

ii Annuity business

Prudential's conventional annuities include level, fixed-increase and retail price index (RPI) annuities. They are mainly written within the subsidiaries PAL, PRIL, Prudential Pensions Limited and the PAC with-profits sub-fund, but there are some annuity liabilities in the non-profit sub-fund and SAIF.

Prudential's fixed-increase annuities incorporate automatic increases in annuity payments by fixed amounts over the policyholder's life. The RPI annuities that Prudential offers provide for a regular annuity payment to which an additional amount is added periodically based on the increase in the UK RPI.

Prudential's with-profits annuities, which are written in the WPSF, combine the income features of annuity products with the investment smoothing features of with-profits products and enable policyholders to obtain exposure to investment return on the WPSF's equity shares, property and other investment categories over time. Policyholders select a 'required smoothed return bonus' from the specific range Prudential offers for the particular product. The amount of the annuity payment each year depends upon the relationship between the required smoothed return bonus rate selected by the policyholder when the product is purchased and the smoothed return bonus rates Prudential subsequently declares each year during the term of the product. If the total bonus rates fall below the anticipated rate, then the annuity income falls.

At 31 December 2010, £35.6 billion (2009: £32.3 billion) of investments relate to annuity business of PAL and PRIL. These investments are predominantly in debt securities (including retail price index-linked bonds to match retail price index-linked annuities), loans and deposits and are duration matched with the estimated duration of the liabilities they support.

iii SAIF

SAIF is a ring-fenced sub-fund of the PAC long-term fund formed following the acquisition of the mutually owned Scottish Amicable Life Assurance Society in 1997. No new business may be written in SAIF, although regular premiums are still being paid on policies in force at the time of the acquisition and incremental premiums are permitted on these policies.

The fund is solely for the benefit of policyholders of SAIF. Shareholders have no interest in the profits of this fund although they are entitled to asset management fees on this business.

The process for determining policyholder bonuses of SAIF with-profits policies, which constitute the vast majority of obligations of the funds, is similar to that for the with-profits policies of the WPSF. However, in addition, the surplus assets in SAIF are allocated to policies in an orderly and equitable distribution over time as enhancements to policyholder benefits i.e. in excess of those based on asset share.

Provision is made for the risks attaching to some SAIF unitised with-profits policies that have MVR-free dates and for those SAIF products which have a guaranteed minimum benefit on death or maturity of premiums accumulated at four per cent per annum.

The Group's main exposure to guaranteed annuities in the UK is through SAIF and a provision of £336 million was held in SAIF at 31 December 2010 (2009: £284 million) to honour the guarantees. As SAIF is a separate sub-fund solely for the benefit of policyholders of SAIF this provision has no impact on the financial position of the Group's shareholders' equity.

D: LIFE ASSURANCE BUSINESSES
CONTINUED

D2: UK INSURANCE OPERATIONS > CONTINUED

iv Unit-linked (non-annuity) and other non-profit business
Prudential UK insurance operations also have an extensive book of unit-linked policies of varying types and provide a range of other non-profit business such as credit life and protection contracts. These contracts do not contain significant financial guarantees.

There are no guaranteed maturity values or guaranteed annuity options on unit-linked policies except for minor amounts for certain policies linked to cash units within SAIF.

f Exposure to market risk
i Non-linked life and pension business
For with-profits business, the absence of guaranteed surrender values and the flexibility given by the operation of the bonus system means that a high proportion of the investments backing the with-profits business are in equities and real estate with the balance in debt securities, deposits and loans.

The investments supporting the protection business are small in value and tend to be assets of a fixed term duration reflecting the guaranteed nature of the liabilities.

ii Pension annuity business
Prudential's UK annuity business mainly employs fixed income investments (including UK retail price index-linked assets) because the liabilities consist of guaranteed payments for as long as each annuitant or surviving partner is alive. Retail price index-linked assets are used to back pension annuities where the payments are linked to the RPI.

iii Unit-linked business
Except through the second order effect on asset management fees, the unit-linked business of the UK insurance operations is not exposed to market risk. The lack of exposure arises from the contract nature whereby policyholder benefits reflect asset value movements of the unit-linked funds.

g Process for setting assumptions and determining contract liabilities
i Overview
The calculation of the contract liabilities involves the setting of assumptions for future experience. This is done following detailed review of the relevant experience including, in particular, mortality, expenses, tax, economic assumptions and where applicable, persistency.

For with-profits business written in the WPSF or SAIF, a market consistent valuation is performed (as described in section (ii) below). Additional assumptions required are for persistency and the management actions under which the fund is managed. Assumptions used for a market consistent valuation typically do not contain margins, whereas those used for the valuation of other classes of business do.

Mortality assumptions are set based on the results of the most recent experience analysis looking at the experience over recent years of the relevant business. For non-profit business, a margin for adverse deviation is added. Different assumptions are applied for different product groups. For annuitant mortality, assumptions for current mortality rates are based on recent experience investigations and expected future improvements in mortality. The expected future improvements are based on recent experience and projections of the business and industry experience generally.

Maintenance and, for some classes of business, termination expense assumptions are expressed as per policy amounts. They are set based on the expenses incurred during the year, including an allowance for ongoing investment expenditure and allocated between entities and product groups in accordance with the operation's internal cost allocation model. For non-profit business a margin for adverse deviation is added to this amount. Expense inflation assumptions are set consistent with the economic basis and based on the difference between yields on nominal gilts and index-linked gilts.

The actual renewal expenses incurred on behalf of SAIF by other Group companies are recharged in full to SAIF.

The assumptions for asset management expenses are based on the charges specified in agreements with the Group's asset management operations, plus a margin for adverse deviation for non-profit business.

Tax assumptions are set equal to current rates of taxation.

For non-profit business excluding unit-linked business, the valuation interest rates used to discount the liabilities are based on the yields as at the valuation date on the assets backing the technical provisions. For fixed interest securities the gross redemption yield is used except for the PAL and PRIL annuity business where the internal rate of return of the assets backing the liabilities is used. Properties are valued using the rental yield, and for equities it is the greater of the dividend yield and the average of the dividend yield and the earnings yield. An adjustment is made to the yield on non risk-free fixed interest securities and property to reflect credit risk. To calculate the non-unit reserves for linked business, assumptions have been set for the gross unit growth rate and the rate of inflation of maintenance expenses, as well as for the valuation interest rate as described above.

ii WPSF and SAIF

The policyholder liabilities reported for the WPSF are primarily for two broad types of business. These are accumulating and conventional with-profits contracts. The policyholder liabilities of the WPSF are accounted for under FRS 27.

The provisions have been determined on a basis consistent with the detailed methodology included in regulations contained in the FSA's rules for the determination of reserves on the FSA's 'realistic' Peak 2 basis. In aggregate, the regime has the effect of placing a value on the liabilities of UK with-profits contracts, which reflects the amounts expected to be paid based on the current value of investments held by the with-profits funds and current circumstances. These contracts are a combination of insurance and investment contracts with discretionary participation features, as defined by IFRS 4.

The FSA's Peak 2 calculation under the realistic regime requires the value of liabilities to be calculated as:

- The with-profits benefits reserve (WPBR); plus
- future policy related liabilities (FPRL); plus
- the realistic current liabilities of the fund.

The WPBR is primarily based on the retrospective calculation of accumulated asset shares but is adjusted to reflect future expected policyholder benefits and other outgoings. Asset shares are calculated as the accumulation of all items of income and outgo that are relevant to each policy type. Income comprises credits for premiums, investment returns (including unrealised gains), and miscellaneous profits. Outgo comprises charges for tax (including an allowance for tax on unrealised gains), guarantees and smoothing, mortality and morbidity, shareholders' profit transfers, miscellaneous losses, and expenses and commission (net of any tax relief).

The FPRL must include a market consistent valuation of costs of guarantees, options and smoothing, less any related charges, and this amount must be determined using either a stochastic approach, hedging costs or a series of deterministic projections with attributed probabilities.

The assumptions used in the stochastic models are calibrated to produce risk-free returns on each asset class. Volatilities of, and correlations between, investment returns from different asset classes are as determined by the Group's Portfolio Management Group and aim to be market consistent.

The cost of guarantees, options and smoothing is very sensitive to the bonus, market value reduction (MVR), and investment policy employed and therefore the stochastic modelling incorporates a range of management actions that would help to protect the fund in adverse investment scenarios. Substantial flexibility has been included in the modelled management actions in order to reflect the discretion that is retained in adverse investment conditions, thereby avoiding the creation of unreasonable minimum capital requirements. The management actions assumed are consistent with the Group's management policy for with-profits funds and the Group's disclosures in the publicly available PPFM.

The contract liabilities for with-profits business also require assumptions for persistency. These are set based on the results of recent experience analysis.

iii Annuity business

Credit risk provisions

For IFRS reporting, the results for UK shareholder-backed annuity business are particularly sensitive to the allowances made for credit risk. The allowance is reflected in the deduction from the valuation rate of interest for discounting projected future annuity payments to policyholders that would have otherwise applied. Since mid-2007 there has been a significant increase in the actual and perceived credit risk associated with corporate bonds as reflected in the significant widening that has occurred in corporate bond spreads. Although bond spreads over swap rates have narrowed from their peak in March 2009, they are still high compared with the levels seen in the years immediately preceding the start of the dislocated markets in 2007. The allowance that should therefore be made for credit risk remains a particular area of judgement.

The additional yield received on corporate bonds relative to swaps can be broken into the following constituent parts:

(a) the expected level of future defaults;
(b) the credit risk premium that is required to compensate for the potential volatility in default levels;
(c) the liquidity premium that is required to compensate for the lower liquidity of corporate bonds relative to swaps; and
(d) the mark to market risk premium that is required to compensate for the potential volatility in corporate bond spreads (and hence market values) at the time of sale.

The sum of (c) and (d) is often referred to as 'liquidity premium'.

The credit risk allowance is a function of the asset mix and the credit quality of the underlying portfolio. At 31 December 2010, 84 per cent (2009: 80 per cent) of the assets backing the UK shareholder annuity and other business were debt securities as shown in D2 (a). This comprises both government and corporate bonds. Government bonds are generally given a credit default allowance of zero. For corporate bonds the credit allowance varies by credit rating. An analysis of the credit ratings of debt securities is included in note D2 (d).

Given that the normal business model for Prudential's annuity business is to hold bonds to match long-term liabilities, the valuation rate that is applied to discount the future annuity payments includes a liquidity premium that reflects the residual element of current bond spreads over swap rates after providing for the credit risk.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D2: UK INSURANCE OPERATIONS > CONTINUED

Historically, until the second half of 2007, when corporate bond spreads widened significantly, the allowance for credit risk was calculated as the long-term expected defaults and a long-term credit risk premium. This long-term credit risk was supplemented by a short-term allowance from 31 December 2007 to allow for the concern that credit ratings applied by the rating agencies may be downgraded and defaults in the short-term might be higher than the long-term assumptions.

The weighted components of the bond spread over swap rates for shareholder-backed fixed and linked annuity business for PRIL at 31 December 2010, 2009 and 2008, based on the asset mix at the relevant balance sheet date are shown below.

	2010		
31 December 2010	Pillar I Regulatory basis (bps)	Adjustment from regulatory to IFRS basis (bps) note v	IFRS (bps)
Bond spread over swap rates[note i]	160	–	160
Credit risk allowance			
Long-term expected defaults[note ii]	16	–	16
Long-term credit risk premium[note iii]	10	–	10
Short-term allowance for credit risk[note iv]	42	(26)	16
Total credit risk allowance	68	(26)	42
Liquidity premium	92	26	118

	2009		
31 December 2009	Pillar I Regulatory basis (bps)	Adjustment from regulatory to IFRS basis (bps) note v	IFRS (bps)
Bond spread over swap rates[note i]	175	–	175
Credit risk allowance			
Long-term expected defaults[note ii]	19	–	19
Long-term credit risk premium[note iii]	13	–	13
Short-term allowance for credit risk[note iv]	39	(24)	15
Total credit risk allowance	71	(24)	47
Liquidity premium	104	24	128

31 December 2008	2008 Pillar I Regulatory basis (bps)	Adjustment from regulatory to IFRS basis (bps) note v	IFRS (bps)
Bond spread over swap rates[note i]	323	–	323
Credit risk allowance			
Long-term expected defaults[note ii]	15	–	15
Long-term credit risk premium[note iii]	11	–	11
Short-term allowance for credit risk[note iv]	54	(25)	29
Total credit risk allowance	80	(25)	55
Liquidity premium	243	25	268

Notes

(i) Bond spread over swap rates reflect market observed data.

(ii) For the valuations prior to 31 December 2010, long-term expected defaults were derived by applying Moody's data from 1970 to 2004 uplifted by between 100 per cent (B) and 200 per cent (AAA) according to credit rating on the annuity asset portfolio. The credit rating assigned to each asset held was based on external credit rating and for this purpose the credit rating assigned to each asset held was the lowest credit rating published by Moody's, Standard and Poors and Fitch.

For the 31 December 2010 valuation, long-term expected defaults are derived by applying Moody's data from 1970 to 2009 and the definition of the credit rating used has been revised from the lowest credit rating to the second highest credit rating published by Moody's, Standard and Poors and Fitch.

(iii) For the valuations prior to 31 December 2010, the long-term credit risk premium provides compensation against the risk of potential volatility in the level of defaults and is derived by applying the 95th percentile from Moody's data from 1970 to 2004 to the annuity asset portfolio. For the 31 December 2010 valuation, the long-term credit risk premium is derived from Moody's data from 1970 to 2009.

The combined effect of this change and the changes described in (ii) above is neutral on the long-term credit risk allowance for PRIL.

(iv) The short-term allowance for credit risk assumed in the Pillar 1 solvency valuations at 31 December 2008 was determined as 25 per cent of the increase in corporate bond spreads (as estimated from the movements in published corporate bond indices) since 31 December 2006. Subsequent to this date movements have reflected events in the period, namely the impact of credit migration, the decision not to release favourable default experience, new business and asset trading amongst other items. This is demonstrated by the analyses below.

(v) The very prudent Pillar 1 regulatory basis reflects the overriding objective of ensuring sufficient provisions and capital to ensure payments to policyholders can be made. The approach for IFRS aims to establish liabilities that are closer to 'best estimate'. IFRS default assumptions are therefore set between the EEV and Pillar I assumptions.

Factors affecting the credit risk allowance at 31 December 2010

The main factors influencing the credit risk allowance at 31 December 2010 are as follows:

a Credit downgrades and default experience

The credit risk allowances have been adjusted during 2010 to take account of emerging downgrade and default experience. Experience in relation to changes in credit rating has improved in 2010 and no assets defaulted for the PRIL business during the year. The allowance for short-term downgrades has been reduced to offset the impact of credit downgrades on the long-term assumptions. In addition, the allowance for short-term defaults has been updated to eliminate any experience profits that would otherwise have arisen due to default experience being better than allowed for in the opening reserves.

b Asset trading

Since the second half of 2009, the Group started trading out of subordinated financial debt into higher quality assets. The continuation of the reduction in the subordinated financial debt holdings in 2010 improved the overall credit quality of the corporate bond portfolio and so allowed for a release of long-term credit reserves.

On a Pillar 1 basis this transaction had no overall impact on the solvency surplus of PRIL, the PAC non-participating sub-fund and PAL. On an IFRS basis, the reduction in subordinated financial debt holdings generated a pre-tax IFRS operating loss of £4 million (2009: loss of £51 million).

c Asset purchases in respect of new business

Similar to 2009, the assets purchased during 2010 to back new business have been of better average credit quality than the assets held at 31 December 2008, in particular no subordinated bank debt or sub-investment grade assets have been bought to back new business. As a result of the lower credit risk of the new business assets the overall allowance for credit risk required at 31 December 2010 is reduced when the new business assets and in-force assets are aggregated together.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D2: UK INSURANCE OPERATIONS > CONTINUED

d Overall impact on the PRIL credit risk allowance

After taking account of the factors noted above the movement on the average basis points allowances for PRIL on the Pillar 1 regulatory and IFRS bases are as follows:

	Pillar 1 Regulatory basis (bps)			IFRS (bps)		
	Long-term	Short-term	Total	Long-term	Short-term	Total
Total allowance for credit risk at 31 December 2009	32	39	71	32	15	47
Credit downgrades	1	(1)	–	1	(1)	–
Retention of surplus from favourable default experience	–	7	7	–	3	3
Asset trading	(5)	–	(5)	(5)	–	(5)
New business	–	(2)	(2)	–	(1)	(1)
Other	(2)	(1)	(3)	(2)	–	(2)
Total allowance for credit risk at 31 December 2010	26	42	68	26	16	42

Overall this has led to the credit allowance for Pillar 1 purposes to be 43 per cent (2009: 41 per cent) of the bond spread over swap rates. For IFRS purposes it represents 26 per cent (2009: 27 per cent) of the bond spread over swap rates.

The reserves for credit risk allowance at 31 December 2010 for UK shareholder annuity fund were as follows:

	Pillar 1 Regulatory basis £bn			IFRS £bn		
	Long-term	Short-term	Total	Long-term	Short-term	Total
PRIL	0.6	1.0	1.6	0.6	0.4	1.0
PAC non-profit sub-fund	0.1	0.1	0.2	0.1	–	0.1
Total	0.7	1.1	1.8	0.7	0.4	1.1

Mortality

The mortality assumptions are set in light of recent population and internal experience. The assumptions used are percentages of standard actuarial mortality tables with an allowance for future mortality improvements. Where annuities have been sold on an enhanced basis to impaired lives an additional age adjustment is made. The percentages of the standard table used are selected according to the source of business.

In 2009, Prudential's annuity business liabilities were determined using the Continuous Mortality Investigation ('CMI') medium cohort projections with a floor. In November 2009 a new mortality projection model was released by the CMI. This model is expected to become the new industry standard. The new model has been applied in determining the 2010 results with calibration to reflect an appropriate view of future mortality improvement. In recognition of the trend in assumed mortality improvements the Company has in previous years included margins in its annuity liabilities. In determining the 2010 results the appropriate level of these margins has been reassessed. See note D2 (i) below for the net effect of applying the new model, releases of margin, and changes to other related mortality assumptions.

The tables and range of percentages used are set out in the following tables:

2010	PAL Males	PAL Females	PRIL Males	PRIL Females
In payment	92% – 98% PCMA00 with future improvements in line with Prudential's own calibration of the CMI 2009 mortality model, with a long-term improvement rate of 2.25%	88% – 100% PCFA00 with future improvements in line with Prudential's own calibration of the CMI 2009 mortality model, with a long-term improvement rate of 1.25%	94% – 95% PCMA00 with future improvements in line with Prudential's own calibration of the CMI 2009 mortality model, with a long-term improvement rate of 2.25%	86% – 97% PCFA00 with future improvements in line with Prudential's own calibration of the CMI 2009 mortality model, with a long-term improvement rate of 1.25%
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

2009	PAL Males	PAL Females	PRIL Males	PRIL Females
In payment	102% – 126% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120	84% – 117% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120	96% – 102% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120	87% – 98% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

2008	PAL Males	PAL Females	PRIL Males	PRIL Females
In payment	102% – 126% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120	84% – 117% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120	97% – 102% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120	88% – 98% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

iv Unit-linked (non-annuity) and other non-profit business

The majority of other long-term business written in the UK insurance operations is unit-linked business or other business with similar features. For these contracts the attaching liability reflects the unit value obligation and provision for expenses and mortality risk. The latter component is determined by applying mortality assumptions on a basis that is appropriate for the policyholder profile.

For unit-linked business, the assets covering unit liabilities are exposed to market risk, but the residual risk when considering the unit-linked liabilities and assets together is limited to the effect on fund-based charges.

For those contracts where the level of insurance risk is insignificant the assets and liabilities arising under the contracts are distinguished between those that relate to the financial instrument liability and acquisition costs and deferred income that relate to the component of the contract that relates to investment management. Acquisition costs and deferred income are recognised consistent with the level of service provision in line with the requirements of IAS 18.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D2: UK INSURANCE OPERATIONS > CONTINUED

h Reinsurance

The Group's UK insurance business cedes only minor amounts of business outside the Group. During 2010, reinsurance premiums for externally ceded business were £128 million (2009: £122 million) and reinsurance recoverable insurance assets were £608 million (2009: £502 million) in aggregate. The gains and losses recognised in profit and loss for the 2010 contracts were immaterial.
During 2009 the Group's UK insurance business wrote a longevity swap on certain aspects of the UK's annuity back-book liabilities. This resulted in a one-off benefit of £34 million to IFRS profit before tax in 2009. The gains and losses recognised in profit and loss for other contracts in 2009 were immaterial.

i Effect of changes in assumptions used to measure insurance assets and liabilities

2010

Credit risk

The approach to reserving for credit risk is set out in note D2(g)(iii).

Other operating assumption changes

Note D2(g)(iii) above explains the application of a new mortality projection model in 2010 to determine the Prudential's annuity business.

The net effect of applying the new model, releases of margins and changes to other related mortality assumptions for shareholder-backed business is a credit of £8 million. With a £38 million benefit from altered expense assumptions the overall credit for shareholder-backed business is £46 million.

For the with-profits sub-fund, the aggregate effect of assumption changes in 2010 was a net charge to unallocated surplus of £62 million, relating to changes in mortality, expense, persistency and economic assumptions.

2009

Credit risk

The approach to reserving for credit risk is set out in note D2(g)(iii).

Other operating assumptions changes

Overall mortality experience was in line with expectations and no change was therefore required to the overall strength of mortality assumptions at 31 December 2009.

For the shareholder-backed business, the aggregate effect of assumption changes in 2009 was a net credit to the shareholder result of £46 million, primarily related to changes to the deflation reserve, expense assumptions and modelling changes.

For the with-profits sub-fund, the aggregate effect of assumption changes in 2009 was a net credit to unallocated surplus of £65 million principally for altered expense assumptions.

j Sensitivity of IFRS basis profit or loss and equity to market and other risks

The risks to which the IFRS basis results of the UK insurance operations are sensitive are asset/liability matching, mortality experience and payment assumptions for shareholder-backed annuity business. Further details are described below.

i With-profits business

SAIF

Shareholders have no interest in the profits of SAIF but are entitled to the asset management fees paid on the investment of the assets of the fund.

With-profits sub-fund business

For with-profits business (including non-participating business of PAL which is owned by the WPSF) adjustments to liabilities and any related tax effects are recognised in the income statement. However, except for any impact on the annual declaration of bonuses, shareholders' profit for with-profits business is unaffected. This is because IFRS basis profits for with-profits business, which are determined on the same basis as on preceding UK GAAP, solely reflect one-ninth of the cost of bonuses declared for the year.

The main factors that influence the determination of bonus rates are the return on the investments of the fund, the effect of inflation, taxation, the expenses of the fund chargeable to policyholders and the degree to which investment returns are smoothed. Mortality and other insurance risk are relatively minor factors.

Unallocated surplus represents the excess of assets over policyholder liabilities of the fund. As unallocated surplus of the WPSF is recorded as a liability, movements in its value do not affect shareholders' profits or equity.

The level of unallocated surplus is particularly sensitive to the level of investment returns on the portion of the life fund assets that represents the surplus. The effects for 2010 and 2009 are demonstrated in note D5.

ii Shareholder-backed annuity business

Profits from shareholder-backed annuity business are most sensitive to:

- The extent to which the duration of the assets held closely matches the expected duration of the liabilities under the contracts. Assuming close matching, the impact of short-term asset value movements as a result of interest rate movements will broadly offset changes in the value of liabilities caused by movements in valuation rates of interest;
- actual versus expected default rates on assets held;
- the difference between long-term rates of return on corporate bonds and risk-free rates;
- the variance between actual and expected mortality experience;
- the extent to which expected future mortality experience gives rise to changes in the measurement of liabilities; and
- changes in renewal expense levels.

A decrease in assumed mortality rates of one per cent would decrease gross profits by approximately £53 million (2009: £44 million). A decrease in credit default assumptions of five basis points would increase gross profits by £119 million (2009: £91 million). A decrease in renewal expenses (excluding asset management expenses) of five per cent would increase gross profits by £23 million (2009: £17 million). The effect on profits would be approximately symmetrical for changes in assumptions that are directionally opposite to those explained above.

iii Unit-linked and other business

Unit-linked and other business represents a comparatively small proportion of the in-force business of the UK insurance operations.

Profits from unit-linked and similar contracts primarily arise from the excess of charges to policyholders, for management of assets under the Company's stewardship, over expenses incurred. The former is most sensitive to the net accretion of funds under management as a function of new business and lapse and timing of death. The accounting impact of the latter is dependent upon the amortisation of acquisition costs in line with the emergence of margins (for insurance contracts) and amortisation in line with service provision (for the investment management component of investment contracts). By virtue of the design features of most of the contracts which provide low levels of mortality cover, the profits are relatively insensitive to changes in mortality experience.

iv Shareholder exposure to interest rate risk and other market risk

By virtue of the fund structure, product features and basis of accounting described in note D2(e) and (g), the policyholder liabilities of the UK insurance operations are, except for pension annuity business, not generally exposed to interest rate risk. For pension annuity business, liabilities are exposed to fair value interest rate risk. However, the net exposure to the PAC WPSF (for PAL) and shareholders (for liabilities of PRIL and the non-profit sub-fund) is very substantially ameliorated by virtue of the close matching of assets with appropriate duration. The level of matching from period to period can vary depending on management actions and economic factors so it is possible for a degree of mis-matching profits or losses to arise.

The close matching by the Group of assets of appropriate duration to annuity liabilities is based on maintaining economic and regulatory capital. The measurement of liabilities under capital reporting requirements and IFRS 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 IFRS reporting purposes. As a result IFRS equity is higher than regulatory capital and therefore more sensitive to interest rate risk.

The estimated sensitivity of the UK non-linked shareholder-backed business (principally pension annuities business) to a movement in interest rates is as follows.

	2010 £m				2009 £m			
	A decrease of 2%	A decrease of 1%	An increase of 1%	An increase of 2%	A decrease of 2%	A decrease of 1%	An increase of 1%	An increase of 2%
Carrying value of debt securities and derivatives	6,547	2,938	(2,434)	(4,481)	5,372	2,422	(2,020)	(3,731)
Policyholder liabilities	(5,977)	(2,723)	2,109	3,929	(5,125)	(2,304)	1,905	3,498
Related deferred tax effects	(154)	(58)	88	149	(69)	(33)	32	65
Net sensitivity of profit after tax and shareholders' equity	416	157	(237)	(403)	178	85	(83)	(168)

In addition the shareholder-backed portfolio of UK non-linked insurance operations covering liabilities and shareholders' equity includes equity securities and investment property. Excluding any second order effects on the measurement of the liabilities for future cash flows 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.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D2: UK INSURANCE OPERATIONS > CONTINUED

	2010 £m		2009 £m	
	A decrease of 20%	A decrease of 10%	A decrease of 20%	A decrease of 10%
Pre-tax profit	(302)	(151)	(292)	(146)
Related deferred tax effects	82	41	82	41
Net sensitivity of profit after tax and shareholders' equity	(220)	(110)	(210)	(105)

A 10 or 20 per cent increase in their value would have an approximately equal and opposite effect on profit and shareholders' equity to the sensitivities shown above. The market risk sensitivities shown above reflect the impact of temporary market movements and, therefore, the primary effect of such movements would, in the Group's segmental analysis of profits, be included within the short-term fluctuations in investment returns.

In the equity risk sensitivity analysis given above, the Group 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 Group 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 Group would be able to put in place mitigating management actions.

k Duration of liabilities

With the exception of most unitised with-profits bonds and other whole of life contracts the majority of the contracts of the UK insurance operations have a contract term. However, in effect, the maturity term of contracts reflects the earlier of death, maturity, or lapsation. In addition, with-profits contract liabilities as noted in note D2(g) include projected future bonuses based on current investment values. The actual amounts payable will vary with future investment performance of SAIF and the WPSF.

The tables below show the carrying value of the policyholder liabilities. Separately, the Group uses cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results. The tables below also show the maturity profile of the cash flows used for 2010 and 2009 for that purpose for insurance contracts, as defined by IFRS, i.e. those containing significant insurance risk, and investment contracts, which do not.

	2010 £m									
	With-profits business			Annuity business (Insurance contracts)			Other			
	Insurance contracts	Investment contracts	Total	PAL	PRIL	Total	Insurance contracts	Investment contracts	Total	TOTAL
Policyholder liabilities	43,691	25,613	69,304	12,282	16,442	28,724	11,737	15,765	27,502	125,530
	2010 %									
Expected maturity:										
0 to 5 years	46	31	40	32	29	30	35	29	32	36
5 to 10 years	25	25	25	25	23	24	26	21	23	24
10 to 15 years	13	19	16	18	17	18	18	20	19	17
15 to 20 years	7	14	10	12	13	12	10	11	11	11
20 to 25 years	4	8	6	7	8	8	6	8	7	7
Over 25 years	5	3	3	6	10	8	5	11	8	5

	2009 £m									
	With-profits business			Annuity business (Insurance contracts)			Other			
	Insurance contracts	Investment contracts	Total	PAL	PRIL	Total	Insurance contracts	Investment contracts	Total	TOTAL
Policyholder liabilities	40,780	24,780	65,560	11,969	14,292	26,261	10,614	13,794	24,408	116,229
	2009 %									
Expected maturity:										
0 to 5 years	50	29	41	32	31	32	34	35	35	38
5 to 10 years	26	25	26	25	23	24	25	22	23	25
10 to 15 years	13	19	15	18	17	17	18	19	18	16
15 to 20 years	6	14	9	11	12	12	11	11	11	10
20 to 25 years	3	9	6	7	8	7	7	6	6	6
Over 25 years	2	4	3	7	9	8	5	7	7	5

Notes

i The cash flow projections of expected benefit payments used in the maturity profile table above are from value of 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 certain unit-linked and similar contracts accounted for under IAS 39 and IAS 18.

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.

v The maturity tables shown above have been prepared on a discounted basis. Details of undiscounted cash flow for investment contracts are shown in note G2.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D3: US INSURANCE OPERATIONS

a Summary results and statement of financial position

i Results and movements in shareholders' equity

	2010 £m	2009[(i)] £m
Operating profit based on longer-term investment returns	833	618
Short-term fluctuations in investment returns	(378)	(132)
Profit before shareholder tax	455	486
Tax	(117)	102
Profit for the year	338	588

	2010 £m	2009 £m
Profit for the year (as above)	338	588
Items recognised in other comprehensive income:		
Exchange movements	85	(231)
Unrealised valuation movements on securities classified as available-for-sale:		
Unrealised holding gains arising during the year	1,170	2,249
Less losses included in the income statement	51	420
Total unrealised valuation movements	1,221	2,669
Related change in amortisation of deferred income and acquisition costs	(469)	(1,069)
Related tax	(247)	(557)
Total other comprehensive income	563	812
Total comprehensive income for the year	901	1,400
Dividends, interest payments to central companies and other movements	(97)	(87)
Net increase in equity	804	1,313
Shareholders' equity at beginning of year	3,011	1,698
Shareholders' equity at end of year	3,815	3,011

Note

(i) The Group has amended the presentation of operating profit for its US insurance operations to remove the net equity hedge accounting effect (incorporating related amortisation of deferred acquisition costs) and include it in short-term fluctuations. The 2009 comparatives have been amended accordingly. Note A4(d)(ii) explains the effect of the change.

Included within the movements in shareholders' equity is a net increase in value of Jackson's debt securities classified as 'available-for-sale' under IAS 39 of £1,221 million (2009: £2,669 million).

With the exception of debt securities for US insurance operations classified as 'available-for-sale' under IAS 39, unrealised value movements on the Group's investments are booked within the income statement. However, for debt securities classified as 'available-for-sale', unless impaired, fair value movements are recognised in other comprehensive income. Realised gains and losses, including impairments, are recorded in the income statement. This classification is applied for most of the debt securities of the Group's US operations. In 2010, Jackson recorded £124 million (2009: £630 million) of impairment losses arising from:

	2010 £m	2009 £m
Residential mortgage-backed securities	71	509
Public fixed income	1	91
Other	52	30
	124	630

Further details on the impairment losses recognised in the year are shown in note B1. Jackson's portfolio of debt securities is managed proactively with credit analysts closely monitoring and reporting on the credit quality of its holdings. Jackson continues to review its investments on a case-by-case basis to determine whether any decline in fair value represents an impairment. In addition, investments in structured securities are subject to a rigorous review of their future estimated cash flows, including expected and stress case scenarios, to identify potential shortfalls in contractual payments (both interest and principal). Impairment charges are recorded on structured securities when the Company forecasts a contractual payment shortfall. Situations where such a shortfall would not lead to a recognition of a loss are rare. However, some structured securities do not have a single determined set of future cash flows and instead, there can be a reasonable range of estimates that could potentially emerge. With this variability, there could be instances where the projected cash flow shortfall under management's base case set of assumptions is so minor that relatively small and justifiable changes to the base case assumptions would eliminate the need for an impairment loss to be recognised. The impairment loss reflects the difference between the fair value and book value.

In 2010, there was a movement in the statement of financial position value for debt securities classified as available-for-sale from a net unrealised gain of £4 million to a net unrealised gain of £1,210 million (2009: net unrealised loss of £2,897 million to a net unrealised gain of £4 million).This increase reflects the effects of tightening credit spreads in the US bond market and lower interest rates. During 2010, the gross unrealised gain in the statement of financial position increased from £970 million at 31 December 2009 to £1,580 million at 31 December 2010 while the gross unrealised loss decreased from £966 million at 31 December 2009 to £370 million at 31 December 2010. Details of the securities in an unrealised loss position are shown in D3(d) below.

These features are included in the table shown below of the movements in the values of available-for-sale securities:

	2010			2009
		Changes in unrealised appreciation‡	Foreign exchange translation	
		Reflected as part of movement in other comprehensive income		
	£m	£m	£m	£m
Assets fair valued at below book value				
Book value*	4,372			8,220
Unrealised loss	(370)	634	(38)	(966)
Fair value (as included in statement of financial position)	4,002			7,254
Assets fair valued at or above book value				
Book value*	20,743			14,444
Unrealised gain	1,580	587	23	970
Fair value (as included in statement of financial position)	22,323			15,414
Total				
Book value*	25,115			22,664
Net unrealised gain (loss)	1,210	1,221	(15)	4
Fair value (as included in statement of financial position)†	26,325			22,668
Reflected as part of movement in other comprehensive income				
Movement in unrealised appreciation	1,221			2,669
Exchange movements	(15)			232
	1,206			2,901

* Book value represents cost/amortised cost of the debt securities.
† Debt securities for US operations as included in the statement of financial position of £26,366 million (2009: £22,831 million) comprise £26,325 million (2009: £22,668 million) in respect of securities classified as 'available-for-sale' and £41 million (2009: £163 million) for securities of consolidated investment funds classified as fair value through profit and loss.
‡ Translated at the average rate of US$1.55: £1.

Included within the movement in gross unrealised losses for the debt securities of Jackson of £634 million (2009: £1,925 million) as shown above was a net increase in value of £84 million (2009: £72 million decrease) relating to the sub-prime and Alt-A securities as referred to in section B6.

D: LIFE ASSURANCE BUSINESSES
CONTINUED

D3: US INSURANCE OPERATIONS > CONTINUED

ii Statement of financial position

	US insurance operations			
	Variable annuity separate account assets and liabilities note i £m	Fixed annuity, GIC and other business note i £m	2010 Total £m	2009 Total £m
ASSETS				
Intangible assets attributable to shareholders:				
Deferred acquisition costs and other intangible assets	–	3,543	3,543	3,092
Total	–	3,543	3,543	3,092
Deferred tax assets	–	1,391	1,391	1,944
Other non-investment and non-cash assets	–	1,241	1,241	1,404
Investments of long-term business and other operations:				
Investment properties	–	26	26	33
Financial investments:				
Loans[note ii]	–	4,201	4,201	4,319
Equity securities and portfolio holdings in unit trusts[note v]	31,203	298	31,501	20,984
Debt securities[note D3d]	–	26,366	26,366	22,831
Other investments[note iii]	–	1,199	1,199	955
Deposits	–	212	212	454
Total investments[note G]	31,203	32,302	63,505	49,576
Properties held for sale	–	3	3	3
Cash and cash equivalents	–	232	232	340
TOTAL ASSETS	31,203	38,712	69,915	56,359
EQUITY AND LIABILITIES				
Equity				
Shareholders' equity	–	3,815	3,815	3,011
Total equity	–	3,815	3,815	3,011
Liabilities				
Policyholder liabilities:[note iv]				
Contract liabilities (including amounts in respect of contracts classified as investment contracts under IFRS 4)	31,203	29,320	60,523	48,311
Total	31,203	29,320	60,523	48,311
Core structural borrowings of shareholder-financed operations	–	159	159	154
Operational borrowings attributable to shareholder-financed operations	–	90	90	203
Deferred tax liabilities	–	1,776	1,776	1,858
Other non-insurance liabilities	–	3,552	3,552	2,822
Total liabilities	31,203	34,897	66,100	53,348
TOTAL EQUITY AND LIABILITIES	31,203	38,712	69,915	56,359

Notes

i Assets and liabilities attaching to variable annuity business that are not held in the separate account are shown within other business.

ii Loans

The loans of the Group's US insurance operations of £4,201 million (2009: £4,319 million) comprise mortgage loans of £3,641 million (2009: £3,774 million), policy loans of £548 million (2009: £530 million) and other loans of £12 million (2009: £15 million). All of the mortgage loans are commercial mortgage loans which are collateralised by properties. The property types are mainly industrial, multi-family residential, suburban office, retail and hotel. The breakdown by property type is as follows:

	2010 %	2009 %
Industrial	31	32
Multi-family residential	18	18
Office	19	20
Retail	21	19
Hotels	10	10
Other	1	1
	100	100

The US insurance operations' commercial mortgage loan portfolio does not include any single-family residential mortgage loans and is therefore not exposed to the risk of defaults associated with residential sub-prime mortgage loans. The average loan size is £6.6 million (2009: £6.3 million). The portfolio has a current estimated average loan to value of 73 per cent (2009: 74 per cent) which provides significant cushion to withstand substantial declines in value.

The policy loans are fully secured by individual life insurance policies or annuity policies. These loans are accounted for at amortised cost, less any impairment.

iii Other investments comprise:

	2010 £m	2009 £m
Derivative assets[note G3*]	645	519
Partnerships in investment pools and other[†]	554	436
	1,199	955

* In the US, Prudential uses derivatives to reduce interest rate risk, to facilitate efficient portfolio management to match liabilities under annuity policies, and for certain equity-based product management activities. After taking account of the derivative liability of £799 million (2009: £461 million), which is also included in the statement of financial position, the derivative position for US operations is a net liability of £154 million (2009: net asset of £58 million).

† Partnerships in investment pools and other comprise primarily investments in limited partnerships. These include interest in the PPM America Private Equity Fund and diversified investments in 161 (2009: 159) other partnerships by independent money managers that generally invest in various equities and fixed income loans and securities.

iv Summary policyholder liabilities (net of reinsurance) and reserves at 31 December 2010

The policyholder liabilities, net of reinsurers' share of £694 million (2009: £667 million), reflect balances in respect of the following:

	2010 £m	2009 £m
Policy reserves and liabilities on non-linked business:		
Reserves for future policyholder benefits and claims payable	1,567	1,645
Deposits on investment contracts (as defined under IFRS 'grandfathered' US GAAP)	25,494	23,706
Guaranteed investment contracts	1,565	1,654
Unit-linked (variable annuity) business	31,203	20,639
	59,829	47,644

In addition to the policyholder liabilities above, Jackson has entered into a programme of funding arrangements under contracts which, in substance, are almost identical to GICs. The liabilities under these funding arrangements totalled £1,411 million (2009: £1,444 million) and are included in 'other non-insurance liabilities' in the statement of financial position above.

v Equity securities and portfolio holdings in unit trusts include investments in mutual funds, the majority of which are equity based.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D3: US INSURANCE OPERATIONS > CONTINUED

b Reconciliation of movement in investments

A reconciliation of the total investments of US insurance operations from the beginning of the year to the end of the year is as follows:

	Variable annuity separate account assets and liabilities £m	Fixed annuity, GIC and other business £m	US insurance operations Total £m
AT 1 JANUARY 2009			
Total investments (including derivative assets)	14,538	31,633	46,171
Less: Derivative liabilities	–	(863)	(863)
Directly held investments, net of derivative liabilities	14,538	30,770	45,308
Net cash inflow (outflow) from operating activities	4,050	(1,295)	2,755
Realised losses in the year	–	(529)	(529)
Unrealised gains and losses and exchange movements in the year	2,051	(470)	1,581
Movement in the year of directly held investments, net of derivative liabilities	6,101	(2,294)	3,807
AT 31 DECEMBER 2009/1 JANUARY 2010			
Total investments (including derivative assets)	20,639	28,937	49,576
Less: Derivative liabilities[note G3]	–	(461)	(461)
Directly held investments, net of derivative liabilities	20,639	28,476	49,115
Net cash inflow from operating activities	6,441	865	7,306
Realised gains in the year	–	21	21
Unrealised gains and losses and exchange movements in the year	4,123	2,141	6,264
Movement in the year of directly held investments, net of derivative liabilities	10,564	3,027	13,591
AT 31 DECEMBER 2010			
Total investments (including derivative assets)	31,203	32,302	63,505
Less: Derivative liabilities[note G3]	–	(799)	(799)
Directly held investments, net of derivative liabilities	31,203	31,503	62,706

c Reconciliation of movement in policyholder liabilities

A reconciliation of the total policyholder liabilities of US insurance operations from the beginning of the year to the end of the year is as follows:

	Variable annuity separate account liabilities £m	Fixed annuity, GIC and other business £m	US insurance operations Total £m
AT 1 JANUARY 2009	14,538	30,823	45,361
Premiums	4,667	4,510	9,177
Surrenders	(882)	(2,373)	(3,255)
Maturities/Deaths	(199)	(534)	(733)
Net flows[note b]	3,586	1,603	5,189
Transfers from general to separate account	984	(984)	–
Investment-related items and other movements[note c]	3,368	(382)	2,986
Foreign exchange translation differences[note a]	(1,837)	(3,388)	(5,225)
AT 31 DECEMBER 2009/1 JANUARY 2010	20,639	27,672	48,311
Premiums	7,420	4,315	11,735
Surrenders	(1,403)	(2,195)	(3,598)
Maturities/Deaths	(259)	(510)	(769)
Net flows[note b]	5,758	1,610	7,368
Transfers from general to separate account	1,411	(1,411)	-
Investment-related items and other movements[note c]	2,875	589	3,464
Foreign exchange translation differences[note a]	520	860	1,380
AT 31 DECEMBER 2010	31,203	29,320	60,523
Average policyholder liabilities			
2010	25,921	28,496	54,417
2009	17,589	29,248	46,837

Notes

a Movements in the year have been translated at an average rate of 1.55 (2009: 1.57). The closing balance has been translated at closing rate of 1.57 (2009: 1.61). Differences upon retranslation are included in foreign exchange translation differences of £1,380 million (2009: £5,225 million).

b Net flows for the year were £7,368 million compared with £5,189 million in 2009, driven largely by increased new business volumes for the variable annuity business.

c Positive investment-related items and other movements in variable annuity separate account liabilities of £2,875 million in 2010 and £3,368 million in 2009 represent increases in the US equity market during the respective periods. Fixed annuity, GIC and other business investment and other movements primarily reflects the movement in the valuation of the product guarantees and interest credited to policyholder accounts. In 2010, interest credited exceeded the small reduction in the guarantee valuation to give an overall increase in liabilities. In 2009, there was a more significant fall in the valuation of guarantees.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D3: US INSURANCE OPERATIONS > CONTINUED

d Information on credit risks of debt securities

Summary	2010 £m Carrying value	2009 £m Carrying value
Corporate and government security and commercial loans:		
Government	2,440	379
Publicly traded and SEC Rule 144A securities	14,747	12,959
Non-SEC Rule 144A securities	3,044	3,117
Total	20,231	16,455
Residential mortgage-backed securities	2,784	3,316
Commercial mortgage-backed securities	2,375	2,104
Other debt securities	976	956
Total debt securities	26,366	22,831

i Credit quality

For statutory reporting in the US, debt securities are classified into six quality categories specified by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC). The categories range from Class 1 (the highest) to Class 6 (the lowest). Performing securities are designated as Classes 1 to 5. Securities in or near default are designated Class 6. Securities designated as Class 3, 4, 5 and 6 are non-investment grade securities. Generally, securities rated AAA to A by nationally recognised statistical ratings organisations are reflected in Class 1, BBB in Class 2, BB in Class 3 and B and below in Classes 4 to 6. If a designation is not currently available from the NAIC, Jackson's investment adviser, PPM America, provides the designation for the purposes of disclosure below.

The following table shows the quality of the publicly traded and non-SEC Rule 144A debt securities by NAIC classifications:

	2010		2009	
	Carrying value		Carrying value	
	£m	% of total	£m	% of total
NAIC designation:				
1	5,338	36	4,688	36
2	8,550	58	7,508	58
3	644	5	598	5
4	201	1	122	1
5	11	–	40	–
6	3	–	3	–
	14,747	100	12,959	100

The following table shows the quality of the non-SEC Rule 144A private placement portfolio by NAIC classifications:

	2010		2009	
	Carrying value		Carrying value	
	£m	% of total	£m	% of total
NAIC designation:				
1	1,125	37	1,084	35
2	1,772	58	1,792	57
3	114	4	162	5
4	18	1	54	2
5	13	–	20	1
6	2	–	5	–
	3,044	100	3,117	100

Included within other debt securities of £976 million (2009: £956 million) in the summary shown above are £723 million (2009: £652 million) of asset-backed securities held directly by Jackson, of which £527 million (2009: £447 million) were NAIC designation 1 and £135 million (2009: £152 million) NAIC designation 2. In addition, other debt securities includes £211 million (2009: £172 million) in respect of securities held by the Piedmont trust entity and £42 million (2009: £132 million) from the consolidation of investment funds managed by PPM America.

In addition to the ratings disclosed above, the following table summarises by rating the debt securities, as at 31 December 2010 using Standard and Poor's (S&P), Moody's, Fitch and implicit ratings of mortgage-backed securities (MBS) based on NAIC valuations:

	2010 £m	2009 £m
	Carrying value	Carrying value
S&P – AAA	4,187	3,287
S&P – AA+ to AA-	801	846
S&P – A+ to A-	5,156	5,192
S&P – BBB+ to BBB-	8,202	7,659
S&P – Other	866	895
	19,212	17,879
Moody's – Aaa	34	273
Moody's – Aa1 to Aa3	32	43
Moody's – A1 to A3	36	32
Moody's – Baa1 to Baa3	73	64
Moody's – Other	135	57
	310	469
Implicit ratings of MBS based on NAIC valuations (see below)		
NAIC 1	3,083	747
NAIC 2	181	105
NAIC 3-6	232	473
	3,496	1,325
Fitch	176	281
Other*	3,172	2,877
Total debt securities	26,366	22,831

* The amounts within Other which are not rated by S&P, Moody's, Fitch nor are MBS securities using the revised regulatory ratings have the following NAIC classifications:

	2010 £m	2009 £m
NAIC 1	1,193	1,102
NAIC 2	1,849	1,623
NAIC 3-6	130	152
	3,172	2,877

In the table above, with the exception of some residential mortgage-backed securities and commercial mortgage-backed securities for 2010, and for residential mortgage-backed securities for 2009, commercial mortgage-backed securities 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. During 2009, the NAIC in the US revised the regulatory ratings process for more than 20,000 residential mortgage-backed securities. In addition, in 2010, the NAIC expanded the revised process to include commercial mortgage-backed securities. The table above includes these securities, where held by Jackson, using the regulatory rating levels established by external third parties (PIMCO for residential mortgage-backed securities and BlackRock Solutions for commercial mortgage-backed securities).

D: LIFE ASSURANCE BUSINESSES CONTINUED

D3: US INSURANCE OPERATIONS > CONTINUED

ii Determining the fair value of debt securities when the markets are not active

Under IAS 39, unless categorised as 'held to maturity' or 'loans and receivables' debt securities are required to be fair valued. Where available, quoted market prices are used. However, where securities do not have an externally quoted price based on regular trades or are quoted in markets that are no longer active as a result of market conditions, IAS 39 requires that valuation techniques be applied. Note G1 sets out further details of the Group's approach to determining fair value and classifies these fair values into a three level hierarchy as required by IFRS 7. At 31 December 2010, 0.3 per cent of Jackson's debt securities were classified as level 3 (2009: three per cent) comprising fair values where there are significant inputs which are not based on observable market data.

iii Asset-backed securities funds exposures

Included within the debt securities of Jackson at 31 December 2010 are exposures to asset-backed securities as follows:

	2010 £m	2009 £m
RMBS Sub-prime (31 Dec 2010: 40% AAA, 11% AA)†	224	194
Alt-A (31 Dec 2010: 15% AAA, 6% AA)	415	443
Prime including agency (31 Dec 2010: 79% AAA, 2% AA)	2,145	2,679
CMBS (31 Dec 2010: 36% AAA, 15% AA)†	2,375	2,104
CDO funds (31 Dec 2010: 4% AAA, 4% AA)*, including £1 million exposure to sub-prime	162	79
ABS (31 Dec 2010: 26% AAA, 20% AA), including £37 million exposure to sub-prime	814	877
	6,135	6,376

* Including Group's economic interest in Piedmont and other consolidated CDO funds.
† MBS ratings refer to the rating implicit within NAIC risk-based capital valuation (see D3(i) previous page).

Jackson defines its exposure to sub-prime mortgages as investments in residential mortgage-backed securities in which the underlying borrowers have a US Fair Isaac Credit Organisation (FICO) credit score of 680 or lower.

iv Debt securities classified as available-for-sale in an unrealised loss position

The following tables show some key attributes of those securities that are in an unrealised loss position at 31 December 2010.

a Fair value of securities as a percentage of book value

The unrealised losses in Jackson's statement of financial position on unimpaired securities are £370 million (2009: £966 million). This relates to assets with fair market value and book value of £4,002 million (2009: £7,254 million) and £4,372 million (2009: £8,220 million) respectively.

The following table shows the fair value of the debt securities in a gross unrealised loss position for various percentages of book value at 31 December:

	2010 £m		2009 £m	
Fair value of securities as a percentage of book value	Fair value	Unrealised loss	Fair value	Unrealised loss
Between 90% and 100%	3,390	(102)	5,127	(169)
Between 80% and 90%	273	(44)	1,201	(203)
Below 80%[note d]	339	(224)	926	(594)
Total	4,002	(370)	7,254	(966)

Included within the table above are amounts relating to sub-prime and Alt–A securities of:

	2010 £m		2009 £m	
Fair value of securities as a percentage of book value	Fair value	Unrealised loss	Fair value	Unrealised loss
Between 90% and 100%	98	(6)	102	(3)
Between 80% and 90%	55	(9)	160	(28)
Below 80%[note d]	56	(25)	159	(88)
Total	209	(40)	421	(119)

b Unrealised losses by maturity of security

	2010 £m	2009 £m
	Unrealised loss	Unrealised loss
Less than 1 year	–	–
1 to 5 years	(6)	(29)
5 to 10 years	(47)	(127)
More than 10 years	(49)	(92)
Mortgage-backed and other debt securities	(268)	(718)
Total	(370)	(966)

c Age analysis of unrealised losses for the years indicated

The following table shows the aged analysis for all the unrealised losses in the portfolio by reference to the length of time the securities have been in an unrealised loss position:

	2010 £m			2009 £m		
	Non-investment grade	Investment grade	Total	Non-investment grade	Investment grade	Total
Less than 6 months	(3)	(67)	(70)	(7)	(51)	(58)
6 months to 1 year	(2)	–	(2)	(25)	(59)	(84)
1 year to 2 years	(13)	(20)	(33)	(59)	(234)	(293)
2 years to 3 years	(27)	(55)	(82)	(125)	(199)	(324)
More than 3 years	(58)	(125)	(183)	(35)	(172)	(207)
	(103)	(267)	(370)	(251)	(715)	(966)

At 31 December 2010, the gross unrealised losses in the statement of financial position for the sub-prime and Alt-A securities in an unrealised loss position were £40 million (2009: £119 million), as shown above in note (a). Of these losses £1 million (2009: £21 million) relate to securities that have been in an unrealised loss position for less than one year and £39 million (2009: £98 million) to securities that have been in an unrealised loss position for more than one year.

d Securities whose fair value were below 80 per cent of the book value

As shown in the table (a) above, £224 million of the £370 million of gross unrealised losses at 31 December 2010 (2009: £594 million of the £966 million of gross unrealised losses) related to securities whose fair values were below 80 per cent of the book value. The analysis of the £224 million, (2009: £594 million) by category of debt securities and by age analysis indicating the length of time for which their fair value was below 80 per cent of the book value, are as follows:

	2010 £m		2009 £m	
Category analysis	Fair value	Unrealised loss	Fair value	Unrealised loss
Residential mortgage-backed securities				
Prime (including agency)	88	(39)	322	(153)
Alt-A	15	(4)	77	(33)
Sub-prime	41	(20)	82	(55)
	144	(63)	481	(241)
Commercial mortgage-backed securities	8	(29)	87	(86)
Other asset-backed securities	123	(105)	183	(188)
Total structured securities	275	(197)	751	(515)
Corporates	64	(27)	175	(79)
Total	339	(224)	926	(594)

D: LIFE ASSURANCE BUSINESSES CONTINUED

D3: US INSURANCE OPERATIONS > CONTINUED

Age analysis of fair value being below 80 per cent for the period indicated:

	2010 £m		2009 £m	
Age analysis	**Fair value**	**Unrealised loss**	**Fair value**	**Unrealised loss**
Less than 3 months	–	(1)	153	(45)
3 months to 6 months	–	–	5	(3)
More than 6 months	339	(223)	768	(546)
	339	(224)	926	(594)

e Products and guarantees

Jackson provides long-term savings and retirement products to retail and institutional customers throughout the US. Jackson offers fixed annuities (interest-sensitive, fixed indexed and immediate annuities), variable annuities (VA), life insurance and institutional products.

i Fixed annuities

Interest-sensitive annuities

At 31 December 2010, interest-sensitive fixed annuities accounted for 19 per cent (2009: 24 per cent) of policy and contract liabilities of Jackson. Interest-sensitive fixed annuities are primarily deferred annuity products that are used for retirement planning and for providing income in retirement. They permit tax-deferred accumulation of funds and flexible payout options.

The policyholder of an interest-sensitive fixed annuity pays Jackson a premium, which is credited to the policyholder's account. Periodically, interest is credited to the policyholder's account and in some cases administrative charges are deducted from the policyholder's account. Jackson makes benefit payments at a future date as specified in the policy based on the value of the policyholder's account at that date.

The policy provides that at Jackson's discretion it may reset the interest rate, subject to a guaranteed minimum. The minimum guarantee varies from 1.5 per cent to 5.5 per cent (2009: 1.5 per cent to 5.5 per cent) depending on the jurisdiction of issue and the date of issue, with 78 per cent (2009: 82 per cent) of the fund at three per cent or less. The average guarantee rate is 3.1 per cent (2009: 3.1 per cent).

Approximately 45 per cent (2009: 61 per cent) of the interest-sensitive fixed annuities Jackson wrote in 2010 provide for a market value adjustment, that could be positive or negative, on surrenders in the surrender period of the policy. This formula-based adjustment approximates the change in value that assets supporting the product would realise as interest rates move up or down. The minimum guaranteed rate is not affected by this adjustment.

Fixed indexed annuities

Fixed indexed annuities accounted for 9 per cent (2009: 10 per cent) of Jackson's policy and contract liabilities at 31 December 2010. Fixed indexed annuities vary in structure, but generally are deferred annuities that enable policyholders to obtain a portion of an equity-linked return (based on participation rates and caps) but provide a guaranteed minimum return. These guaranteed minimum rates are generally set at 1.25 to 3 per cent.

Jackson hedges the equity return risk on fixed indexed products using futures and options linked to the relevant index as well as through offsetting equity exposure in the VA product. The cost of these hedges is taken into account in setting the index participation rates or caps. Jackson bears the investment and surrender risk on these products.

Immediate annuities

At 31 December 2010, immediate annuities accounted for two per cent (2009: two per cent) of Jackson's policy and contract liabilities. Immediate annuities guarantee a series of payments beginning within a year of purchase and continuing over either a fixed period of years and/or the life of the policyholder. If the term is for the life of the policyholder, then Jackson's primary risk is mortality risk. The implicit interest rate on these products is based on the market conditions that exist at the time the policy is issued and is guaranteed for the term of the annuity.

ii Variable annuities

At 31 December 2010, VAs accounted for 58 per cent (2009: 49 per cent) of Jackson's policy and contract liabilities. VAs are deferred annuities that have the same tax advantages and payout options as interest-sensitive and fixed indexed annuities.

The primary differences between VAs and interest-sensitive or fixed indexed annuities are investment risk and return. If a policyholder chooses a VA, the rate of return depends upon the performance of the selected fund portfolio. Policyholders may allocate their investment to either the fixed or variable account. Investment risk on the variable account is borne by the policyholder, while investment risk on the fixed account is borne by Jackson through guaranteed minimum fixed rates of return. At 31 December 2010, approximately 12 per cent (2009: approximately 14 per cent) of VA funds were in fixed accounts.

Jackson issues VA contracts where it contractually guarantees to the contractholder either a) return of no less than total deposits made to the contract adjusted for any partial withdrawals, b) total deposits made to the contract adjusted for any partial withdrawals plus a minimum return, or c) the highest contract value on a specified anniversary date adjusted for any withdrawals following the contract anniversary. These guarantees include benefits that are payable in the event of death (guaranteed minimum death benefit (GMDB)), annuitisation (guaranteed minimum income benefit (GMIB)), or at specified dates during the accumulation period (guaranteed minimum withdrawal benefit (GMWB)) and guaranteed minimum accumulation benefit (GMAB). Jackson hedges these risks using equity options and futures contracts as described in note D3(f). The GMIB is no longer offered, with existing coverage being reinsured.

iii Life insurance
Jackson's life insurance products accounted for seven per cent (2009: nine per cent) of Jackson's policy and contract liabilities at 31 December 2010. The products offered include variable universal life insurance, term life insurance and interest-sensitive life insurance.

iv Institutional products
Jackson's institutional products consist of GICs, funding agreements (including agreements issued in conjunction with Jackson's participation in the US Federal Home Loan Bank programme) and medium-term note funding agreements. At 31 December 2010, institutional products accounted for five per cent of policy and contract liabilities (2009: six per cent). Under a traditional GIC, the policyholder makes a lump sum deposit. The interest rate paid is fixed and established when the contract is issued. If deposited funds are withdrawn earlier than the specified term of the contract, an adjustment is made that approximates a market value adjustment.

Under a funding agreement, the policyholder either makes a lump sum deposit or makes specified periodic deposits. Jackson agrees to pay a rate of interest, which may be fixed but which is usually a floating short-term interest rate linked to an external index. The average term of the funding arrangements is one to two years. Funding agreements terminable by the policyholder with less than 90 days' notice account for less than one per cent (2009: one per cent) of total policyholder reserves.

Medium-term note funding agreements are generally issued to support trust instruments issued on non-US exchanges or to qualified investors (as defined by SEC Rule 144A). Through the funding agreements, Jackson agrees to pay a rate of interest, which may be fixed or floating, to the holders of the trust instruments.

f Exposure to market risk and risk management
Jackson's main exposures are to market risk through its exposure to interest rate risk and equity risk. Approximately 91 per cent (2009: 90 per cent) of its general account investments support interest-sensitive and fixed indexed annuities, life business and surplus and nine per cent (2009: ten per cent) support institutional business. All of these types of business contain considerable interest rate guarantee features and, consequently, require that the assets that support them are primarily fixed income or fixed maturity.

Prudential is exposed primarily to the following risks in the US arising from fluctuations in interest rates:

- the risk of loss related to meeting guaranteed rates of accumulation following a sharp and sustained fall in interest rates;
- the risk of loss related to policyholder withdrawals following a sharp and sustained increase in interest rates; and
- the risk of mismatch between the expected duration of certain annuity liabilities and prepayment risk and extension risk inherent in mortgage-backed securities.

Prudential is also exposed to the following risks in the US arising from equity market movements:

- the risk of loss related to the incidence of benefits related to guarantees issued in connection with its VA contracts; and
- the risk of loss related to meeting contractual accumulation requirements in FIA contracts.

Jackson enters into financial derivative transactions, including those noted below to reduce and manage business risks. These transactions manage the risk of a change in the value, yield, price, cash flows, or quantity of, or a degree of exposure with respect to assets, liabilities or future cash flows, which Jackson has acquired or incurred.

Jackson uses free-standing derivative instruments for hedging purposes. Additionally, certain liabilities, primarily trust instruments supported by funding agreements, fixed indexed annuities, certain GMWB variable annuity features and reinsured GMIB variable annuity features contain embedded derivatives as defined by IAS 39, 'Financial Instruments: Recognition and Measurement'. Jackson does not account for such derivatives as either fair value or cash flow hedges as might be permitted if the specific hedge documentation requirements of IAS 39 were followed. Financial derivatives, including derivatives embedded in certain host liabilities that have been separated for accounting and financial reporting purposes are carried at fair value.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D3: US INSURANCE OPERATIONS > CONTINUED

Value movements on the derivatives are reported within the income statement. In preparing Jackson's segment profit as shown in note B1, value movements on Jackson's derivative contracts, are included within short-term fluctuations in investment returns and excluded from operating results based on longer-term investment returns (defined as segment profit). The types of derivatives used by Jackson and their purpose are as follows:

- interest rate swaps generally involve the exchange of fixed and floating payments over the period for which Jackson holds the instrument without an exchange of the underlying principal amount. These agreements are used for hedging purposes;
- put-swaption contracts provide the purchaser with the right, but not the obligation, to require the writer to pay the present value of a long-duration interest rate swap at future exercise dates. Jackson purchases and writes put-swaptions with maturities up to 10 years. Put-swaptions hedge against significant movements in interest rates;
- equity index futures contracts and equity index options (including various call and put options and put spreads) are used to hedge Jackson's obligations associated with its issuance of fixed indexed immediate and deferred annuities and certain VA guarantees. These annuities and guarantees contain embedded options which are fair valued for financial reporting purposes;
- total return swaps in which Jackson receives equity returns or returns based on reference pools of assets in exchange for short-term floating rate payments based on notional amounts, are held for both hedging and investment purposes;
- cross-currency swaps, which embody spot and forward currency swaps and additionally, in some cases, interest rate swaps and equity index swaps, are entered into for the purpose of hedging Jackson's foreign currency denominated funding agreements supporting trust instrument obligations;
- spread cap options are used as a macro-economic hedge against declining short-term interest rates. Jackson receives quarterly settlements based on the spread between the two-year and the 10-year constant maturity swap rates in excess of a specified spread; and
- credit default swaps, represent agreements under which Jackson has purchased default protection on certain underlying corporate bonds held in its portfolio. These contracts allow Jackson to sell the protected bonds at par value to the counterparty if a defined default event occurs in exchange for periodic payments made by Jackson for the life of the agreement.

Note D3(j) parts (iii) and (iv) show the sensitivities of Jackson's results through its exposure to equity risk and interest rate risk.

g Process for setting assumptions and determining contract liabilities

Under the MSB of reporting applied under IFRS 4 for insurance contracts, providing the requirements of the Companies Act, UK GAAP standards and the ABI SORP are met, it is permissible to reflect the previously applied UK GAAP basis. Accordingly, and consistent with the basis explained in note A4, in the case of Jackson the carrying values of insurance assets and liabilities are consolidated into the Group accounts based on US GAAP.

Under US GAAP, investment contracts (as defined for US GAAP purposes) are accounted for by applying in the first instance a retrospective deposit method to determine the liability for policyholder benefits. This is then augmented by potentially three additional amounts. These amounts are for:

- any amounts that have been assessed to compensate the insurer for services to be performed over future periods (i.e. deferred income);
- any amounts previously assessed against policyholders that are refundable on termination of the contract; and
- any probable future loss on the contract (i.e. premium deficiency).

Capitalised acquisition costs and deferred income for these contracts are amortised over the life of the book of contracts. The present value of the estimated gross profits is generally computed using the rate of interest that accrues to policyholder balances (sometimes referred to as the contract rate). Estimated gross profits include estimates of the following elements, each of which will be determined based on the best estimate of amounts of the following individual elements over the life of the book of contracts without provision for adverse deviation for:

- amounts expected to be assessed for mortality less benefit claims in excess of related policyholder balances;
- amounts expected to be assessed for contract administration less costs incurred for contract administration;
- amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances;
- amounts expected to be assessed against policyholder balances upon termination of contracts (sometimes referred to as surrender charges); and
- other expected assessments and credits.

VA contracts written by Jackson may, as described above, provide for GMDB, GMIB, GMWB and GMAB features. In general terms, liabilities for these benefits are accounted for under US GAAP by using estimates of future benefits and fees under best estimate persistency assumptions.

In accordance with US GAAP, the grandfathered basis for IFRS, which specifies how certain guarantee features should be accounted for the GMDB and certain 'for life' GMWB liabilities are not fair valued but are instead determined each period end by estimating the expected value of benefits in excess of the projected account balance and recognising the excess ratably over the life of the contract based on total expected assessments. At 31 December 2010, these liabilities were valued using a series of deterministic investment performance scenarios, a mean investment return of 8.4 per cent (2009: 8.4 per cent) and assumptions for lapse, mortality and expense that are the same as those used in amortising the capitalised acquisition costs.

The direct GMIB liability is determined by estimating the expected value of the annuitisation benefits in excess of the projected account balance at the date of annuitisation and recognising the excess ratably over the accumulation period based on total expected assessments.

The assumptions used for calculating the direct GMIB liability at 31 December 2010 and 2009 are consistent with those used for calculating the GMDB and 'for life' GMWB liabilities. The change in these reserves, along with claim payments and associated fees included in reserves are included along with the hedge results in short-term fluctuations, resulting in removal of the market impact from the operating profit based on longer-term investment returns.

Jackson regularly evaluates estimates used and adjusts the additional GMDB and GMIB liability balances, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised.

GMIB benefits are essentially fully reinsured, subject to annual claim limits. As this reinsurance benefit is net settled, it is considered to be a derivative under IAS 39 and is, therefore, recognised at fair value with the change in fair value included as a component of short-term derivative fluctuations.

GMWB 'not for life' features, are considered to be embedded derivatives under IAS 39. Therefore, provisions for these benefits are recognised at fair value, with the change in fair value included in short-term fluctuations.

For GMWB and GMIB reinsurance embedded derivatives that are fair valued under IAS 39, Jackson bases its volatility assumptions solely on implied market volatility with no reference to historical volatility levels and explicitly incorporates Jackson's own credit risk in determining discount rates.

Volatility assumptions are based on a weighting of available market data on implied volatility for durations up to ten years, at which point the projected volatility is held constant. Non-performance risk is incorporated into the calculation through the use of discount interest rates sourced from a AA corporate credit curve. Other risk margins, particularly for market illiquidity and policyholder behaviour are also incorporated into the model through the use of explicitly conservative assumptions. On a periodic basis, Jackson rationalises the resulting fair values based on comparisons to other models and market movements.

With the exception of the GMDB, GMIB, GMWB and GMAB features of VA contracts, the financial guarantee features of Jackson's contracts are in most circumstances not explicitly valued, but the impact of any interest guarantees would be reflected as they are earned in the current account value (i.e. the US GAAP liability).

For traditional life insurance contracts, provisions for future policy benefits are determined under US GAAP using the net level premium method and assumptions as of the issue date as to mortality, interest, policy lapses and expenses plus provisions for adverse deviation.

Institutional products are accounted for as investment contracts under IFRS with the liability classified as being in respect of financial instruments rather than insurance contracts, as defined by IFRS 4. In practice, there is no material difference between the IFRS and US GAAP basis of recognition and measurement for these contracts.

Certain institutional products representing obligations issued in currencies other than US dollars have been hedged for changes in exchange rates using cross-currency swaps. The fair value of derivatives embedded in funding agreements, as well as foreign currency transaction gains and losses, are included in the carrying value of the trust instruments supported by funding agreements recorded in other non-insurance liabilities.

Deferred acquisition costs

Under IFRS 4, the Group applies grandfathered US GAAP for measuring the insurance assets and liabilities of Jackson. In the case of Jackson term business, acquisition costs are deferred and amortised in line with expected premiums. For annuity and interest-sensitive life business, acquisition costs are deferred and amortised in line with a combination of historical and future expected gross profits on the relevant contracts. For fixed and indexed annuity and interest-sensitive life business, the key assumption is the long-term spread between the earned rate on investments and the rate credited to policyholders, which is based on an annual spread analysis. Expected gross profits also depend on mortality assumptions, assumed unit costs and terminations other than deaths (including the related charges), all of which are based on a combination of actual experience of Jackson, industry experience and future expectations. A detailed analysis of actual mortality, lapse, and expense experience is performed using internally developed experience studies.

As with fixed and indexed annuity and interest-sensitive life business, acquisition costs for Jackson's variable annuity products are amortised in line with the emergence of profits. The measurement of the amortisation in part reflects current period fees (including those for guaranteed minimum death, income, or withdrawal benefits) earned on assets covering liabilities to policyholders, and the historical and expected level of future gross profits which depends on the assumed level of future fees, as well as components related to mortality, lapse, and expense.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D3: US INSURANCE OPERATIONS > CONTINUED

Under US GAAP (as grandfathered under IFRS 4) the projected gross profits reflect an assumed long-term level of equity return which, for Jackson, is 8.4 per cent after deduction of net external fund management fees. This is applied to the period end level of separate account equity assets after application of a mean reversion technique that removes a portion of the effect of levels of short-term variability in current market returns. Under the mean reversion technique applied by Jackson, the projected level of return for each of the next five years is adjusted from period to period so that in combination with the actual rates of return for the preceding two years and the current year, the 8.4 per cent annual return is realized on average over the entire eight year period. Projected returns after the mean reversion period revert back to the 8.4 per cent target. A capping feature, which currently applies due to the very sharp market falls in 2008, is that the projected rates of return for the next five years can be no more than 15 per cent (gross of asset management fee) per annum. If Jackson had not applied the mean reversion methodology and had instead applied a constant 8.4 per cent annual return from today's asset values, the Jackson DAC balance of £3,543 million would fall approximately £80 million to £3,463 million at 31 December 2010.

The amortisation charge to the income statement is reflected in operating profit and short-term fluctuations in investment returns. The amortisation charge to the operating profit in a reporting period will incorporate an element of acceleration or deceleration that reflects the variance between the actual level of return attained and the assumed level in the mean reversion calculation. In 2010, the element of DAC amortisation charge included in operating profit includes £11 million of accelerated amortisation. This amount reflects actual separate account return shortfalls in the periods compared with the assumed level of 15 per cent for the year. For 2009, reflecting the excess of actual separate account returns over the 15 per cent assumed level, the operating profit incorporates a credit for decelerated amortisation of £39 million.

For 2010, the separate account return (gross of asset management fees) was approximately 13 per cent. In 2011, while the capping feature is in effect, each one per cent divergence of the actual separate account return below or above the assumed return of 15 per cent is estimated to give rise to accelerated or decelerated amortisation, respectively, of approximately £6 million (£3 million if the projected rate falls below the 15 per cent cap).

In the absence of significant market declines between now and the end of 2011, Jackson would expect to see higher amortisation levels than normal in 2011. This would essentially represent a reversal of the mean reversion benefits to date, as at that point highly negative returns from 2008 will no longer be included in the mean reverting return calculation.

Statement of changes in equity – 'shadow DAC adjustments'

Consequent upon the positive unrealised valuation movement in 2010 of £1,221 million (2009: positive £2,669 million) there is a debit of £496 million (2009: £1,069 million debit) for altered 'shadow' amortisation booked within other comprehensive income. These adjustments reflect movement from period to period, in the changes to the pattern of reported gross profits that would have happened if the assets reflected in the statement of financial position had been sold, crystallising the unrealised gains or losses, and the proceeds reinvested at the yields currently available in the market. At 31 December 2010 the cumulative 'shadow DAC balance' was negative £520 million (2009: negative £10 million).

h Reinsurance

The principal reinsurance ceded by Jackson outside the Group is on term life insurance, direct and assumed accident and health business and GMIB variable annuity guarantees. In 2010, the premiums for such ceded business amounted to £83 million (2009: £82 million). Net commissions received on ceded business and claims incurred ceded to external reinsurers totalled £12 million and £72 million respectively, during 2010 (2009: £12 million and £66 million respectively). There were no deferred gains or losses on reinsurance contracts in either 2010 or 2009. The reinsurance asset for business ceded outside the Group was £694 million (2009: £667 million).

i Effect of changes in assumptions used to measure insurance assets and liabilities

2010

There are no changes of assumptions that had a material impact on the 2010 results of US insurance operations.

Separately, in 2010, the Group amended its presentation of operating profit for its US insurance operations to exclude the net equity hedge accounting effect of negative £367 million (2009: negative £159 million) relating to its variable and fixed index annuity business and reclassified it as a short-term fluctuation within the Group's supplementary analysis of profit. This is explained further in note A4(d)(ii). This change had no effect on the measurement of insurance assets and liabilities and therefore on total profit or shareholders' equity.

2009

Measurement basis for embedded derivatives of variable annuity business and other policyholder liability

Certain variable annuity products sold by Jackson include Guaranteed Minimum Withdrawal Benefits (GMWB) with lifetime benefits which, in accordance with the Group's accounting policies, are measured within the IFRS balance sheet at fair value. This requires a number of assumptions related to projected future cash flows, including those driven by policyholder behaviours such as lapses, fund selections and withdrawals utilisation.

During 2009 the GMWB utilisation assumptions were revised to take account of the more recent experience of policyholder behaviour. Previously policyholder behaviour for the utilisation of GMWB was assumed to be largely driven by the extent to which benefits were 'in the money'. For 2009, the assumption has been altered to take account of recent experience which shows that the attained age of the policyholder is the key factor in determining utilisation levels. This has led to a release in policyholder liabilities of £96 million which is offset by a corresponding DAC amortisation charge of £68 million to give an overall impact on profit before tax of £28 million. This assumption change has been offset by sundry other assumption changes such that the overall impact on operating profit of policyholder liability assumption changes, after taking into account DAC amortisation offsets, is a charge of £4 million. 2010 has been prepared on a consistent basis to 2009.

j Sensitivity of IFRS basis profit and equity to market and other risks

i Currency fluctuations

Consistent with the Group's accounting policies, the profits of the Group's US operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2010, the rates were US$1.55 (2009: US$1.57) and US$1.57 (2009: US$1.61) to £1 sterling, respectively. A 10 per cent increase or decrease in these rates would reduce or increase profit (loss) before tax attributable to shareholders, profit (loss) for the year and shareholders' equity attributable to US insurance operations respectively as follows:

	A 10% increase in exchange rates		A 10% decrease in exchange rates	
	2010 £m	**2009** £m	**2010** £m	**2009** £m
Profit (loss) before tax attributable to shareholders[note i]	(41)	(44)	50	54
Profit (loss) for the year	(31)	(54)	37	65
Shareholders' equity attributable to US insurance operations	(347)	(274)	424	335

Note

i Sensitivity on profit (loss) before tax i.e. aggregate of the operating profit based on longer-term investment returns and short-term fluctuations, as discussed in note B1.

ii Other sensitivities

The principal determinants of variations in operating profit based on longer-term returns are:

- growth in the size of assets under management covering the liabilities for the contracts in force;
- variations in fees and other income, offset by variations in market value adjustment payments and, where necessary, strengthening of liabilities;
- spread returns for the difference between investment returns and rates credited to policyholders; and
- amortisation of deferred acquisition costs.

For term business, acquisition costs are deferred and amortised in line with expected premiums. For annuity business, acquisition costs are deferred and amortised in line with expected gross profits on the relevant contracts. For interest-sensitive business, the key assumption is the expected long-term spread between the earned rate and the rate credited to policyholders, which is based on an annual spread analysis. In addition, expected gross profits depend on mortality assumptions, assumed unit costs and terminations other than deaths (including the related charges) all of which are based on a combination of actual experience of Jackson, industry experience and future expectations.

A detailed analysis of actual experience is measured by internally developed mortality and persistency studies. For variable annuity business, the key assumption is the expected long-term level of equity market returns, which for 2010 and 2009 was 8.4 per cent per annum implemented using a mean reversion methodology. These returns affect the level of future expected profits through their effects on the fee income and the required level of provision for guaranteed minimum benefits. The mean reversion methodology dampens the impact of equity market movements during a particular year, but does not fully eliminate the effects of movements in the equity markets.

In addition, the mean reversion methodology includes both a cap and a floor that determine the maximum impact that the methodology may have. The projected rates of return are capped at no more than 15 per cent for each of the next five years. Further details are explained in note D3(g) above.

Except to the extent of mortality experience, which primarily affects profits through variations in claim payments and GMDB reserves, the profits of Jackson are relatively insensitive to changes in insurance risk.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D3: US INSURANCE OPERATIONS > CONTINUED

iii Exposure to equity risk

Variable annuity contracts related

Jackson issues variable annuity contracts through its separate accounts for which investment income and investment gains and losses accrue to, and investment risk is borne by, the contract holder (traditional variable annuities). It also issues variable annuity and life contracts through separate accounts where it contractually guarantees to the contract holder (variable contracts with guarantees) either a) return of no less than deposits made to the contract adjusted for any partial withdrawals, b) total deposits made to the contract adjusted for any partial withdrawals plus a minimum return, or c) the highest contract value on a specified anniversary date adjusted for any withdrawals following the contract anniversary. These guarantees include benefits that are payable in the event of death (GMDB), annuitisation (GMIB), at specified dates during the accumulation period (GMWB) or at the end of a specified period (GMAB).

At 31 December 2010 and 2009, Jackson had variable annuity contracts with guarantees, for which the net amount at risk ('NAR') is generally the amount of guaranteed benefit in excess of current account value, as follows:

31 December 2010	Minimum return	Account value £m	Net amount at risk £m	Weighted average attained age	Period until expected annuitisation
Return of net deposits plus a minimum return					
GMDB	0-6%	25,540	2,106	64.0 years	
GMWB – Premium only	0%	2,742	149		
GMWB – For life	0-5%*	1,996	415†		
GMAB – Premium only	0%	48	1		
Highest specified anniversary account value minus withdrawals post-anniversary					
GMDB		3,742	466	63.3 years	
GMWB – Highest anniversary only		2,010	343		
GMWB – For life		852	196†		
Combination net deposits plus minimum return, highest specified anniversary account value minus withdrawals post-anniversary					
GMDB	0-6%	1,768	311	65.7 years	
GMIB	0-6%	1,933	418		5.1 years
GMWB – For life	0-8%*	15,025	672†		

31 December 2009	Minimum return	Account value £m	Net amount at risk £m	Weighted average attained age	Period until expected annuitisation
Return of net deposits plus a minimum return					
GMDB	0-6%	16,915	2,834	63.8 years	
GMWB – Premium only	0%	2,505	277		
GMWB – For life	0-5%*	1,240	471†		
GMAB – Premium only	0%	27	2		
Highest specified anniversary account value minus withdrawals post-anniversary					
GMDB		2,933	691	62.8 years	
GMWB – Highest anniversary only		1,694	496		
GMWB – For life		811	258†		
Combination net deposits plus minimum return, highest specified anniversary account value minus withdrawals post-anniversary					
GMDB	0-6%	1,307	384	65.1 years	
GMIB	0-6%	1,815	488		5.9 years
GMWB – For life	0-7%*	6,934	568†		

* Ranges shown based on simple interest. The upper limits of five per cent, seven per cent and eight per cent simple interest are approximately equal to 4.1 per cent, 5.5 per cent and six per cent respectively, on a compound interest basis over a typical 10-year bonus period.

† The NAR for GMWB - 'For life' has been estimated as the present value of future expected benefit payments remaining after the amount of the 'not for life' guaranteed benefit is zero.

Account balances of contracts with guarantees were invested in variable separate accounts as follows:

	2010 £m	2009 £m
Mutual fund type		
Equity	23,841	15,477
Bond	3,417	2,340
Balanced	3,345	2,186
Money market	451	522
Total	31,054	20,525

As noted in note D3(f), Jackson is exposed to equity risk through the options embedded in the fixed indexed liabilities and GMDB and GMWB guarantees included in certain VA benefits as illustrated above. This risk is managed using a comprehensive equity hedging programme to minimise the risk of a significant economic impact as a result of increases or decreases in equity market levels while taking advantage of naturally offsetting exposures in Jackson's operations. Jackson purchases external futures and options that hedge the risks inherent in these products, while also considering the impact of rising and falling separate account fees.

As a result of this hedging programme, if the equity markets were to increase further in the future, Jackson's free-standing derivatives would decrease in value. However, over time, this movement would be broadly offset by increased separate account fees and reserve decreases, net of the related changes to amortisation of deferred acquisition costs. Due to the nature of the free-standing and embedded derivatives, this hedge, while highly effective on an economic basis, may not completely mute the immediate impact of the market movements as the free-standing derivatives reset immediately while the hedged liabilities reset more slowly and fees are recognised prospectively. The opposite impacts would be observed if the equity markets were to decrease.

At 31 December 2010, based on the hedges in place at that time, it is estimated that an immediate decrease in the equity markets of 10 per cent would result in an accounting benefit, net of related DAC amortisation, before tax of up to £100 million, excluding the impact on future separate account fees (2009: £60 million). After related deferred tax there would have been an estimated increase in shareholders' equity at 31 December 2010 of up to £60 million (2009: £40 million). An immediate decrease in the equity markets of 20 per cent is estimated to result in an accounting benefit, net of related DAC amortisation, before tax of up to £170 million (2009: £110 million), excluding the impact on future separate account fees. After related deferred tax there would have been an estimated increase in shareholders' equity at 31 December 2010 of up to £110 million (2009: £80 million). An immediate increase in the equity markets of 10 and 20 per cent is estimated to result in an approximately equal and opposite estimated effect on profit and shareholders' equity as that disclosed above for a decrease.

The actual impact on financial results would vary contingent upon the volume of new product sales and lapses, changes to the derivative portfolio, correlation of market returns and various other factors including volatility, interest rates and elapsed time.

Other exposure to equity risk

In addition to the above, Jackson is also exposed to equity risk from its holding of equity securities, partnerships in investment pools and other financial derivatives.

A range of reasonably possible movements in the value of equity securities, partnerships in investment pools and other financial derivatives have been applied to Jackson's holdings at 31 December 2010 and 31 December 2009. The table below shows the sensitivity to a 10 and 20 per cent fall in value and the impact that this would have on pre-tax profit, net of related changes in amortisation of DAC, profit after tax and shareholders' equity.

	2010 £m		2009 £m	
	A decrease of 20%	A decrease of 10%	A decrease of 20%	A decrease of 10%
Pre-tax profit, net of related changes in amortisation of DAC	(143)	(72)	(117)	(58)
Related deferred tax effects	50	25	41	20
Net sensitivity of profit after tax and shareholders' equity	(93)	(47)	(76)	(38)

A 10 or 20 per cent increase in their value is estimated to 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 Group 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 Group 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 Group would be able to put in place mitigating management actions.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D3: US INSURANCE OPERATIONS > CONTINUED

iv Exposure to interest rate risk

Notwithstanding the market risk exposure described in note D3(f), except in the circumstances of interest rate scenarios where the guarantee rates included in contract terms are higher than crediting rates that can be supported from assets held to cover liabilities, the accounting measurement of fixed annuity liabilities of Jackson products is not generally sensitive to interest rate risk. This position derives from the nature of the products and the US GAAP basis of measurement described in notes D3(e) and D3(g). The GMWB features attaching to variable annuity business (other than 'for-life') represents embedded derivatives which are fair valued and so will be sensitive to changes in interest rate.

Debt securities and related derivatives are marked to fair value. Value movements on derivatives, net of related changes to amortisation of DAC and deferred tax, are recorded within profit and loss. Fair value movements on debt securities, net of related changes to amortisation of DAC and deferred tax, are recorded within other comprehensive income. The estimated sensitivity of these items and policyholder liabilities to a one per cent and two per cent decrease and increase in interest rates at 31 December 2010 and 2009 is as follows:

	2010 £m				2009 £m			
	A 2% decrease	A 1% decrease	A 1% increase	A 2% increase	A 2% decrease	A 1% decrease	A 1% increase	A 2% increase
Profit and loss								
Direct effect								
Derivatives value change	842	363	(277)	(529)	(319)	(148)	159	370
Policyholder liabilities	(547)	(243)	219	416	(418)	(185)	170	334
Related effect on amortisation of DAC	47	23	(34)	(63)	364	162	(156)	(328)
Pre-tax profit effect:								
Operating profit based on longer-term investment returns	579	245	(181)	(345)	(144)	(62)	56	109
Short-term fluctuations in investment returns	(237)	(102)	89	169	(229)	(109)	117	267
	342	143	(92)	(176)	(373)	(171)	173	376
Related effect on charge for deferred tax	(120)	(50)	32	62	131	60	(60)	(131)
Net profit effect	222	93	(60)	(114)	(242)	(111)	113	245
Other comprehensive income								
Direct effect on carrying value of debt securities	2,663	1,454	(1,454)	(2,663)	2,183	1,179	(1,179)	(2,183)
Related effect on amortisation of DAC	(1,174)	(641)	641	1,174	(764)	(413)	413	764
Related effect on movement in deferred tax	(521)	(285)	285	521	(497)	(268)	268	497
Net effect	968	528	(528)	(968)	922	498	(498)	(922)
Total net effect on IFRS equity	1,190	621	(588)	(1,082)	680	387	(385)	(677)

k Duration of liabilities

The table below shows the carrying value of policyholder liabilities. Separately, the Group uses cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results. The table below also shows the maturity profile of the cash flows used for that purpose for 2010 and 2009:

	2010 £m			2009 £m		
	Fixed annuity and other business (including GICs and similar contracts)	Variable annuity	Total	Fixed annuity and other business (including GICs and similar contracts)	Variable annuity	Total
Policyholder liabilities	29,320	31,203	60,523	27,672	20,639	48,311
	%	%	%	%	%	%
Expected maturity:						
0 to 5 years	50	50	50	52	50	51
5 to 10 years	27	29	28	27	28	28
10 to 15 years	11	12	12	10	12	11
15 to 20 years	5	6	5	5	6	5
20 to 25 years	3	2	3	3	2	2
Over 25 years	4	1	2	3	2	3

The maturity tables shown above have been prepared on a discounted basis. Details of undiscounted cash flows for investment contracts are shown in note G2.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D4: ASIAN INSURANCE OPERATIONS

a Summary statement of financial position

	With-profits business note i £m	Unit-linked assets and liabilities £m	Other £m	Asian insurance operations 2010 Total £m	Asian insurance operations 2009 Total £m
ASSETS					
Intangible assets attributable to shareholders:					
Goodwill	–	–	236	236	80
Deferred acquisition costs and other intangible assets	–	–	939	939	822
Total	–	–	1,175	1,175	902
Intangible assets attributable to with-profit funds:					
Deferred acquisition costs and other intangible assets	97	–	–	97	97
Deferred tax assets	–	–	98	98	132
Other non-investment and non-cash assets	205	94	512	811	880
Investments of long-term business and other operations:					
Investment properties	–	–	9	9	11
Investments accounted for using the equity method	–	–	2	2	2
Financial investments:					
Loans[note ii]	874	–	466	1,340	1,207
Equity securities and portfolio holdings in unit trusts	4,321	9,637	506	14,464	11,182
Debt securities[note d]	6,759	3,009	4,340	14,108	9,984
Other investments	192	58	132	382	258
Deposits	6	251	381	638	746
Total investments[note b]	12,152	12,955	5,836	30,943	23,390
Cash and cash equivalents	536	337	728	1,601	837
TOTAL ASSETS	12,990	13,386	8,349	34,725	26,238
EQUITY AND LIABILITIES					
Equity					
Shareholders' equity	–	–	2,149	2,149	1,462
Non-controlling interests	–	–	5	5	1
Total equity	–	–	2,154	2,154	1,463
Liabilities					
Policyholder liabilities and unallocated surplus of with-profits funds:					
Contract liabilities (including amounts in respect of contracts classified as investment contracts under IFRS 4)	10,958	12,724	4,992	28,674	21,858
Unallocated surplus of with-profits funds	66	–	–	66	53
Total	11,024	12,724	4,992	28,740	21,911
Other non-insurance liabilities:					
Operational borrowings attributable to shareholders-financed operations	–	–	189	189	210
Deferred tax liabilities	341	25	129	495	384
Other non-insurance liabilities	1,625	637	885	3,147	2,270
Total liabilities	12,990	13,386	6,195	32,571	24,775
TOTAL EQUITY AND LIABILITIES	12,990	13,386	8,349	34,725	26,238

Notes

i The statement of financial position for with-profits business comprises the with-profits assets and liabilities of the Hong Kong, Malaysia and Singapore with-profits operations. Assets and liabilities of other participating business are included in the column for 'other business'.

ii The loans of the Group's Asian insurance operations of £1,340 million (2009: £1,207 million) comprise mortgage loans of £25 million (2009: £13 million), policy loans of £528 million (2009: £437 million) and other loans of £787 million (2009: £757 million). The mortgage and policy loans are secured by properties and life insurance policies respectively. The majority of the other loans are commercial loans held by the Malaysian operation and which are all investment graded by two local rating agencies.

Summary policyholder liabilities (net of reinsurance) and unallocated surplus

At 31 December 2010, the policyholder liabilities (net of reinsurance of £41 million (2009: £18 million)) and unallocated surplus for Asian operations of £28.7 billion (2009: £21.9 billion) comprised the following:

	2010 £m	**2009** £m
Singapore	9,731	6,960
Hong Kong	6,621	5,762
Malaysia	2,544	1,823
Indonesia	1,475	968
Korea	1,897	1,519
Taiwan	968	545
Other countries	5,463	4,316
Total Asian operations	28,699	21,893

b Reconciliation of movement in investments

A reconciliation of the total investments of Asian insurance operations from the beginning of the year to the end of the year is as follows:

	With-profits business £m	**Unit-linked assets and liabilities** £m	**Other** £m	**Asian insurance operations Total** £m
AT 1 JANUARY 2009				
Total investments (including derivative assets)	8,866	7,330	5,613	21,809
Less: Investments held by consolidated investment funds	(705)	(153)	(243)	(1,101)
Less: Derivative liabilities	–	–	(32)	(32)
Directly held investments, net of derivative liabilities	8,161	7,177	5,338	20,676
Net cash inflow from operating activities	565	1,243	1,220	3,028
Disposal of Taiwan agency business	–	(734)	(2,527)	(3,261)
Realised gains (losses) in the year	(183)	1	(61)	(243)
Unrealised gains and losses and exchange movements in the year	671	2,048	(393)	2,326
Movement in the year of directly held investments, net of derivative liabilities	1,053	2,558	(1,761)	1,850
AT 31 DECEMBER 2009/1 JANUARY 2010				
Total investments (including derivative assets)	9,547	9,953	3,890	23,390
Less: Investments held by consolidated investment funds	(270)	(218)	(230)	(718)
Less: Derivative liabilities[note G3]	(63)	–	(83)	(146)
Directly held investments, net of derivative liabilities	9,214	9,735	3,577	22,526
Net cash inflow from operating activities	278	838	1,051	2,167
Realised gains in the year	638	327	19	984
Unrealised gains and losses and exchange movements in the year	993	1,786	522	3,301
Acquisition of UOB Life Assurance Limited	527	3	474	1,004
Movement in the year of directly held investments, net of derivative liabilities	2,436	2,954	2,066	7,456
AT 31 DECEMBER 2010				
Total investments (including derivative assets)	12,152	12,955	5,836	30,943
Less: Investments held by consolidated investment funds	(382)	(266)	(91)	(739)
Less: Derivative liabilities[note G3]	(120)	–	(102)	(222)
Directly held investments, net of derivative liabilities	11,650	12,689	5,643	29,982

D: LIFE ASSURANCE BUSINESSES CONTINUED

D4: ASIAN INSURANCE OPERATIONS > CONTINUED

c Reconciliation of movement in policyholder liabilities and unallocated surplus of with-profits funds

A reconciliation of the total policyholder liabilities and unallocated surplus of with-profits funds of Asian insurance operations from the beginning of the year to the end of the year is as follows:

	With-profits business £m	Unit-linked assets and liabilities £m	Other £m	Asian insurance operations Total £m
AT 1 JANUARY 2009	8,094	7,220	5,755	21,069
Premiums				
New business[note ii]	46	643	517	1,206
In-force	777	1,223	601	2,601
	823	1,866	1,118	3,807
Surrenders[note iii]	(361)	(666)	(174)	(1,201)
Maturities/Deaths	(253)	(19)	(70)	(342)
Net flows	209	1,181	874	2,264
Change in reserving basis in Malaysia[note iv]	–	(9)	(54)	(63)
Change in other reserving basis	–	–	(4)	(4)
Shareholders' transfers post-tax	(20)	–	–	(20)
Investment-related items and other movements	1,431	2,661	150	4,242
Foreign exchange translation differences[note i]	(853)	(612)	(604)	(2,069)
Disposal of Taiwan agency business[note vi]	–	(724)	(2,784)	(3,508)
AT 31 DECEMBER 2009/1 JANUARY 2010	8,861	9,717	3,333	21,911
Comprising:				
– Policyholder liabilities	8,808	9,717	3,333	21,858
– Unallocated surplus of with-profits funds	53	–	–	53
Premiums				
New business[note ii]	141	1,072	452	1,665
In-force	897	1,130	616	2,643
	1,038	2,202	1,068	4,308
Surrenders[note iii]	(441)	(1,572)	(228)	(2,241)
Maturities/Deaths	(326)	(40)	(132)	(498)
Net flows	271	590	708	1,569
Change in other reserving basis	–	–	19	19
Shareholders' transfers post-tax	(24)	–	–	(24)
Investment-related items and other movements[note v]	693	1,405	118	2,216
Foreign exchange translation differences[note i]	719	1,009	353	2,081
Acquisition of UOB Life Assurance Limited[note vii]	504	3	461	968
AT 31 DECEMBER 2010	11,024	12,724	4,992	28,740
Comprising:				
– Policyholder liabilities	10,958	12,724	4,992	28,674
– Unallocated surplus of with-profits funds	66	–	–	66
Average policyholder liability balances*				
2010	10,135	11,222	4,393	25,750
2009	8,371	8,107	3,152	19,630

*Adjusted for transactions in the period and excluding the unallocated surplus of with-profits funds.

Notes

i Movements in the year have been translated at the average exchange rate for the year ended 31 December 2010. The closing balance has been translated at the closing spot rates as at 31 December 2010. Differences upon retranslation are included in foreign exchange translation differences of positive £2,081 million in 2010 (2009: negative £2,069 million).

ii The increase in policyholder liabilities due to new business premium for the unit-linked business was predominantly driven by an increase in sales during the year of individual linked products.

iii Following the recovery of the stock markets in Asia in late 2009 and 2010, policyholders in Asia took the opportunity to capitalise on the increased value of their unit-linked policies through withdrawals, principally in Indonesia, Malaysia, and India.
The depressed state of the investment markets in late 2008 and 2009 resulted in both the number of, and average value of, withdrawals of investment related products decreasing.

iv The change in reserving basis in Malaysia of £63 million reflects the change made following the adoption of a risk-based capital (RBC) approach to the local regulatory reporting in that country.

v The positive investment related items and other movements in 2010 for with-profits (£693 million) and unit-linked business (£1,405 million) are mainly driven from Asian equity market gains in the period.

vi The disposal of Taiwan agency business reflects the liabilities transferred at the date of disposal.

vii The acquisition of UOB Life Assurance Limited reflects the liabilities acquired at the date of acquisition.

d Information on credit risks of debt securities

The following table summarises the credit quality of the debt securities of the Asian insurance operations as at 31 December 2010 by rating agency ratings:

	2010 £m				2009 £m
	With-profits business	Unit-linked business	Other business	Total	Total
S&P – AAA	2,199	349	386	2,934	2,259
S&P – AA+ to AA-	744	100	1,294	2,138	1,594
S&P – A+ to A-	1,337	861	645	2,843	1,496
S&P – BBB+ to BBB-	729	24	160	913	682
S&P – Other	649	465	659	1,773	917
	5,658	1,799	3,144	10,601	6,948
Moody's – Aaa	49	10	6	65	134
Moody's – Aa1 to Aa3	44	48	23	115	349
Moody's – A1 to A3	55	16	59	130	309
Moody's – Baa1 to Baa3	50	10	35	95	40
Moody's – Other	31	–	18	49	15
	229	84	141	454	847
Fitch	4	33	12	49	39
Other	868	1,093	1,043	3,004	2,150
Total debt securities	6,759	3,009	4,340	14,108	9,984

Of the £1,043 million (2009: £517 million) debt securities for other business which are not rated in the table above, £350 million (2009: £225 million) are in respect of government bonds and £666 million (2009: £265 million) are in respect of corporate bonds rated as investment grade by local external ratings agencies, and £5 million (2009: £22 million) structured deposits issued by banks which are themselves rated but where the specific deposits have not been.

e Products and guarantees

The life insurance products offered by the Group's Asian operations include a range of with-profits and non-participating term, whole life, endowment and unit-linked policies. The Asian operations also offer health, disability, critical illness and accident coverage to supplement its core life products.

The terms and conditions of the contracts written by the Asian operations and, in particular, the products' options and guarantees, vary from territory to territory depending upon local market circumstances.

In general terms, the Asian participating products provide savings and protection where the basic sum assured can be enhanced by a profit share (or bonus) from the underlying fund as determined at the discretion of the insurers. The Asian operations' non-participating term, whole life and endowment products offer savings and/or protection where the benefits are guaranteed or determined by a set of defined market-related parameters. Unit-linked products combine savings with protection, the cash value of the policy depends on the value of the underlying unitised funds. Health and Protection (H&P) policies provide mortality or morbidity benefits and include health, disability, critical illness and accident coverage. H&P products are commonly offered as supplements to main life policies but can be sold separately.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D4: ASIAN INSURANCE OPERATIONS > CONTINUED

Subject to local market circumstances and regulatory requirements, the guarantee features described in note D2(e) in respect of UK business broadly apply to similar types of participating contracts written in the Hong Kong branch, Singapore and Malaysia. Participating products have both guaranteed and non-guaranteed elements.

Non-participating long-term products are the only ones where the insurer is contractually obliged to provide guarantees on all benefits. Investment-linked products have the lowest level of guarantee, if any.

Product guarantees in Asia can be broadly classified into four main categories, namely premium rate, cash value and interest rate guarantees, policy renewability and convertibility options.

The risks on death coverage through premium rate guarantees are low due to appropriate product pricing.

Cash value and interest rate guarantees are of three types:

- Maturity values
  Maturity values are guaranteed for non-participating products and on the guaranteed portion of participating products. Declared annual bonuses are also guaranteed once vested. Future bonus rates and cash dividends are not guaranteed on participating products.
- Surrender values
  Surrender values are guaranteed for non-participating products and on the guaranteed portion of participating products. The surrender value of declared reversionary bonuses are also guaranteed once vested. Market value adjustments and surrender penalties are used where the law permits such adjustments in cash values.
- Interest rate guarantees
  It is common in Asia for regulations or market-driven demand and competition to provide some form of capital value protection and minimum crediting interest rate guarantees. This would be reflected within the guaranteed maturity and surrender values.
  The guarantees are borne by shareholders for non-participating and investment-linked (non-investment guarantees only) products. Participating product guarantees are predominantly supported by the segregated life funds and their estates.

Whole of life contracts with floor levels of policyholder benefits that accrue at rates set at inception and do not vary subsequently with market conditions are written in the Korean life operations. This is to a much lesser extent than the policies written by the Taiwan agency business which was sold in the first half of 2009, as Korea has a much higher proportion of linked and health business. The Korean business has non-linked liabilities and linked liabilities at 31 December 2010 of £408 million and £1,491 million respectively (2009: £349 million and £1,173 million respectively).

The other area of note in respect of guarantees is the Japanese business where pricing rates are higher than current bond yields. Lapse risk is a feature in that policyholders could potentially surrender their policies on guaranteed terms if interest rates significantly increased leaving the potential for losses if bond values had depreciated significantly. However, the business is matched to a relatively short realistic liability duration.

The method for determining liabilities of insurance contracts for UK GAAP and IFRS purposes for some Asian operations is based on US GAAP principles and this method applies to contracts with cash value and interest rate guarantees. Following standard US GAAP procedure, premium deficiency reserve calculations are performed each year to establish whether the carrying values of the liabilities are sufficient.

On the US GAAP basis the calculations are deterministic, that is to say based on a single set of projections, and expected long-term rates of return are applied.

f Exposure to market risk

The Asian operations sell with-profits and unit-linked policies and, although the with-profits business generally has a lower terminal bonus element than in the UK, the investment portfolio still contains a proportion of equities and, to a lesser extent, property. Non-participating business is largely backed by debt securities or deposits. The exposure to market risk of the Group arising from its Asian operations is therefore at modest levels. This arises from the fact that the Asian operations have a balanced portfolio of with-profits, unit-linked and other types of business.

g Process for setting assumptions and determining liabilities

The future policyholder benefit provisions for Asian businesses in the Group's IFRS accounts and previously under the MSB, are determined in accordance with methods prescribed by local GAAP adjusted to comply, where necessary, with UK GAAP.

For Asian operations in countries where local GAAP is not well established and in which the business written is primarily non-participating and linked business, US GAAP is used as the most appropriate reporting basis. This basis is applied in Japan, Vietnam and Taiwan. The future policyholder benefit provisions for non-linked business are determined using the net level premium method, with an allowance for surrenders, maintenance and claims expenses. Rates of interest used in establishing the policyholder benefit provisions vary by operation depending on the circumstances attaching to each block of business.

h Reinsurance
The Asian businesses cede only minor amounts of business outside the Group with immaterial effects on reported profit. During 2010, reinsurance premiums for externally ceded business were £146 million (2009: £119 million) and the reinsurance assets were £41 million (2009: £18 million) in aggregate.

i Effect of changes in bases, estimates and assumptions used to measure insurance assets and liabilities
2010
In 2010, one-off changes made to reserving assumptions resulted in a release from liabilities of £19 million.

2009
In 2009, the local regulatory basis in Malaysia was replaced by the Malaysian authority's risk-based capital (RBC) framework. In the light of this development, the Company has remeasured the liabilities by reference to the method applied under the new RBC framework, but with an overlay constraint to the method such that negative reserves derived at an individual policyholder level are not included. This change resulted in a one-off release from liabilities at 1 January 2009 of £63 million. Excluding the change in Malaysia, the 2009 result for Asian operations was reduced by the effect of a number of individually small assumption changes of, in aggregate £4 million.

j Sensitivity of IFRS basis profit and equity to market and other risks
Currency translation
Consistent with the Group's accounting policies, the profits of the Asian insurance operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2010, the rates for the most significant operations are given in note B4.

A 10 per cent increase or decrease in these rates would have reduced or increased profit before tax attributable to shareholders, profit for the year and shareholders' equity, excluding goodwill, attributable to Asian operations respectively as follows:

	A 10% increase in exchange rates		A 10% decrease in exchange rates	
	2010 £m	2009 £m	2010 £m	2009 £m
(Loss) profit before tax attributable to shareholders[note i]	(65)	(40)	80	49
(Loss) profit for the year	(58)	(35)	71	43
Shareholders' equity, excluding goodwill, attributable to Asian operations	(193)	(129)	236	158

Note
i Sensitivity on profit before tax i.e. aggregate of the operating profit based on longer-term investment returns, short-term fluctuations in investment returns, and actuarial gains and losses on defined benefit pension schemes but excluding the loss on sale and results for Taiwan agency business, as discussed in note B1.

Other risks
i With-profits business
Similar principles to those explained for UK with-profits business apply to profit emergence for the Asian with-profits business. Correspondingly, the profit emergence reflects bonus declaration and is relatively insensitive to period by period fluctuations in insurance risk or interest rate movements.

ii Unit-linked business
As for the UK insurance operations, the profits and shareholders' equity related to the Asian operations is primarily driven by charges related to invested funds. For the Asian operations, substantially all of the contracts are classified as insurance contracts under IFRS 4, i.e. containing significant insurance risk. The sensitivity of profits and equity to changes in insurance risk is minor and, to interest rate risk, not material.

iii Other business
a Interest rate risk
Asian operations offer a range of insurance and investment products, predominately with-profits and non-participating term, whole life endowment and unit-linked. Excluding with-profit and unit-linked business, the results of the Asian business are sensitive to the vagaries of routine movements in interest rates.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D4: ASIAN INSURANCE OPERATIONS > CONTINUED

For the purposes of analysing sensitivity to variations in interest rates, it has been determined for the majority of territories that a movement of one per cent in the 10 year government bond rate can be considered reasonably possible. At 31 December 2010, 10 year government bond rates vary from territory to territory and range from 1.1 per cent to 12.25 per cent (2009: 1.3 per cent to 11.45 per cent). Exception to this arises in Japan and Taiwan where reasonably possible interest rate movements have been determined as 0.5 per cent (2009: Japan and Taiwan 0.5 per cent). These reasonably possible changes would have the following impact:

	2010 £m	2009 £m
	A decrease of 1% note i	A decrease of 1% note i
Pre-tax profit	110	91
Related deferred tax (where applicable)	(41)	(22)
Net effect on profit and equity	69	69

Note

i One per cent sensitivity has been used in all territories (except Japan and Taiwan (0.5 per cent)) (2009: Japan and Taiwan 0.5 per cent). The pre-tax impacts, if they arose, would mostly be recorded within the category short-term fluctuations in investments returns in the Group's segmental analysis of profit before tax.
At 31 December 2010, an increase in the rates of one per cent (Japan and Taiwan (0.5 per cent)) (2009: one per cent except Japan and Taiwan 0.5 per cent) is estimated to have the effect of decreasing pre-tax profit by £112 million (2009: £109 million). After adjusting these results for deferred tax the reasonable possible effect on shareholders' equity is a decrease of £82 million (2009: £83 million).

b Equity price risk

The non-linked shareholder business has limited exposure to equity and property investment (£515 million at 31 December 2010). Generally changes in equity and property investment values are not automatically matched by investments in policyholder liabilities. However, for the Vietnam business, to the extent that equity investment appreciation is realised through sales of securities then policyholders' liabilities are adjusted to the extent that policyholders participate.

The estimated sensitivity to a 10 and 20 per cent change in equity and property prices for shareholder-backed Asian other business, which would be reflected in the short-term fluctuation component of the Group's segmental analysis of profit before tax at 31 December 2010 and 2009, would be as follows:

	2010 £m		2009 £m	
	A decrease of 20%	A decrease of 10%	A decrease of 20%	A decrease of 10%
Pre-tax profit	(103)	(52)	(58)	(29)
Related deferred tax (where applicable)	10	5	8	4
Net effect on profit and equity	(93)	(47)	(50)	(25)

A 10 or 20 per cent increase in their value is estimated to 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 Group 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 Group 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 Group would be able to put in place mitigating management actions.

c Insurance risk

Many of the territories in Asia are exposed to mortality/morbidity risk and provision is made within IFRS policyholder liabilities on a prudent regulatory basis to cover the potential exposure. If these prudent assumptions were strengthened by five per cent (estimated at one in ten year shock) then it is estimated that post-tax IFRS profit would be impacted by approximately £21 million (2009: £9 million) (with a corresponding change to IFRS shareholders' equity). Mortality/morbidity has a symmetrical effect on portfolio and so a weakening of mortality/morbidity assumptions would have an approximately equal and opposite similar impact.

k Duration of liabilities

The table below shows the carrying value of policyholder liabilities. Separately the Group uses cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results. The table below also shows the maturity profile of the cash flows, taking account of expected future premiums and investment returns used for that purpose for 2010 and 2009:

	2010 £m	2009 £m
Policyholder liabilities	28,674	21,858
	%	%
Expected maturity:		
0 to 5 years	24	24
5 to 10 years	20	21
10 to 15 years	15	15
15 to 20 years	12	12
20 to 25 years	10	9
Over 25 years	19	19

D: LIFE ASSURANCE BUSINESSES
CONTINUED

D5: CAPITAL POSITION STATEMENT FOR LIFE ASSURANCE BUSINESSES

a Summary statement

The Group's estimated capital position for life assurance businesses with reconciliations to shareholders' equity is shown below. Available capital for each fund or group of companies is determined by reference to local regulation at 31 December 2010 and 2009.

	2010 £m									
31 December 2010	SAIF	WPSF note i	Total PAC with-profits fund	Other UK life assurance subsidiaries and funds note ii	Jackson	Asian life assurance subsidiaries	Total life assurance operations	M&G (including Prudential Capital)	Parent company and shareholders' equity of other subsidiaries and funds	Group total
GROUP SHAREHOLDERS' EQUITY										
Held outside long-term funds:										
Net assets	–	–	–	716	3,815	1,913	6,444	254	(1,532)	5,166
Goodwill	–	–	–	–	–	236	236	1,153	77	1,466
Total	–	–	–	716	3,815	2,149	6,680	1,407	(1,455)	6,632
Held in long-term funds[note iii]	–	–	–	1,399	–	–	1,399	–	–	1,399
Total Group shareholders' equity	–	–	–	2,115	3,815	2,149	8,079	1,407	(1,455)	8,031
ADJUSTMENTS TO REGULATORY BASIS										
Unallocated surplus of with-profits funds[note v]	–	10,187	10,187	–	–	66	10,253			
Shareholders' share of realistic liabilities	–	(2,938)	(2,938)	–	–	–	(2,938)			
Deferred acquisition costs of non-participating business not recognised for regulatory reporting purposes and goodwill	–	(13)	(13)	(116)	(3,543)	(993)	(4,665)			
Jackson surplus notes[note iv]	–	–	–	–	159	–	159			
Investment and policyholder liabilities valuation differences between IFRS basis and regulatory basis for Jackson[note viii]	–	–	–	–	1,900	–	1,900			
Adjustment from IAS 19 basis pension deficit attributable to WPSF to pension liability for regulatory purposes[note vii]	–	60	60	–	–	–	60			
Valuation difference on PAL between IFRS 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 v]	–	706	706	(292)	576	156	1,146			
Total adjustments	–	6,800	6,800	(408)	(908)	(771)	4,713			
TOTAL AVAILABLE CAPITAL RESOURCES OF LIFE ASSURANCE BUSINESSES ON LOCAL REGULATORY BASES	–	6,800	6,800	1,707	2,907	1,378	12,792			

31 December 2010	SAIF	WPSF note i	Total PAC with-profits fund	Other UK life assurance subsidiaries and funds note ii	Jackson	Asian life assurance subsidiaries	Total life assurance operations
	2010 £m						
POLICYHOLDER LIABILITIES							
With-profits liabilities of UK regulated with-profits funds:							
Insurance contracts	9,115	31,395	40,510	–	–	5,284	45,794
Investment contracts (with discretionary participation features)	376	25,237	25,613	–	–	119	25,732
Total	9,491	56,632	66,123	–	–	5,403	71,526
Other liabilities:							
Insurance contracts:							
With-profits liabilities of non-UK regulated funds	–	–	–	–	–	5,555	5,555
Unit-linked, including variable annuity	–	2,128	2,128	8,882	31,203	12,724	54,937
Other life assurance business	268	13,067	13,335	19,297	27,438	4,935	65,005
Investment contracts without discretionary participation features (principally unit-linked and similar contracts in the UK and GIC liabilities of Jackson)note vi	–	–	–	15,765	1,882	57	17,704
Total	268	15,195	15,463	43,944	60,523	23,271	143,201
TOTAL POLICYHOLDER LIABILITIES SHOWN IN THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION	9,759	71,827	81,586	43,944	60,523	28,674	214,727

D: LIFE ASSURANCE BUSINESSES CONTINUED

D5: CAPITAL POSITION STATEMENT FOR LIFE ASSURANCE BUSINESSES > CONTINUED

	2009 £m									
31 December 2009	SAIF	WPSF note i	Total PAC with-profits fund	Other UK life assurance subsidiaries and funds note ii	Jackson	Asian life assurance subsidiaries	Total life assurance operations	M&G (including Prudential Capital)	Parent company and shareholders' equity of other subsidiaries and funds	Group total
GROUP SHAREHOLDERS' EQUITY										
Held outside long-term funds:										
Net assets	–	–	–	788	3,011	1,382	5,181	173	(1,507)	3,847
Goodwill	–	–	–	–	–	80	80	1,153	77	1,310
Total	–	–	–	788	3,011	1,462	5,261	1,326	(1,430)	5,157
Held in long-term funds note iii	–	–	–	1,114	–	–	1,114	–	–	1,114
Total Group shareholders' equity	–	–	–	1,902	3,011	1,462	6,375	1,326	(1,430)	6,271
ADJUSTMENTS TO REGULATORY BASIS										
Unallocated surplus of with-profits funds note v	–	9,966	9,966	–	–	53	10,019			
Shareholders' share of realistic liabilities	–	(3,001)	(3,001)	–	–	–	(3,001)			
Deferred acquisition costs of non-participating business not recognised for regulatory reporting purposes and goodwill	(2)	(7)	(9)	(124)	(3,092)	(786)	(4,011)			
Jackson surplus notes note iv	–	–	–	–	154	–	154			
Investment and policyholder liabilities valuation differences between IFRS basis and regulatory basis for Jackson note viii	–	–	–	–	2,221	–	2,221			
Adjustment from IAS 19 basis pension deficit attributable to WPSF to pension liability for regulatory purposes note vii	–	65	65	–	–	–	65			
Valuation difference on PAL between IFRS 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 v	2	703	705	(171)	194	400	1,128			
Total adjustments	–	6,432	6,432	(295)	(523)	(333)	5,281			
TOTAL AVAILABLE CAPITAL RESOURCES OF LIFE ASSURANCE BUSINESSES ON LOCAL REGULATORY BASES	–	6,432	6,432	1,607	2,488	1,129	11,656			

31 December 2009	2009 £m						
	SAIF	**WPSF** note i	**Total PAC with-profits fund**	**Other UK life assurance subsidiaries and funds** note ii	**Jackson**	**Asian life assurance subsidiaries**	**Total life assurance operations**
POLICYHOLDER LIABILITIES							
With-profits liabilities of UK regulated with-profits funds:							
Insurance contracts	9,285	28,449	37,734	–	–	4,766	42,500
Investment contracts (with discretionary participation features)	396	24,384	24,780	–	–	100	24,880
Total	9,681	52,833	62,514	–	–	4,866	67,380
Other liabilities:							
Insurance contracts:							
With-profits liabilities of non-UK regulated funds	–	–	–	–	–	3,942	3,942
Unit-linked, including variable annuity	–	1,998	1,998	6,793	20,639	9,717	39,147
Other life assurance business	291	12,726	13,017	18,113	25,707	3,287	60,124
Investment contracts without discretionary participation features (principally unit-linked and similar contracts in the UK and GIC liabilities of Jackson)note vi	–	–	–	13,794	1,965	46	15,805
Total	291	14,724	15,015	38,700	48,311	16,992	119,018
TOTAL POLICYHOLDER LIABILITIES SHOWN IN THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION	9,972	67,557	77,529	38,700	48,311	21,858	186,398

Notes

i WPSF unallocated surplus includes amounts related to the Hong Kong branch. Policyholder liabilities of the Hong Kong branch are included in the amounts of Asian life assurance subsidiaries.

ii Excluding PAC shareholders' equity that is included in 'parent company and shareholders' equity of other subsidiaries and funds'.

iii The term shareholders' equity 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.

iv For regulatory purposes the Jackson surplus notes are accounted for as capital.

v Other adjustments to shareholders' equity and unallocated surplus include amounts for the value of non-participating business for UK regulated with-profits funds, deferred tax, admissibility and other items measured differently on the regulatory basis. For Jackson the principal reconciling item is deferred tax related to the differences between IFRS and regulatory bases as shown in the table above and other methodology differences.

vi Insurance business accounted for as financial instruments under IAS 39.

vii In determining the IAS 19 adjustment for the purposes of this table the deficit in the Group's main pension scheme used for the calculation includes amounts for investments in Prudential insurance policies (see note I3).

viii The investment and policyholder liabilities valuation difference between IFRS and regulatory bases for Jackson is mainly due to not all investments being carried at fair value under the regulatory basis and also due to the valuation difference on annuity reserves.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D5: CAPITAL POSITION STATEMENT FOR LIFE ASSURANCE BUSINESSES > CONTINUED

b Basis of preparation, capital requirements and management
Each of the Group's long-term business operations is capitalised to a sufficiently strong level for its individual circumstances. Details of the Group's major operations are shown below.

i UK insurance operations
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 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.

PAC WPSF and SAIF
Under FSA rules, insurers with with-profits liabilities of more than £500 million must hold capital equal to the higher of the MCR and the Enhanced Capital Requirement (ECR). The ECR is intended to provide a more risk responsive and 'realistic' measure of a with-profit insurer's 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' (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 of £6.8 billion (2009: £6.4 billion) 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 estimated to be £1.5 billion at 31 December 2010 (2009: £1.4 billion).

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 one 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.

As noted in section D2(g)(ii), PAC 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 PAC 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, PAC 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 PAC 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 situations the PAC 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 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.

Other UK life assurance subsidiaries and funds

The available capital of £1,707 million (2009: £1,607 million) reflects the excess of regulatory basis assets over liabilities of the subsidiaries and funds, before deduction of the capital resources requirement of £1,086 million (2009: £952 million).

The capital resources requirement for these companies broadly reflects a formula which, for active funds, equates to a percentage of regulatory reserves plus a percentage of death strains. Death strains represent the payments made to policyholders upon death in excess of amounts explicitly allocated to fund the provisions for policyholders claims and maturities.

ii Jackson

The regulatory framework for Jackson is governed by the requirements of the US NAIC approved risk-based capital standards. Under these requirements life insurance companies report for the most part on a formula-based capital standard that they calculate by applying factors to various asset, premium and reserve items and separate model based calculations of risk associated primarily with variable annuity products. The risk-based capital formula takes into account the risk characteristics of a company, including asset risk, insurance risk, interest rate risk, market risk and business risk.

The available capital of Jackson shown above of £2,907 million (2009: £2,488 million) reflects US regulatory basis assets less liabilities including asset valuation reserves. The asset valuation reserve is designed to provide for future credit-related losses on debt securities and losses on equity investments. Available capital includes a reduction for the effect of the interest maintenance reserve, which is designed by state regulators to defer recognition of non-credit related realised capital gains and losses and to recognise them rateably in the future.

Jackson's risk-based capital ratio is significantly in excess of regulatory requirements. At 31 December 2010, Jackson had a permitted practice in effect as granted by the local regulator allowing Jackson to carry certain interest rate swaps at book value, as if statutory hedge accounting were in place, instead of at fair value as would have been otherwise required. Jackson was also required to demonstrate the effectiveness of its interest rate swap programme pursuant to the Michigan Insurance Code. The total effect of this permitted practice, which expires on 1 October 2011 was to increase statutory surplus by £83 million at 31 December 2010.

iii Asian operations

The available capital shown above of £1,378 million (2009: £1,129 million) represents the excess of local regulatory basis assets over liabilities before deduction of required capital of £572 million (2009: £438 million). These amounts have been determined applying the local regulations in each of the operations.

The businesses in Asia are subject to local capital requirements in the jurisdictions in which they operate. The Hong Kong business branch of PAC and its capital requirements are subsumed within those of the PAC long-term fund. For the other material Asian operations, the details of the basis of determining regulatory capital and regulatory capital requirements are as follows:

Singapore

In Singapore a risk-based regulatory framework applies rather than one based on a net premium approach.

For participating business, a gross premium reserve, determined using prudent best estimate assumptions and which makes allowance for future bonus, is held. The amount held is subject to a minimum of the higher of the assets attributed to participating business and a gross premium reserve calculated on specified assumptions, but without allowance for future bonus, that include prescribed provisions for adverse deviations (PADs).

For non-participating business, gross premium reserves are held. For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

Indonesia

Policy reserves for traditional business are determined on a modified net premium basis. The valuation interest rates are capped at nine per cent for local currency products and five per cent for foreign currency products.

For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology. Solvency capital is determined using a risk-based capital approach. Insurance companies in Indonesia are expected to maintain the level of net assets above 120 per cent of solvency capital. Due to the 2008 financial crisis, the local regulator provided relief in solvency capital and the measure continues until further notice.

Japan

Mathematical reserves for traditional business are determined on a net premium basis using prescribed mortality and interest rates. Interest rates reflect the original pricing assumptions.

For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

With regard to solvency, the adjusted solvency capital assets of the Company must exceed 200 per cent of the risk related capital requirement value at risk. It is thus a risk-based capital approach.

D: LIFE ASSURANCE BUSINESSES
CONTINUED

D5: CAPITAL POSITION STATEMENT FOR LIFE ASSURANCE BUSINESSES > CONTINUED

Malaysia

In Malaysia, a risk-based capital framework applies since 2009.

For participating business, a gross premium reserve on the guaranteed and non-guaranteed benefits determined using best estimate assumptions is held. The amount held is subject to a minimum of a gross premium reserve on the guaranteed benefits, determined using best estimate assumptions along with provisions of risk margin for adverse deviations (PRADs) discounted at the risk-free rate.

For non-participating business, gross premium reserves determined using best estimate assumptions along with provisions of risk margin for adverse deviations (PRADs) discounted at the risk-free rate are held. For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

The risk-free rate is derived from a yield curve of zero-coupon spot yields of Malaysian Government Securities.

Vietnam

Mathematical reserves are calculated using a modified net premium approach, using a stable set of assumptions agreed with the regulator.

The capital requirement is determined as four per cent of reserves plus a specified percentage of 0.1 per cent of sums at risk for policies with original term less than or equal to five years or 0.3 per cent of sums at risk for policies with original term of more than five years. An additional capital requirement of Vietnamese Dong 200 billion is also required for companies transacting unit-linked business.

Korea

Policy reserves for traditional business are determined on net premium reserve basis using pricing mortality and prescribed standard interest rates.

For linked business, the value of units is held together with the non-unit reserves calculated in accordance with regulatory standard actuarial methodology.

The capital requirement in Korea has moved to a risk-based regulatory framework in April 2009 with a two-year transition period where insurers can choose between the prior and new framework. The risk-based regulatory framework was adopted in 2009 by the Company. Under the new framework, insurance companies in Korea are expected to maintain a level of free surplus in excess of the capital requirements with the general target level of solvency margin being in excess of 150 per cent of the risk-based capital.

iv Group capital requirements

In addition to the requirements at individual company level, FSA requirements under the IGD apply additional prudential requirements for the Group as a whole. Discussion of the Group's estimated IGD position at 31 December 2010, together with market risk sensitivity disclosure provided to key management, is provided in the business review section of the Group's 2010 Annual Report and in section C.

c Movements in total available capital

Total available capital for the Group's life assurance operations has changed during 2010 as follows:

	2010 £m				
	WPSF note i	Other UK life assurance subsidiaries and funds note iii	Jackson note ii	Asian life assurance subsidiaries note iv	Group total
AVAILABLE CAPITAL AT 31 DECEMBER 2009	6,432	1,607	2,488	1,129	11,656
Changes in assumptions	(83)	30	–	(2)	(55)
Changes in management policy	364	–	–	–	364
Changes in regulatory requirements	–	–	(60)	–	(60)
New business and other factors(note v)	87	70	479	251	887
AVAILABLE CAPITAL AT 31 DECEMBER 2010	6,800	1,707	2,907	1,378	12,792

Detail on the movement for 2009 is as follows:

	2009 £m				
	WPSF note i	Other UK life assurance subsidiaries and funds note iii	Jackson note ii	Asian life assurance subsidiaries note iv	Group total
AVAILABLE CAPITAL AT 31 DECEMBER 2008	5,362	1,053	2,758	1,410	10,583
Changes in assumptions	18	23	–	2	43
Changes in management policy	–	26	–	(101)	(75)
Changes in regulatory requirements	–	–	128	178	306
New business and other factors(note v)	1,052	505	(398)	(360)	799
AVAILABLE CAPITAL AT 31 DECEMBER 2009	6,432	1,607	2,488	1,129	11,656

Notes

i WPSF
The increase in 2010 reflects primarily the positive effect of changes in management policy in respect of hedge strategy, asset allocation, and other risk alignment changes.
The increase in 2009 reflected primarily the positive investment returns earned on the opening available capital and £18 million positive effect of changes in assumptions on a regulatory basis.

ii Jackson
The increase of £419 million in 2010 reflects an underlying increase of £340 million (applying the 2010 year end exchange rate of $1.57:£1) and £79 million of exchange translation gains.
The decrease of £270 million in 2009 reflected an underlying increase of £33 million (applying the 2009 year end exchange rate of $1.61:£1) and £303 million of exchange translation loss.
The underlying movement of the available capital of Jackson included the effects of capital contributions, dividends paid to the parent company, impairment losses and also the effects of hedging transactions.

iii Other UK life assurance subsidiaries and funds
The effect from the changes in assumptions of valuation interest rates on insurance liabilities is broadly matched by the corresponding effect on assets leaving no significant impact on the available capital.

iv Asian life assurance subsidiaries
The increase of £251 million in 2010 reflects an underlying increase of £127 million (applying the relevant 2010 year end exchange rates) and £124 million of exchange translation gain. The underlying increase of available capital in 2010 included the effects of the acquisition of UOB Life Assurance Limited in Singapore in February 2010.
The decrease of £281 million in 2009 reflected an underlying decrease of £152 million (applying the relevant 2009 year end exchange rates) and £129 million of exchange translation loss. The underlying decrease of available capital in 2009 included the effects of the change to a risk-based capital framework in Malaysia from 1 January 2009 as explained in section b above and also the sale of the Taiwan agency business in June 2009.

v New business and other factors comprise the effect of changes in new business, valuation interest rate, investment return, foreign exchange and other factors.

d Transferability of available capital

For PAC and all other UK long-term insurers, long-term business assets and liabilities must, by law, be maintained in funds separate from those for the assets and liabilities attributable to non-life insurance business or to shareholders. Only the 'established surplus', the excess of assets over liabilities in the long-term fund determined through a formal valuation, may be transferred so as to be available for other purposes. Distributions from the with-profits sub-fund to shareholders reflect the shareholders' one-ninth share of the cost of declared policyholders' bonuses.

Accordingly, the excess of assets over liabilities of the PAC long-term fund is retained within that company. The retention of the capital enables it to support with-profits and other business of the fund by, for example, providing the benefits associated with smoothing and guarantees. It also provides 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.

For other UK long-term business subsidiaries, the amounts retained within the companies are at levels which provide an appropriate level of capital strength in excess of the regulatory minimum.

For Jackson, capital retention is maintained at a level consistent with an appropriate rating by Standard & Poor's. Currently Jackson is rated AA. Jackson can pay dividends on its capital stock only out of earned surplus unless prior regulatory approval is obtained. Furthermore, dividends which exceed the greater of statutory net gain from operations for the prior year or 10 per cent of Jackson's statutory surplus require prior regulatory approval.

For Asian subsidiaries, the amounts retained within the companies are at levels that provide an appropriate level of capital strength in excess of the local regulatory minimum. For ring-fenced with-profits funds, the excess of assets over liabilities is retained with distribution tied to the shareholders' share of bonuses through declaration of actuarially determined surplus. The Singapore and Malaysian businesses may, in general, remit dividends to the UK, provided the statutory insurance fund meets the capital adequacy standard required under local statutory regulations.

D: LIFE ASSURANCE BUSINESSES CONTINUED

D5: CAPITAL POSITION STATEMENT FOR LIFE ASSURANCE BUSINESSES > CONTINUED

Available capital of the non-insurance business units is transferable to the life assurance businesses after taking account of an appropriate level of operating capital, based on local regulatory solvency targets, over and above basis liabilities. The economic capital model described in section D1 (concentration of risks) takes into account restrictions on mobility of capital across the Group with capital transfers to and from business units triggered at a solvency level consistent with these targets. The model takes into account restrictions on the availability to the Group of the estate of the various with-profits funds throughout the Group.

e Sensitivity of liabilities and total capital to changed market conditions and capital management policies

Prudential manages its assets, liabilities and capital locally, in accordance with local regulatory requirements and reflecting the different types of liabilities Prudential has in each business. As a result of the diversity of products offered by Prudential and the different regulatory requirements in which it operates, Prudential employs differing methods of asset/liability and capital management, depending on the business concerned.

Stochastic modelling of assets and liabilities is undertaken in the UK, Jackson and Asia to assess the economic capital requirements under different confidence intervals and time horizons. In addition, reserve adequacy testing under a range of scenarios and dynamic solvency testing is carried out, including under certain scenarios mandated by the UK, US and Asian regulators.

A stochastic approach models the inter-relationship between asset and liability movements, taking into account asset correlation, management actions and policyholder behaviour under a large number of alternative economic scenarios. These scenarios are projected forward over a period of time, typically 25 years or longer, and the liabilities and solvency position of the fund are calculated in each scenario in each future year. The fund's policy on management actions, including bonus and investment policy, continue to be set in order that they are consistent with the available capital and the targeted risk of default.

The sensitivity of liabilities and other components of total capital vary depending upon the type of business concerned and this conditions the approach to asset/liability management.

For example, for businesses that are most sensitive to interest rate changes, such as immediate annuity business, Prudential uses cash flow analysis to create a portfolio of debt securities whose value changes in line with the value of liabilities when interest rates change. This type of analysis helps protect profits from changing interest rates. This type of analysis is used in the UK for annuity business and by Jackson for its interest-sensitive and fixed indexed annuities and stable value products.

For businesses that are most sensitive to equity price changes, Prudential uses stochastic modelling and scenario testing to look at the future returns on its investments under different scenarios which best reflect the large diversity in returns that equities can produce. This allows Prudential to devise an investment and with-profits policyholder bonus strategy that, on the model assumptions, allows it to optimise returns to its policyholders and shareholders over time while maintaining appropriate financial strength. Prudential uses this methodology extensively in connection with its UK with-profits business.

f Intra-group arrangements in respect of SAIF

Should the assets of SAIF be inadequate to meet the guaranteed benefit obligations to the policyholders of SAIF, the PAC 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 PAC long-term fund or the Group's shareholders' funds, under their obligation to maintain the capital position of long-term funds generally, having to contribute to SAIF is remote.

E: ASSET MANAGEMENT (INCLUDING US BROKER-DEALER) AND OTHER OPERATIONS

E1: INCOME STATEMENT FOR ASSET MANAGEMENT OPERATIONS

The Group's asset management operations are based in the UK, Asia and the US where they operate different models and under different brands tailored to their markets.

Asset management in the UK is undertaken through M&G which is made up of three distinct businesses, being Retail, Wholesale and Finance, and whose operations include retail asset management, institutional fixed income, pooled life and pension funds, property and private finance.

Asset management in Asia serves both the life companies in Asia by managing the life funds and funds underlying the investment linked products and third-party customers through mutual fund business. Asia offers mutual fund investment products in a number of countries within the region, allowing customers to participate in debt, equity and money market investments.

Asset management in the US is undertaken through PPM America which manages assets for the Group's US, UK and Asian affiliates plus also provides investment services to other affiliated and unaffiliated institutional clients including CDOs, private investment funds, institutional accounts and mutual funds. In addition, broker-dealer activities are undertaken in the US where trades in securities are carried out for both third-party customers and for its own account.

Other operations covers unallocated corporate activities and includes the head office functions.

a The profit included in the income statement in respect of asset management operations for the year is as follows:

	Asset management operations				
	2010 £m				2009 £m
	M&G	US	Asia§	Total	Total
Revenue (excluding revenue of consolidated investment funds and NPH broker-dealer fees)	943	229	251	1,423	1,097
Revenue of consolidated investment funds*	11	–	–	11	102
NPH broker-dealer fees†	–	369	–	369	317
Gross revenue	954	598	251	1,803	1,516
Charges (excluding revenue of consolidated investment funds and NPH broker-dealer fees)	(617)	(207)	(179)	(1,003)	(744)
Charges of consolidated investment funds*	(11)	–	–	(11)	(102)
NPH broker-dealer fees†	–	(369)	–	(369)	(317)
Gross charges	(628)	(576)	(179)	(1,383)	(1,163)
PROFIT BEFORE TAX	326	22	72	420	353
Comprising:					
Operating profit based on longer-term investment returns	284	22	72	378	297
Short-term fluctuations in investment returns‡	47	–	–	47	70
Shareholders' share of actuarial gains and losses on defined benefit pension schemes	(5)	–	–	(5)	(14)
PROFIT BEFORE TAX	326	22	72	420	353

*Revenue in respect of consolidated investment funds. The investment funds are managed on behalf of third-parties and are consolidated under IFRS in recognition of the control arrangements for the funds. The gains (losses) in respect of the investment funds are non-recourse to M&G and the Group and are added back through charges and consequently there is no impact on the profit before tax.
† NPH broker-dealer fees represents commissions received and then paid to the writing broker on sales of investment products.
‡ Short-term fluctuations for M&G are primarily in respect of unrealised value movements on Prudential Capital's bond portfolio.
§ Included within Asian asset management charges of £179 million are £60 million of commissions (2009: £57 million).

E: ASSET MANAGEMENT (INCLUDING US BROKER-DEALER) AND OTHER OPERATIONS CONTINUED

E1: INCOME STATEMENT FOR ASSET MANAGEMENT OPERATIONS > CONTINUED

b M&G operating profit based on longer-term investment returns:

	2010 £m	2009 £m
Asset management fee income	612	457
Other income	3	13
Staff costs	(263)	(205)
Other costs	(123)	(100)
Underlying profit before performance-related fees	229	165
Performance-related fees	17	12
Operating profit from asset management operations	246	177
Operating profit from Prudential Capital	38	61
Total M&G operating profit based on longer-term investment returns	284	238

The difference between the fees and other income shown above in respect of asset management operations, and the revenue figure for M&G shown (excluding consolidated investment funds) in the main table primarily relates to total revenue of Prudential Capital including short-term fluctuations of £136 million (2009: £155 million) and commissions which have been netted off in arriving at the fee income of £612 million (2009: £457 million) in the table above. The difference in the presentation of commission is aligned with how management reviews the business.

E2: STATEMENT OF FINANCIAL POSITION FOR ASSET MANAGEMENT OPERATIONS

Assets, liabilities and shareholders' funds included in the Group consolidated statement of financial position in respect of asset management operations are as follows:

	Asset management operations				
	2010 £m				2009 £m
	M&G note iii	US	Asia	Total	Total
ASSETS					
Intangible assets:					
Goodwill	1,153	16	61	1,230	1,230
Deferred acquisition costs	9	–	–	9	8
Total	1,162	16	61	1,239	1,238
Other non-investment and non-cash assets	854	174	94	1,122	850
Financial investments:					
Loans note i	1,418	–	–	1,418	1,413
Equity securities and portfolio holdings in unit trusts	141	–	10	151	137
Debt securities note ii	1,560	–	14	1,574	1,164
Other investments note v	51	1	7	59	113
Deposits	33	22	25	80	63
Total financial investments	3,203	23	56	3,282	2,890
Cash and cash equivalents note v	1,269	39	128	1,436	970
TOTAL ASSETS	6,488	252	339	7,079	5,948
EQUITY AND LIABILITIES					
Equity					
Shareholders' equity	1,407	122	258	1,787	1,659
Non-controlling interests	4	–	–	4	3
Total equity	1,411	122	258	1,791	1,662
LIABILITIES					
Core structural borrowing of shareholder-financed operations	250	–	–	250	–
Intra Group debt represented by operational borrowings at Group level note iv	2,560	–	–	2,560	2,038
Net asset value attributable to external holders of consolidated unit trusts and similar funds note v	458	–	–	458	410
Other non-insurance liabilities	1,809	130	81	2,020	1,838
Total liabilities	5,077	130	81	5,288	4,286
TOTAL EQUITY AND LIABILITIES	6,488	252	339	7,079	5, 948

Notes

i Loans
The M&G loans of £1,418 million (2009: £1,413 million) relate to loans and receivables managed by Prudential Capital. These assets are generally secured but have no external credit ratings. Internal ratings prepared by the Group's asset management operations as part of the risk management process, are £213 million A+ to A- (2009: £92 million), £873 million BBB+ to BBB- (2009: £835 million), £219 million BB+ to BB- (2009: £330 million) and £113 million B+ to B- (2009: £156 million).

ii Debt securities
Of the total debt securities of £1,574 million in 2010 (2009: £1,164 million) of which £1,560 relates to M&G (2009: £1,149 million), £1,468 million were rated AAA to A- by Standard and Poor's or Aaa rated by Moody's (2009: £1,072 million).

iii M&G includes those assets and liabilities in respect of Prudential Capital.

iv Intra Group debt represented by operational borrowings at Group level
Operational borrowings for M&G are in respect of Prudential Capital's short-term fixed income security programme and comprise £2,311 million (2009: £2,031million) of commercial paper and £249 million (2009: £7 million) of medium-term notes.

v Consolidated investment funds
The M&G statement of financial position shown above includes investment funds which are managed on behalf of third-parties. In respect of these funds, the statement of financial position includes cash and cash equivalents of £304 million (2009: £269 million), £167 million of other investments (2009: £158 million), £(13) million of other net assets and liabilities (2009: £(17) million) and the net asset value attributable to external unit holders of £458 million (2009: £410 million) which are non-recourse to M&G and the Group.

E: ASSET MANAGEMENT (INCLUDING US BROKER-DEALER) AND OTHER OPERATIONS CONTINUED

E2: STATEMENT OF FINANCIAL POSITION FOR ASSET MANAGEMENT OPERATIONS > CONTINUED

Reconciliation of movement in investments

A reconciliation of the total investments of asset management operations from the beginning of the year to the end of the year is as follows:

	M&G £m	US £m	Asia £m	Total £m
AT 1 JANUARY 2009				
Total investments (including derivative assets)	3,216	40	47	3,303
Less: Derivative liabilities	(292)	–	–	(292)
Directly held investments, net of derivative liabilities	2,924	40	47	3,011
Net cash outflow from operating activities	(124)	(21)	(3)	(148)
Realised gains in the year	34	–	–	34
Unrealised gains and losses and exchange movements in the year	(48)	(4)	(4)	(56)
Movement in the year of directly held investments, net of derivative liabilities	(138)	(25)	(7)	(170)
AT 31 DECEMBER 2009/1 JANUARY 2010				
Total investments (including derivative assets)	2,835	15	40	2,890
Less: Derivative liabilities note G3	(49)	–	–	(49)
Directly held investments, net of derivative liabilities	2,786	15	40	2,841
Net cash inflow from operating activities	310	8	11	329
Realised gains in the year	11	–	–	11
Unrealised gains and losses and exchange movements in the year	18	–	5	23
Movement in the year of directly held investments, net of derivative liabilities	339	8	16	363
AT 31 DECEMBER 2010				
Total investments (including derivative assets)	3,203	23	56	3,282
Less: Derivative liabilities note G3	(78)	–	–	(78)
Directly held investments, net of derivative liabilities	3,125	23	56	3,204

E3: REGULATORY AND OTHER SURPLUS

Certain asset management operations are subject to regulatory requirements. The movement in the year of the surplus regulatory capital position of these operations, combined with the movement in the IFRS basis shareholders' funds for unregulated asset management operations, is as follows:

	Asset management operations				
	2010 £m				**2009** £m
	M&G	US	Asia	Total	Total
REGULATORY AND OTHER SURPLUS					
Beginning of year	85	111	126	322	155
Gains during the year	245	12	55	312	97
Movement in capital requirement	9	–	(32)	(23)	125
Capital injection	–	–	1	1	9
Distributions made	(152)	(4)	(38)	(194)	(37)
Exchange movement	–	3	11	14	(27)
End of year	187	122	123	432	322

The movement in the year reflects gains driven by profits generated during the year and also changes in regulatory requirements. Distributions consist of dividends paid up to the parent company.

The M&G figures include those for Prudential Capital.

E4: SENSITIVITY OF PROFIT AND EQUITY TO MARKET AND OTHER FINANCIAL RISK

i Currency translation

Consistent with the Group's accounting policies, the profits of the Asia and PPM America asset management operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2010, the rates for the most significant operations are given in note B4.

A 10 per cent increase in the relevant Asian exchange rates would have reduced reported profit before tax attributable to shareholders and shareholders' equity, excluding goodwill attributable to Asia and PPM America asset management operations, by £9 million (2009: £5 million) and £28 million (2009: £23 million) respectively.

ii Other sensitivities to other financial risks for asset management operations

The principal sensitivities to other financial risk of asset management operations are credit risk on the bridging loan portfolio (as described in note E2) of the Prudential Capital operation and the indirect effect of changes to market values of funds under management. Due to the nature of the asset management operations there is limited direct sensitivity to movements in interest rates. Total debt securities held at 31 December 2010 by asset management operations were £1,574 million (2009: £1,164 million), the majority of which are held by the Prudential Capital operation. Debt securities held by M&G and Prudential Capital are in general variable rate bonds and so market value is limited in sensitivity to interest rate movements and consequently any change in interest rates would not have a material impact on profit or shareholder's equity. Asset management operations do not hold significant investments in property or equities.

E5: OTHER OPERATIONS

Other operations consist of unallocated corporate activities relating to Group Head Office and the Asia regional head office, with net income and expenditure for the year of negative £450 million (2009: negative £395 million) as detailed in note B1. An analysis of the assets and liabilities of other operations is shown in note B6.

F: INCOME STATEMENT NOTES

F1: SEGMENTAL INFORMATION

	Year ended 31 December 2010 £m								
	Insurance operations			Asset management (note E1)					
	UK	US	Asia	M&G	US	Asia	Total segment	Unallo-cated corporate	Group total
Gross premiums earned	6,371	11,817	6,380	–	–	–	24,568	–	24,568
Outward reinsurance premiums	(128)	(83)	(146)	–	–	–	(357)	–	(357)
Earned premiums, net of reinsurance	6,243	11,734	6,234	–	–	–	24,211	–	24,211
Investment return[note ii]	14,374	4,576	2,744	186	1	3	21,884	(115)	21,769
Other income	233	(24)	139	768	597	248	1,961	(295)	1,666
Total revenue, net of reinsurance	20,850	16,286	9,117	954	598	251	48,056	(410)	47,646
Benefits and claims	(18,674)	(15,472)	(6,462)	–	–	–	(40,608)	–	(40,608)
Outward reinsurers' share of benefits and claims	243	49	43	–	–	–	335	–	335
Movement in unallocated surplus of with-profits funds[note iv]	70	–	(315)	–	–	–	(245)	–	(245)
Benefits and claims and movements in unallocated surplus of with-profits funds, net of reinsurance	(18,361)	(15,423)	(6,734)	–	–	–	(40,518)	–	(40,518)
Acquisition costs and other operating expenditure[note F3]	(1,093)	(395)	(1,662)	(628)	(576)	(179)	(4,533)	(266)	(4,799)
Finance costs: interest on core structural borrowings of shareholder-financed operations	–	(13)	–	–	–	–	(13)	(244)	(257)
Total charges, net of reinsurance	(19,454)	(15,831)	(8,396)	(628)	(576)	(179)	(45,064)	(510)	(45,574)
Profit (loss) before tax *(being tax attributable to shareholders' and policyholders' returns)*[note i]	1,396	455	721	326	22	72	2,992	(920)	2,072
Tax charge attributable to policyholders' returns	(536)	–	(75)	–	–	–	(611)	–	(611)
Profit (loss) from continuing operations before tax attributable to shareholders	860	455	646	326	22	72	2,381	(920)	1,461

This is represented in the segmental analysis of profit from continuing operations before tax attributable to shareholders in note B1 as follows:

	Year ended 31 December 2010 £m								
	Insurance operations			Asset management					
	UK	US	Asia	M&G	US	Asia	Total segment	Unallo-cated corporate	Group total
Operating profit based on longer-term investment returns[note iii]	719	833	532	284	22	72	2,462	(521)	1,941
Short-term fluctuations in investment returns on shareholder-backed business	116	(378)	114	47	–	–	(101)	(22)	(123)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	(5)	–	–	(5)	–	–	(10)	–	(10)
Costs of terminated AIA transaction	–	–	–	–	–	–	–	(377)	(377)
Gain on dilution of holding in PruHealth investment	30	–	–	–	–	–	30	–	30
Profit (loss) from continuing operations before tax attributable to shareholders	860	455	646	326	22	72	2,381	(920)	1,461

	Year ended 31 December 2009 £m								
	Insurance operations			Asset management (note E1)					
	UK	US	Asia	M&G	US	Asia	Total segment	Unallo-cated corporate	Group total
Gross premiums earned	5,757	9,197	5,345	–	–	–	20,299	–	20,299
Outward reinsurance premiums	(122)	(82)	(119)	–	–	–	(323)	–	(323)
Earned premiums, net of reinsurance	5,635	9,115	5,226	–	–	–	19,976	–	19,976
Investment return[note ii]	17,366	5,070	4,357	420	68	74	27,355	(466)	26,889
Other income	176	(18)	110	379	432	143	1,222	12	1,234
Total revenue, net of reinsurance	23,177	14,167	9,693	799	500	217	48,553	(454)	48,099
Benefits and claims	(18,521)	(13,297)	(8,083)	–	–	–	(39,901)	–	(39,901)
Outward reinsurers' share of benefits and claims	214	12	39	–	–	–	265	–	265
Movement in unallocated surplus of with-profits funds[note iv]	(1,893)	–	334	–	–	–	(1,559)	–	(1,559)
Benefits and claims and movements in unallocated surplus of with-profits funds, net of reinsurance	(20,200)	(13,285)	(7,710)	–	–	–	(41,195)	–	(41,195)
Acquisition costs and other operating expenditure[note F3]	(1,508)	(383)	(1,536)	(505)	(496)	(162)	(4,590)	18	(4,572)
Finance costs: interest on core structural borrowings of shareholder-financed operations	–	(13)	–	–	–	–	(13)	(196)	(209)
Loss on sale of Taiwan agency business	–	–	(559)	–	–	–	(559)	–	(559)
Total charges, net of reinsurance	(21,708)	(13,681)	(9,805)	(505)	(496)	(162)	(46,357)	(178)	(46,535)
Profit (loss) before tax *(being tax attributable to shareholders' and policyholders' returns)*[note i]	1,469	486	(112)	294	4	55	2,196	(632)	1,564
Tax charge attributable to policyholders' returns	(750)	–	(68)	–	–	–	(818)	–	(818)
Profit (loss) from continuing operations before tax attributable to shareholders	719	486	(180)	294	4	55	1,378	(632)	746

This is represented in the segmental analysis of profit from continuing operations before tax attributable to shareholders in note B1 as follows:

	Year ended 31 December 2009 £m								
	Insurance operations			Asset management					
	UK	US	Asia	M&G	US	Asia	Total segment	Unallo-cated corporate	Group total
Operating profit based on longer-term investment returns[note iii]	657	618	410	238	4	55	1,982	(418)	1,564
Short-term fluctuations in investment returns on shareholder-backed business	108	(132)	31	70	–	–	77	(200)	(123)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	(46)	–	–	(14)	–	–	(60)	(14)	(74)
Loss on sale and results for Taiwan agency business	–	–	(621)	–	–	–	(621)	–	(621)
Profit (loss) from continuing operations before tax attributable to shareholders	719	486	(180)	294	4	55	1,378	(632)	746

F: INCOME STATEMENT NOTES CONTINUED

F1: SEGMENTAL INFORMATION > CONTINUED

Notes

i The measure is the formal profit (loss) before tax measure under IFRS but is not the result attributable to shareholders.

ii Investment return principally comprises:
- Interest and dividends;
- Realised and unrealised gains and losses on securities and derivatives classified as fair value through profit and loss under IAS 39; and
- Realised gains and losses, including impairment losses, on securities classified as available-for-sale under IAS 39.

iii The Group has amended the presentation of operating profit for its US insurance operations to remove the net equity hedge accounting effect (incorporating related amortisation of deferred acquisition costs) and include it in short-term fluctuations. The 2009 comparatives have been amended accordingly. Note A4d(ii) explains the effect of the change.

iv The movement in unallocated surplus of with-profits funds for Asia above includes movement relating to the Hong Kong branch of PAC. For the purpose of the presentation of unallocated surplus of with-profits funds within the statement of financial position, the Hong Kong branch balance is shown within the unallocated surplus of the PAC with-profits sub-fund.

F2: REVENUE

	2010 £m	2009 £m
LONG-TERM BUSINESS PREMIUMS		
Insurance contract premiums	23,647	19,347
Investment contracts with discretionary participation feature premiums	750	789
Inwards reinsurance premiums	171	163
Less: reinsurance premiums ceded	(357)	(323)
Earned premiums, net of reinsurance[note iv]	24,211	19,976
INVESTMENT RETURN		
Realised and unrealised gains and losses on securities at fair value through profit and loss	14,728	18,175
Realised and unrealised losses and gains on derivatives at fair value through profit and loss	(891)	1,164
Realised losses on available-for-sale securities, previously recognised in other comprehensive income	(51)	(420)
Realised losses on loans	(12)	(115)
Interest[notes i,ii]	5,976	5,575
Dividends	1,394	1,755
Other investment return	625	755
Investment return	21,769	26,889
FEE INCOME FROM INVESTMENT CONTRACT BUSINESS AND ASSET MANAGEMENT[notes iii,iv]	1,666	1,234
TOTAL REVENUE	47,646	48,099

Notes

i The segmental analysis of interest income is as follows:

	2010 £m	2009 £m
Insurance operations:		
UK	4,371	3,848
US	1,014	1,051
Asia	412	522
Asset management operations:		
M&G	127	140
US	–	2
Asia	2	2
TOTAL SEGMENT	5,926	5,565
Unallocated corporate	50	10
TOTAL	5,976	5,575

ii Interest income includes £21 million (2009: £17 million) accrued in respect of impaired securities.

iii Fee income includes £11 million (2009: £1 million) relating to financial instruments that are not held at fair value through profit and loss. These fees primarily related to prepayment fees, late fees and syndication fees.

iv **The following table provides additional segmental analysis of revenue from external customers:**

	2010 £m				
	Asia	US	UK	Intragroup	Total
Revenue from external customers:					
Insurance operations	6,373	11,710	6,476	(10)	24,549
Asset management	248	597	768	(314)	1,299
Unallocated corporate	–	–	29	–	29
Intragroup revenue eliminated on consolidation	(77)	(72)	(175)	324	–
Total revenue from external customers	6,544	12,235	7,098	–	25,877

	2009 £m				
	Asia	US	UK	Intragroup	Total
Revenue from external customers:					
Insurance operations	5,336	9,097	5,822	(11)	20,244
Asset management	213	499	513	(271)	954
Unallocated corporate	–	–	12	–	12
Intragroup revenue eliminated on consolidation	(70)	(67)	(145)	282	–
Total revenue from external customers	5,479	9,529	6,202	–	21,210

Revenue from external customers is made up of the following:

	2010 £m	2009 £m
Earned premiums, net of reinsurance	24,211	19,976
Fee income from investment contract business and asset management (included within 'Other income')	1,666	1,234
Total revenue from external customers	25,877	21,210

In their capacity as fund managers to fellow Prudential Group subsidiaries, M&G, the US and the Asian asset management businesses earn fees for investment management and related services. Intragroup fees included within asset management revenue were £314 million (2009: £271 million) earned £165 million (2009: £134 million) by M&G, £72 million (2009: £67 million) by the US asset management segment and £77 million (2009: £70 million) by the Asian asset management segment. In 2010, the remaining £10 million (2009: £11 million) of intragroup revenue was recognised by UK insurance operations. These services are charged at appropriate arm's length prices, typically priced as a percentage of funds under management.

Revenue from external customers of Asian, US and UK insurance operations shown above are net of outwards reinsurance premiums of £146 million, £83 million and £128 million respectively (2009: £119 million, £82 million and £122 million respectively).

In Asia, revenue from external customers from no individual country exceeds 10 per cent of the Group total. The largest country is Hong Kong with a total revenue from external customers of £1,246 million (2009: £1,013 million).

Due to the nature of the business of the Group, there is no reliance on any major customers.

F: INCOME STATEMENT NOTES CONTINUED

F3: ACQUISITION COSTS AND OTHER EXPENDITURE

	2010 £m	2009 £m
Acquisition costs incurred[notes i,ii]	2,024	1,796
Acquisition costs deferred less amortisation of acquisition costs	(918)	(763)
Administration costs and other expenditure	3,496	2,924
Movements in amounts attributable to external unit holders[note v]	197	615
Total acquisition costs and other expenditure[notes iii,iv,vi]	4,799	4,572

Notes

i The acquisition costs as shown on the table above relate to policy acquisition costs. Acquisition costs from business combinations are included within other expenditure. Acquisition costs in 2010 comprise amounts related to insurance contracts of £941 million (2009: £871 million), and investment contracts and asset management contracts of £165 million (2009: £162 million).

ii There were no fee expenses relating to financial liabilities held at amortised cost included in acquisition costs in 2010 and 2009.

iii The total depreciation and amortisation expense is £309 million (2009: £377 million). Of this amount, £226 million (2009: £305 million) relates to amortisation of deferred acquisition costs of insurance contracts and asset management contracts, which is primarily borne by the insurance operations. The segmental analysis of total depreciation and amortisation expense is as follows:

	2010 £m	2009 £m
Insurance operations:		
UK	35	25
US	(6)	88
Asia	258	246
Asset management operations:		
M&G	8	2
US	2	2
Asia	4	4
TOTAL SEGMENT	301	367
Unallocated corporate	8	10
TOTAL	309	377

iv Interest expense, excluding interest on core structural borrowings of shareholder-financed operations, amounted to £113 million (2009: £89 million) and is included within total acquisition costs and other operating expenditure as part of investment management expenses. The segmental analysis of this interest expense is as follows:

	2010 £m	2009 £m
Insurance operations:		
UK	28	28
US	33	32
Asia	13	1
Asset management operations:		
M&G	19	–
US	–	–
Asia	–	–
TOTAL SEGMENT	93	61
Unallocated corporate	20	28
TOTAL	113	89

v Movements in amounts attributable to external unit holders comprises £61 million (2009: £310 million) for UK insurance operations £136 million (2009: £305 million) for Asian insurance operations.

vi The total amounts for acquisition costs and other expenditure shown above includes Corporate Expenditure shown in note B1 (Segment disclosure – income statement). The charge for Corporate Expenditure comprises:

	2010 £m	2009 £m
Group head office:		
Regular and project costs	(147)	(140)
Provision for property leases and other non-recurrent items	(25)	(6)
	(172)	(146)
Asia regional office:		
Gross costs	(90)	(95)
Recharges to Asia operations	42	38
	(48)	(57)
Total	(220)	(203)

F4: FINANCE COSTS: INTEREST ON CORE STRUCTURAL BORROWINGS OF SHAREHOLDER-FINANCED OPERATIONS

Finance costs consist of £244 million (2009: £196 million) interest on core debt of the parent company and £13 million (2009: £13 million) on US insurance operations' surplus notes.

F5: TAX

a Total tax charge by nature of expense

An analysis of the total tax benefit (expense) of continuing operations recognised in the income statement by nature of benefit (expense) is as follows:

	2010 £m	2009 £m
Current tax expense:		
Corporation tax	(378)	(500)
Adjustments in respect of prior years	287	(29)
Total current tax	(91)	(529)
Deferred tax arising from:		
Origination and reversal of temporary differences	(518)	(340)
Expense in respect of a previously unrecognised tax loss, tax credit or temporary difference from a prior period	(27)	(4)
Total deferred tax charge	(545)	(344)
Total tax charge	(636)	(873)

The total tax expense arises as follows:

	2010 £m	2009 £m
Current tax expense:		
UK	(61)	(527)
Foreign	(30)	(2)
	(91)	(529)
Deferred tax (charge) credit:		
UK	(252)	(368)
Foreign	(293)	24
	(545)	(344)
Total	(636)	(873)

F: INCOME STATEMENT NOTES CONTINUED

F5: TAX > CONTINUED

The current tax charge of £91 million includes £13 million for 2010 (2009: charge of £6 million) in respect of the tax charge for Hong Kong. The Hong Kong current tax charge is calculated as 16.5 per cent for all periods on either (i) five per cent of the net insurance premium or (ii) the estimated assessable profits, depending on the nature of the business written.

The total tax charge of £636 million for 2010 (2009: charge of £873 million) comprises a charge of £313 million (2009: charge of £895 million) for UK tax and a charge of £323 million (2009: credit of £22 million) for overseas tax.

This tax charge comprises tax attributable to policyholders and unallocated surplus of with-profits funds, unit-linked policies and shareholders. The tax charge attributable to shareholders of £25 million for 2010 (2009: charge of £55 million) comprises a credit of £187 million (2009: charge of £176 million) for UK tax and a charge of £212 million (2009: credit of £121 million) for overseas tax. The tax charge attributable to shareholders' returns includes an exceptional tax credit of £158 million which primarily relates to the impact of a settlement agreed with the UK Tax authorities. This exceptional tax credit is recorded within 'Adjustments in respect of prior years'. In addition, adjustments in respect of prior years also includes other changes that arose as a result of routine revision of tax returns.

The total deferred tax (charge) arises as follows:

	2010 £m	2009 £m
Unrealised gains and losses on investments	(217)	(35)
Balances relating to investment and insurance contracts	(28)	(12)
Short-term timing differences	(431)	(105)
Capital allowances	(8)	1
Unused tax losses	139	(193)
Deferred tax charge	(545)	(344)

In 2010, a deferred tax charge of £287 million (2009: charge of £546 million) has been taken through other comprehensive income. Other movements in deferred tax totalling a £40 million charge is mainly comprised of foreign exchange movements. When these amounts are taken with the deferred tax charge shown above the result is an increase of £0.9 billion in the Group's net deferred tax liability (2009: increase of £0.8 billion).

b Reconciliation of effective tax rate

The total tax charge is attributable to shareholders and policyholders as summarised in the income statement.

i Summary of pre-tax profit and tax (charge)

The income statement includes the following items:

	2010 £m	2009 £m
Profit before tax	2,072	1,564
Tax charge attributable to policyholders' returns	(611)	(818)
Profit before tax attributable to shareholders	1,461	746
Tax attributable to shareholders' profits:		
Tax charge	(636)	(873)
Less: tax attributable to policyholders' returns	611	818
Tax (charge) attributable to shareholders' returns	(25)	(55)
Profit from continuing operations after tax	1,436	691

ii Overview

For the purposes of explaining the relationship between tax expense and accounting profit, it is appropriate to consider the sources of profit and tax by reference to those that are attributable to shareholders and policyholders, as follows:

	2010 £m			2009 £m		
	Attributable to shareholders	Attributable to policyholders*	Total	Attributable to shareholders	Attributable to policyholders*	Total
Profit before tax	1,461	611	2,072	746	818	1,564
Taxation charge:						
Expected tax rate	28%	100%	49%	31%	100%	67%
Expected tax charge	(406)	(611)	(1,017)	(233)	(818)	(1,051)
Variance from expected tax charge[note v(ii)]	381	–	381	178	–	178
Actual tax (charge)	(25)	(611)	(636)	(55)	(818)	(873)
Average effective tax rate	2%	100%	31%	7%	100%	56%

* For the column entitled 'Attributable to policyholders', the profit before tax represents income, net of post-tax transfers to unallocated surplus of with-profits funds, before tax attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies.

Due to the requirements of the financial reporting standards IAS 1 and IAS 12, the profit (loss) before tax and tax charge reflect the aggregate of amounts that are attributable to shareholders and policyholders.

Profit (loss) before tax comprises profit attributable to shareholders and pre-tax profit attributable to policyholders of linked and with-profits funds and unallocated surplus of with-profits funds.

The total tax charge for linked and with-profits business includes tax expense on unit-linked and with-profits funds attributable to policyholders, the unallocated surplus of with-profits funds and the shareholders' profits. This feature arises from the basis of taxation applied to life and pension business, principally in the UK, but with similar bases applying in certain Asian operations, and is explained in note (iii) below.

Furthermore, the basis of preparation of Prudential's financial statements incorporates the additional feature that, as permitted under IFRS 4, the residual equity of the Group's with-profits funds, i.e. unallocated surplus, is recorded as a liability with transfers to and from that liability reflected in pre-tax profits. This gives rise to anomalous effective tax rates for profits attributable to policyholders (as described in note (iv) below).

In meeting the reconciliation requirements set out in paragraph 81(c) of IAS 12, the presentation shown in this disclosure note seeks to ensure that the explanation of the relationship between tax expense and accounting profit draw properly the distinction between the elements of the profit and tax charge that are attributable to policyholders and shareholders as explained below in notes (iv) and (v) respectively. Due to the nature of the basis of taxation of UK life and pension business (as described in note (iii) below), and the significance of the results of the business to the Group, it is inappropriate to seek to explain the effective tax rate on profit before tax by the traditional approach that would apply for other industries.

The shareholder elements are the components of the profit and tax charge that are of most direct relevance to investors, and it is this aspect that the IAS 12 reconciliation requirement is seeking to explain for companies that do not need to account for both with-profits and unit-linked funds, where tax is borne by the Company on the policyholders' behalf and which is not contemplated by the IFRS requirement.

F: INCOME STATEMENT NOTES CONTINUED

F5: TAX > CONTINUED

iii Basis of taxation for UK life and pension business

Different rules apply under UK tax law for taxing pension business and life insurance business and there are detailed rules for apportioning the investment return and profits of the fund between the types of business.

The investment return referable to pension business, and some other less significant classes of business, is exempt from taxation, but tax is charged on the profit that shareholders derive from writing such business at the corporate rate of tax. The rules for taxing life insurance business are more complex. Initially, the UK regime seeks to tax the regulatory basis investment return less management expenses (I-E) on this business as it arises. However, in determining the actual tax charge, a calculation of the shareholder profits for taxation purposes from writing life insurance business also has to be made and compared with the I-E profit.

If the shareholder profit is higher than the I-E amount, extra income is attributable to the I-E calculation until the I-E profit equals the shareholder profit. If on the other hand, the I-E profit is the greater, then an amount equal to the shareholder profit is taxed at the corporate rate of tax, with the remainder of the I-E profit being taxed at the lower policyholder rate of tax.

The purpose of this approach is to ensure that the Company is always at a minimum taxed on the profit, as defined for taxation purposes by reference to the Company's regulatory returns (rather than IFRS basis results), that it has earned. The shareholders' portion of the long-term business is taxed at the shareholders' rate, with the remaining portion taxed at rates applicable to the policyholders.

It is to be noted that the calculations described are determined using data from the regulatory basis returns rather than the IFRS basis results. The differences between the regulatory and accounting bases are very significant and extremely complex, rendering any explanation in general purpose financial statements to be of little if any use to users.

iv Profits attributable to policyholders and related tax

As noted above, it is necessary under IFRS requirements to include the total tax charge of the Company (both policyholder and shareholder elements) in the tax charge disclosed in the income statement.

For with-profits business, total pre-tax profits reflect the aggregate of profits attributable to policyholders and shareholders. However, amounts attributable to the equity of with-profits funds are carried in the liability for unallocated surplus. Also, as described in note (iii), UK with-profits business is taxed on a basis that affects policyholders' unallocated surplus of with-profits funds and shareholders. For the PAC with-profits sub-fund, transfers to and from unallocated surplus are recorded in the income statement, so that after charging the total tax borne by the fund, the net balance reflects the statutory transfer from the fund for the year. The statutory transfer represents 10 per cent of the actuarially determined surplus for the year that is attributable to shareholders.

For SAIF, similar transfers are made. However, in the case of SAIF, a net nil balance is derived, reflecting the lack of shareholder interest in the financial performance of the fund (other than through asset management arrangements).

The accounting anomaly that arises under IFRS is that due to the fact that the net of tax profit attributable to with-profits policyholders is zero, the Company's presentation of pre-tax profit attributable to policyholders reflects an amount that is the mirror image of the tax charge attributable to policyholders.

For unit-linked business, pre-tax profits also reflect the aggregate of profits attributable to policyholders and shareholders. The pre-tax profits attributable to policyholders represent fees earned that are used to pay tax borne by the Company on policyholders' behalf. The net of tax profit attributable to policyholders for unit-linked business is thus zero.

The combined effect of these features is such that providing a reconciliation of the tax charge attributable to policyholders to an expected charge based on the standard corporate rate of tax on IFRS basis profits attributable to policyholders is not relevant.

In summary, for accounting purposes, in all cases and for all reporting periods, the apparent effective rate for profit attributable to policyholders and unallocated surplus is 100 per cent. However, it is to be noted that the 100 per cent rate does not reflect a rate paid on the profits attributable to policyholders. It instead reflects the basis of accounting for unallocated surplus coupled with the distinction made for performance reporting between sources of profit attributable to shareholders, policyholders and unallocated surplus and IFRS requirements in respect of reporting of all pre-tax profits and all tax charges irrespective of policyholder or shareholder economic interest.

v ***Reconciliation of tax charge on profit attributable to shareholders for continuing operations:***

	2010 £m (except for tax rates)				
	Asian insurance operations	**US insurance operations**	**UK insurance operations**	**Other operations**	**Total**
Profit (loss) before tax attributable to shareholders:					
Operating profit based on longer-term investment returns[note iii]	532	833	719	(143)	1,941
Short-term fluctuations in investment returns	114	(378)	116	25	(123)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	(5)	(5)	(10)
Cost of terminated AIA transaction				(377)	(377)
Gain on dilution of holding in PruHealth	–	–	30	–	30
Total	646	455	860	(500)	1,461
Expected tax rates:[note i]					
Operating profit based on longer-term investment returns[note iii]	22%	35%	28%	28%	29%
Short-term fluctuations in investment returns	25%	35%	28%	28%	52%
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	28%	28%	20%
Cost of terminated AIA transaction	–	–	–	28%	28%
Gain on dilution of holding in PruHealth	–	–	28%	–	28%
Expected tax (charge) credit based on expected tax rates:					
Operating profit based on longer-term investment returns[note iii]	(117)	(292)	(201)	40	(570)
Short-term fluctuations in investment returns	(29)	132	(32)	(7)	64
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	1	1	2
Cost of terminated AIA transaction	–	–	–	106	106
Gain on dilution of holding in PruHealth	–	–	(8)	–	(8)
Total	(146)	(160)	(240)	140	(406)
Variance from expected tax charge:[note ii]					
Operating profit based on longer-term investment returns[note iii]	59	43	18	237	357
Short-term fluctuations in investment returns	21	–	–	7	28
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	1	1
Cost of terminated AIA transaction	–	–	–	(13)	(13)
Gain on dilution of holding in PruHealth	–	–	8	–	8
Total	80	43	26	232	381
Actual tax (charge) credit:					
Operating profit based on longer-term investment returns, excluding exceptional tax credit[note iii]	(58)	(249)	(183)	119	(371)
Exceptional tax credit*	–	–	–	158	158
Operating profit based on longer-term investment returns	(58)	(249)	(183)	277	(213)
Short-term fluctuations in investment returns	(8)	132	(32)	–	92
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	1	2	3
Cost of terminated AIA transaction	–	–	–	93	93
Gain on dilution of holding in PruHealth	–	–	–	–	–
Total	(66)	(117)	(214)	372	(25)
Actual tax rate:					
Operating profit based on longer-term investment returns	11%	30%	25%	194%	11%
Total profit	10%	26%	25%	74%	2%
Actual tax rate (excluding exceptional tax credit):*					
Operating profit based on longer-term investment returns	11%	30%	25%	83%	19%
Total profit	10%	26%	25%	43%	13%

* The tax charge attributable to shareholders' return includes an exceptional tax credit of £158 million which primarily relates to the impact of a settlement agreed with the UK tax authorities.

F: INCOME STATEMENT NOTES CONTINUED

F5: TAX > CONTINUED

	2009* £m (except for tax rates)				
	Asian insurance operations	US insurance operations	UK insurance operations	Other operations	Total
Profit (loss) before tax attributable to shareholders:					
Operating profit based on longer-term investment returns[note iii]	410	618	657	(121)	1,564
Short-term fluctuations in investment returns	31	(132)	108	(130)	(123)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	(46)	(28)	(74)
Loss on sale and results for Taiwan agency business	(621)	–	–	–	(621)
Total	(180)	486	719	(279)	746
Expected tax rates:[note i]					
Operating profit based on longer-term investment returns[note iii]	24%	35%	28%	28%	30%
Short-term fluctuations in investment returns	25%	35%	28%	36%	45%
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	28%	28%	28%
Loss on sale and results for Taiwan agency business	25%	–	–	–	25%
Expected tax (charge) credit based on expected tax rates:					
Operating profit based on longer-term investment returns[note iii]	(98)	(216)	(184)	34	(464)
Short-term fluctuations in investment returns	(8)	46	(30)	47	55
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	13	8	21
Loss on sale and results for Taiwan agency business	155	–	–	–	155
Total	49	(170)	(201)	89	(233)
Variance from expected tax charge:[note ii]					
Operating profit based on longer-term investment returns[note iii]	35	76	(29)	8	90
Short-term fluctuations in investment returns	15	196	–	14	225
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	–	–
Loss on sale and results for Taiwan agency business	(137)	–	–	–	(137)
Total	(87)	272	(29)	22	178
Actual tax (charge) credit:					
Operating profit based on longer-term investment returns[note iii]	(63)	(140)	(213)	42	(374)
Short-term fluctuations in investment returns	7	242	(30)	61	280
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	13	8	21
Loss on sale and results for Taiwan agency business	18	–	–	–	18
Total	(38)	102	(230)	111	(55)
Actual tax rate:					
Operating profit based on longer-term investment returns	15%	23%	32%	35%	24%
Total profit	(21)%	(21)%	32%	40%	7%

* The Group has amended the presentation of operating profit for its US insurance operations to remove the net equity hedge accounting effect (incorporating related amortisation of deferred acquisition costs) and include it in short-term fluctuations. The 2009 comparatives have been amended accordingly. Note A4d(ii) explains the effect of the change.

Notes

(i) Expected tax rates for profit (loss) attributable to shareholders:
- The expected tax rates shown in the table above reflect the corporation tax rates generally applied to taxable profits of the relevant country jurisdictions.
- For Asian operations the expected tax rates reflect the corporation tax rates weighted by reference to the source of profits of operations contributing to the aggregate business result.
- The expected tax rate for Other operations reflects the mix of business between UK and overseas operations, which are taxed at a variety of rates. The rates will fluctuate from year to year dependent on the mix of profits.

(ii) For 2010 and 2009, the principal variances arise from a number of factors, including:

(a) Asian long-term operations
For 2010 and 2009, profits in certain countries which are not taxable partly offset by the inability to fully recognise deferred tax assets on losses being carried forward.

(b) Jackson
For 2010, the benefit of a deduction from taxable income of a proportion of dividends received attributable to the variable annuity business. For 2009, the ability to fully recognise deferred tax assets on losses brought forward which we were previously unable to recognise together with income subject to a lower level of taxation and the benefit of a deduction from taxable income of a proportion of dividends received attributable to the variable annuity business.

(c) UK insurance operations
For 2010, routine revisions to prior period tax returns. For 2009, adjustments in respect of prior year tax charge and different tax bases of UK life business.

(d) Other operations
For 2010, an exceptional tax credit which primarily relates to the impact of the settlement agreed with the UK tax authorities and the ability to recognise a deferred tax credit on various tax losses which we were previously unable to recognise, partly offset by the inability to fully recognise a tax credit in respect of non deductible capital costs incurred in relation to the terminated AIA transaction. For 2009, the ability to recognise a deferred tax asset on various tax losses which we were previously unable to recognise partly offset by adjustments in respect of the prior year tax charge.

(e) For 2009, the actual tax rate in relation to Asia excluding the result for the sold Taiwan agency business would have been 13 per cent.

(iii) Operating profit based on longer-term investment returns is net of attributable restructuring costs and development expenses.

F: INCOME STATEMENT NOTES CONTINUED

F6: ALLOCATION OF INVESTMENT RETURN BETWEEN POLICYHOLDERS AND SHAREHOLDERS

Investment return is attributable to policyholders and shareholders. A key feature of the accounting policies under IFRS is that the investment return included in the income statement relates to all investment assets of the Group, irrespective of whether the return is attributable to shareholders, or to policyholders or the unallocated surplus of with-profits funds, the latter two of which have no net impact on shareholders' profit. The table below provides a breakdown of the investment return for each regional operation attributable to each type of business.

	2010 £m	2009 £m
ASIAN OPERATIONS		
Policyholder returns		
Assets backing unit-linked liabilities	1,279	2,539
With-profits business	1,039	1,519
	2,318	4,058
Shareholder returns	429	373
Total	2,747	4,431
US OPERATIONS		
Policyholder returns		
Assets held to back (separate account) unit-linked liabilities	3,520	3,760
Shareholder returns		
Realised gains and losses (including impairment losses on available-for-sale bonds)	21	(529)
Value movements on derivative hedging programme for general account business	20	340
Interest/dividend income and value movements on other financial instruments for which fair value movements are booked in the income statement	1,016	1,567
	1,057	1,378
Total	4,577	5,138
UK OPERATIONS		
Policyholder returns		
Scottish Amicable Insurance Fund (SAIF)	1,075	1,438
Assets held to back unit-linked liabilities	2,119	2,947
With-profits fund (excluding SAIF)	8,815	10,461
	12,009	14,846
Shareholder returns		
Prudential Retirement Income Limited (PRIL)	1,717	1,827
Other business	834	1,113
	2,551	2,940
Total	14,560	17,786
UNALLOCATED CORPORATE		
Shareholder returns	(115)	(466)
GROUP TOTAL		
Policyholder returns	17,847	22,664
Shareholder returns	3,922	4,225
Total	21,769	26,889

The returns as shown in the table above, are delineated between those returns allocated to policyholders and those allocated to shareholders. In making this distinction, returns allocated to policyholders are those from investments in which shareholders have no direct economic interest, namely:

- unit-linked business in the UK, Asia and SAIF in the UK, for which the investment return is wholly attributable to policyholders;
- separate account business of US operations, the investment return of which is also wholly attributable to policyholders; and
- with-profits business (excluding SAIF) in the UK and Asia (in which the shareholders' economic interest, and the basis of recognising IFRS basis profits, is restricted to a share of the actuarially determined surplus for distribution (in the UK 10 per cent)). Except for this surplus the investment return of the with-profit funds is attributable to policyholders (through the asset-share liabilities) or the unallocated surplus, which is accounted for as a liability under IFRS 4.

The investment return related to the types of business above does not impact shareholders' profits directly. However, there is an indirect impact, for example, investment-related fees or the effect of investment return on the shareholders' share of the cost of bonuses of with-profits funds.

Investment returns for unit-linked and similar products have reciprocal impact on benefits and claims, with a decrease in market returns on the attached pool of assets affecting policyholder benefits on these products. Similarly for with-profits funds there is a close correlation between increases or decreases in investment returns and the level of combined charge for policyholder benefits and movement on unallocated surplus that arises from such returns.

Shareholder returns

For shareholder-backed non-participating business of the UK (comprising PRIL and other non-linked non-participating business) and of the Asian operations, the investment return is not directly attributable to policyholders and therefore does impact shareholders' profit directly. However, it should be noted that for UK shareholder-backed annuity business, principally PRIL, where the durations of asset and liability cash flows are closely matched, the discount rate applied to measure liabilities to policyholders (under 'grandfathered' UK GAAP and under IFRS 4) reflects movements in asset yields (after allowances for the future defaults) of the backing portfolios. Therefore, the net impact on the shareholders' profits of the investment return of the assets backing liabilities of the UK shareholder-backed annuity business is after taking into account the consequential effect on the movement in policyholder liabilities.

Changes in shareholder investment returns for US operations reflect primarily movements in the investment income, movements in the value of the derivative instruments held to manage the general account assets and liability portfolio, and realised gains and losses. However, separately reflecting Jackson's types of business an allocation is made to policyholders through the application of crediting rates. The shareholder investment return for US operations also includes the fair value movement of the derivatives and the movement on the related liabilities of the variable annuity guarantees under Jackson's dynamic hedging programme.

The majority of the investments held to back the US non-participating business are debt securities for which the available-for-sale designation is applied for IFRS basis reporting. Under this designation the return included in the income statement reflects the aggregate of investment income and realised gains and losses (including impairment losses). However, movements in unrealised appreciation or depreciation are recognised in other comprehensive income. The return on these assets is attributable to shareholders.

F: INCOME STATEMENT NOTES
CONTINUED

F7: BENEFITS AND CLAIMS AND MOVEMENTS IN UNALLOCATED SURPLUS OF WITH-PROFITS FUNDS, NET OF REINSURANCE

Benefits and claims represent payments, including final bonuses, to policyholders in respect of maturities, surrenders and deaths plus the change in technical provisions (which primarily represents the movement in amounts owed to policyholders). Benefits and claims are amounts attributable to policyholders. The movement in unallocated surplus of with-profits funds represents the transfer to (from) the unallocated surplus each year through a charge (credit) to the income statement of the annual excess (shortfall) of income over expenditure of the with-profits funds, after declaration and attribution of the cost of bonuses to policyholders and shareholders.

Benefits and claims and movements in unallocated surplus of with-profits funds net of reinsurance can be further analysed as follows:

	2010 £m			
	Asia	US	UK	Total
Claims incurred	(2,595)	(4,348)	(9,941)	(16,884)
Increase in policyholder liabilities	(3,824)	(11,075)	(8,490)	(23,389)
Movement in unallocated surplus of with-profits funds	(315)	–	70	(245)
	(6,734)	(15,423)	(18,361)	(40,518)

	2009 £m			
	Asia	US	UK	Total
Claims incurred	(1,814)	(4,092)	(9,875)	(15,781)
Increase in policyholder liabilities	(6,230)	(9,193)	(8,432)	(23,855)
Movement in unallocated surplus of with-profits funds	334	–	(1,893)	(1,559)
	(7,710)	(13,285)	(20,200)	(41,195)

G: FINANCIAL ASSETS AND LIABILITIES

G1: FINANCIAL INSTRUMENTS – DESIGNATION AND FAIR VALUES

The Group designates all financial assets as either fair value through profit and loss, available-for-sale, or as loans and receivables. Financial liabilities are designated as either fair value through profit and loss, amortised cost, or as investment contracts with discretionary participation features accounted for under IFRS 4 as described in note A4.

	2010 £m				
	Fair value through profit and loss	Available-for-sale	Loans and Receivables	Total carrying value	Fair value
FINANCIAL ASSETS					
Cash and cash equivalents	–	–	6,631	6,631	6,631
Deposits	–	–	9,952	9,952	9,952
Equity securities and portfolio holdings in unit trusts	86,635	–	–	86,635	86,635
Debt securities[note i]	90,027	26,325	–	116,352	116,352
Loans[note ii]	227	–	9,034	9,261	9,083
Other investments[note iii]	5,779	–	–	5,779	5,779
Accrued investment income	–	–	2,668	2,668	2,668
Other debtors	–	–	903	903	903
	182,668	26,325	29,188	238,181	

	2010 £m				
	Fair value through profit and loss[v]	Amortised cost	IFRS 4 basic value	Total carrying value	Fair value
FINANCIAL LIABILITIES					
Core structural borrowings of shareholder-financed operations[notes i,H13]	–	3,676	–	3,676	3,866
Operational borrowings attributable to shareholder-financed operations[H13]	–	3,004	–	3,004	2,991
Borrowings attributable to with-profits funds[H13]	82	1,440	–	1,522	1,524
Obligations under funding, securities lending and sale and repurchase agreements	–	4,199	–	4,199	4,236
Net asset value attributable to unit holders of consolidated unit trust and similar funds	3,372	–	–	3,372	3,372
Investment contracts with discretionary participation features[note iv]	–	–	25,732	25,732	–
Investment contracts without discretionary participation features	15,822	1,882	–	17,704	17,652
Other creditors	–	2,321	–	2,321	2,321
Derivative liabilities	2,037	–	–	2,037	2,037
Other liabilities	–	1,129	–	1,129	1,129
	21,313	17,651	25,732	64,696	

G: FINANCIAL ASSETS AND LIABILITIES CONTINUED

G1: FINANCIAL INSTRUMENTS – DESIGNATION AND FAIR VALUES > CONTINUED

	2009 £m				
	Fair value through profit and loss	Available-for-sale	Loans and Receivables	Total carrying value	Fair value
FINANCIAL ASSETS					
Cash and cash equivalents	–	–	5,307	5,307	5,307
Deposits	–	–	12,820	12,820	12,820
Equity securities and portfolio holdings in unit trusts	69,354	–	–	69,354	69,354
Debt securities[note i]	79,083	22,668	–	101,751	101,751
Loans[note ii]	–	–	8,754	8,754	8,686
Other investments[note iii]	5,132	–	–	5,132	5,132
Accrued investment income	–	–	2,473	2,473	2,473
Other debtors	–	–	762	762	762
	153,569	22,668	30,116	206,353	

	2009 £m				
	Fair value through profit and loss[v]	Amortised cost	IFRS 4 basic value	Total carrying value	Fair value
FINANCIAL LIABILITIES					
Core structural borrowings of shareholder-financed operations[notes i,H13]	–	3,394	–	3,394	3,424
Operational borrowings attributable to shareholder-financed operations[H13]	–	2,751	–	2,751	2,751
Borrowings attributable to with-profits funds[H13]	105	1,179	–	1,284	1,281
Obligations under funding, securities lending and sale and repurchase agreements	–	3,482	–	3,482	3,540
Net asset value attributable to unit holders of consolidated unit trust and similar funds	3,809	–	–	3,809	3,809
Investment contracts with discretionary participation features[note iv]	–	–	24,880	24,880	–
Investment contracts without discretionary participation features	13,840	1,965	–	15,805	15,866
Other creditors	–	1,612	–	1,612	1,612
Derivative liabilities	1,501	–	–	1,501	1,501
Other liabilities	–	877	–	877	877
	19,255	15,260	24,880	59,395	

Notes

i As at 31 December 2010, £685 million (2009: £659 million) of convertible bonds were included in debt securities and £352 million (2009: £347 million) were included in borrowings.

ii Loans and receivables are reported net of allowance for loan losses of £52 million (2009: £44 million).

iii See note G3 for details of the derivative assets included. The balance also contains the PAC with-profits fund's participation in various investment funds and limited liability property partnerships.

iv It is impractical to determine the fair value of investment contracts with discretionary participation features due to the lack of a reliable basis to measure such features.

v For financial liabilities designated as fair value through profit and loss there was no 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 IFRS are determined by the use of current market bid prices for exchange-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 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 Group'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 disclosed value cannot 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 Group 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. In accordance with the Group's risk management framework, all internally generated valuations are subject to assessment against external counterparties' valuations.

For investment contracts in the US with fixed and guaranteed terms the fair value is determined based on the present value of future cash flows discounted at current interest rates.

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 Group financial instruments

In March 2009, IFRS 7 'Financial Instruments: Disclosures' was amended by the IASB to require certain additional disclosures to be included in IFRS financial statements. This includes, as is presented below, a table of financial instruments carried at fair value analysed by level of the IFRS 7 defined fair value hierarchy. This hierarchy is based on the inputs of the fair value measurement and reflects the lowest level input that is significant to that measurement.

The classification criteria and its application to Prudential 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 (including net assets attributable to unit-holders of consolidated unit trusts and similar funds) 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 net assets attributable to unit-holders of consolidated unit trusts and similar funds and investment contract liabilities that are valued using observable inputs.

The nature of Prudential's operations in the US and the UK mean that a significant proportion of the assets backing non-linked shareholder-backed business are held in corporate bonds, structured securities and other non-national government debt securities. These assets, in line with market practice, are generally valued using independent pricing providers in the US and third-party broker quotes in the UK and Asia either directly or via third-parties, such as IDC or Bloomberg. Such assets are generally classified as level 2 as the nature of these quotations means that they do not strictly meet the definition of level 1 assets. These valuations are determined using independent external quotations from multiple sources and are subject to a number of monitoring controls, such as monthly price variances, stale price reviews and variance analysis on prices achieved on subsequent trades.

Pricing services, where available, are used to obtain the third-party broker quotes. Where pricing services providers are used, a single valuation is obtained and applied.

G: FINANCIAL ASSETS AND LIABILITIES CONTINUED

G1: FINANCIAL INSTRUMENTS – DESIGNATION AND FAIR VALUES > CONTINUED

When prices are not available from pricing services, quotes are sourced directly from brokers. Prudential seeks to obtain a number of quotes from different brokers so as to obtain the most comprehensive information available on their executability. Where quotes are sourced directly from brokers, the price used in the valuation is normally selected from one of the quotes based on a number of factors, including the timeliness and regularity of the quotes and the accuracy of the quotes considering the spreads provided. The selected quote is the one which best represents an executable quote for the security at the measurement date.

Generally, no adjustment is made to the prices obtained from independent third-parties. Adjustment is made in only limited circumstances, where it is determined that the third-party valuations obtained do not reflect fair value (e.g. either because the value is stale and/or the values are extremely diverse in range). These are usually securities which are distressed or that could be subject to a debt restructure or where reliable market prices are no longer available due to an inactive market or market dislocation. In these instances, prices are derived using internal valuation techniques including those as described above in this note 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 techniques used require a number of assumptions relating to variables such as credit risk and interest rates. Examples of such variables include an average credit spread based on the corporate bond universe and the relevant duration of the asset being valued. Prudential measures the input assumptions based on the best available information at the measurement dates. Securities valued in such manner are classified as level 3 where these significant inputs are not based on observable market data.

In addition level 2 includes debt securities that are valued internally using standard market practices. Of the total level 2 debt securities of £89,948 million at 31 December 2010 (2009: £83,301 million), £6,638 million are valued internally (2009: £6,426 million). The majority of such securities are valued using matrix pricing, which is based on assessing the credit quality of the underlying borrower to derive a suitable discount rate relative to government securities of a comparable duration. 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 majority of the parameters used in this valuation technique are readily observable in the market and, therefore, are not subject to interpretation.

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, investments which are internally valued or subject to a significant number of unobservable assumptions and certain derivatives which are bespoke or long dated. 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 Group held £4,194 million (2009: £5,190 million), two per cent of the fair valued financial instruments (2009: three per cent), within level 3. Of these amounts £3,359 million (2009: £3,510 million) was held by the Group'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 3.3 per cent of the total assets of the participating funds at 31 December 2010 (2009: 3.7 per cent). Total level 3 liabilities at 31 December 2010 were £371 million out of total participating fund liabilities of £112,196 million (2009: £348 million out of £104,817 million).

Of the £866 million level 3 fair valued financial investments at 31 December 2010 (2009: £1,684 million), net of derivative liabilities which support non-linked shareholder-backed business (1.6 per cent of the total financial investments net of derivative liabilities backing this business) (2009: 3.6 per cent), £728 million are externally valued and £138 million are internally valued (2009: £1,653 million and £31 million respectively). Internal valuations, which represent 0.2 per cent of the total financial investments net of derivative liabilities supporting non-linked shareholder-backed business at 31 December 2010 (2009: 0.06 per cent), are inherently more subjective than external valuations.

If the value of all level 3 investments backing non-linked shareholder-backed business was varied downwards by 10 per cent, the change in valuation would be £14 million (2009: £3 million), which would reduce shareholders' equity by this amount before tax. Of this amount a £7 million decrease (2009: £5 million increase) would pass through the income statement substantially as part of short-term fluctuations in investment returns outside of operating profit and a £7 million decrease (2009: offset by an £8 million decrease) would be included as part of other comprehensive income, being unrealised movements on assets classified as available-for-sale.

	31 December 2010 £m			
	Level 1	Level 2	Level 3	Total
WITH-PROFITS				
Equity securities and portfolio holdings in unit trusts	29,675	1,281	415	31,371
Debt securities	11,114	41,375	772	53,261
Other investments (including derivative assets)	137	1,207	2,543	3,887
Derivative liabilities	(56)	(626)	(25)	(707)
Total financial investments, net of derivative liabilities	40,870	43,237	3,705	87,812
Borrowings attributable to the with-profits fund held at fair value	–	(82)	–	(82)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(519)	(511)	(346)	(1,376)
Total	40,351	42,644	3,359	86,354
Percentage of total	47%	49%	4%	100%
UNIT-LINKED AND VARIABLE ANNUITY SEPARATE ACCOUNT				
Equity securities and portfolio holdings in unit trusts	54,272	2	–	54,274
Debt securities	3,784	5,268	2	9,054
Other investments (including derivative assets)	43	88	–	131
Derivative liabilities	–	–	–	–
Total financial investments, net of derivative liabilities	58,099	5,358	2	63,459
Investment contracts without discretionary participation features held at fair value	–	(13,841)	–	(13,841)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(1,360)	–	–	(1,360)
Total	56,739	(8,483)	2	48,258
Percentage of total	118%	(18)%	–	100%
NON-LINKED SHAREHOLDER-BACKED				
Loans	–	227	–	227
Equity securities and portfolio holdings in unit trusts	808	21	161	990
Debt securities	10,389	43,305	343	54,037
Other investments (including derivative assets)	52	1,146	563	1,761
Derivative liabilities	(80)	(1,049)	(201)	(1,330)
Total financial investments, net of derivative liabilities	11,169	43,650	866	55,685
Investment contracts without discretionary participation features held at fair value	–	(1,981)	–	(1,981)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(220)	(383)	(33)	(636)
Total	10,949	41,286	833	53,068
Percentage of total	20%	78%	2%	100%
GROUP TOTAL				
Loans	–	227	–	227
Equity securities and portfolio holdings in unit trusts	84,755	1,304	576	86,635
Debt securities	25,287	89,948	1,117	116,352
Other investments (including derivative assets)	232	2,441	3,106	5,779
Derivative liabilities	(136)	(1,675)	(226)	(2,037)
Total financial investments, net of derivative liabilities	110,138	92,245	4,573	206,956
Borrowings attributable to the with-profits fund held at fair value	–	(82)	–	(82)
Investment contracts without discretionary participation features held at fair value	–	(15,822)	–	(15,822)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(2,099)	(894)	(379)	(3,372)
Total	108,039	75,447	4,194	187,680
Percentage of total	58%	40%	2%	100%

G: FINANCIAL ASSETS AND LIABILITIES CONTINUED

G1: FINANCIAL INSTRUMENTS – DESIGNATION AND FAIR VALUES > CONTINUED

	31 December 2009 £m			
	Level 1	Level 2	Level 3	Total
WITH-PROFITS				
Equity securities and portfolio holdings in unit trusts	28,688	799	475	29,962
Debt securities	7,063	39,051	1,213	47,327
Other investments (including derivative assets)	79	1,199	2,170	3,448
Derivative liabilities	(54)	(504)	(25)	(583)
Total financial investments, net of derivative liabilities	35,776	40,545	3,833	80,154
Borrowings attributable to the with-profits fund held at fair value	–	(105)	–	(105)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(1,354)	(305)	(323)	(1,982)
Total	34,422	40,135	3,510	78,067
Percentage of total	44%	51%	5%	100%
UNIT-LINKED AND VARIABLE ANNUITY SEPARATE ACCOUNT				
Equity securities and portfolio holdings in unit trusts	38,616	4	–	38,620
Debt securities	3,283	5,525	40	8,848
Other investments (including derivative assets)	30	80	–	110
Derivative liabilities	–	–	–	–
Total financial investments, net of derivative liabilities	41,929	5,609	40	47,578
Investment contracts without discretionary participation features held at fair value	–	(12,242)	–	(12,242)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(1,324)	(7)	(2)	(1,333)
Total	40,605	(6,640)	38	34,003
Percentage of total	119%	(19)%	0%	100%
NON-LINKED SHAREHOLDER-BACKED				
Equity securities and portfolio holdings in unit trusts	557	36	179	772
Debt securities	5,783	38,725	1,068	45,576
Other investments (including derivative assets)	155	787	632	1,574
Derivative liabilities	(20)	(703)	(195)	(918)
Total financial investments, net of derivative liabilities	6,475	38,845	1,684	47,004
Investment contracts without discretionary participation features held at fair value	–	(1,598)	–	(1,598)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(110)	(342)	(42)	(494)
Total	6,365	36,905	1,642	44,912
Percentage of total	14%	82%	4%	100%
GROUP TOTAL				
Equity securities and portfolio holdings in unit trusts	67,861	839	654	69,354
Debt securities	16,129	83,301	2,321	101,751
Other investments (including derivative assets)	264	2,066	2,802	5,132
Derivative liabilities	(74)	(1,207)	(220)	(1,501)
Total financial investments, net of derivative liabilities	84,180	84,999	5,557	174,736
Borrowings attributable to the with-profits fund held at fair value	–	(105)	–	(105)
Investment contracts without discretionary participation features held at fair value	–	(13,840)	–	(13,840)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(2,788)	(654)	(367)	(3,809)
Total	81,392	70,400	5,190	156,982
Percentage of total	52%	45%	3%	100%

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

The following tables reconcile the value of level 3 financial instruments at 1 January 2010 to that presented at 31 December 2010 and at 1 January 2009 to that presented at 31 December 2009.

Total gains and losses recorded in the income statement in the year 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 an individual entity's overseas investments. All these amounts are included within 'investment return' within the income statement.

Total gains and losses recorded in other comprehensive income includes unrealised gains and losses on debt securities held as available-for-sale within Jackson and foreign exchange movements arising from the retranslation of the Group's overseas subsidiaries and branches.

The transfers out from level 3 during 2010 comprise mainly transfers within the Jackson's portfolio. Certain broker-priced assets of Jackson were previously classified as level 3 holdings as a result of illiquidity in the market and the resultant lack of observability into the assumptions used to produce those fair values. During 2010, as a result of ongoing consideration regarding the use of assumptions by pricing sources and the changes in the level of observability of these inputs over recent periods, Jackson determined that these assets would be more appropriately categorised as level 2. As a result, Jackson transferred debt securities of £606 million and derivative assets of £101 million from level 3 to level 2. The remaining transfers out of level 3 of the Group are primarily debt securities reclassifications from level 3 to level 2 which reflect improving liquidity during the period.

The transfers out from level 3 during 2009 included a transfer of £2,072 million from level 3 to level 2 in respect of structured securities of Jackson. At 31 December 2008, Jackson had utilised internal valuations for certain structured securities given the illiquidity of the market at that time. These assets had therefore been classified as level 3 given the unobservable nature of assumptions within the internal valuation models used. During the first half of 2009, improvements were observed in the level of liquidity for these structured securities such that external prices based on observable inputs from pricing services or brokers were used to value nearly all of the structured securities at 31 December 2009. The remaining transfers in and out of level 3 in 2009 represented sundry individual asset reclassifications, none of which are materially significant as highlighted in the table below.

G: FINANCIAL ASSETS AND LIABILITIES CONTINUED

G1: FINANCIAL INSTRUMENTS – DESIGNATION AND FAIR VALUES > CONTINUED

	At 1 Jan 2010 £m	Total gains/ losses in income statement £m	Total gains/ losses recorded in other compre-hensive income £m	Purchases £m	Sales £m	Settled £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	475	(6)	–	48	(59)	–	–	(43)	415
Debt securities	1,213	(113)	18	15	(158)	(34)	11	(180)	772
Other investments (including derivative assets)	2,170	309	5	372	(312)	–	–	(1)	2,543
Derivative liabilities	(25)	–	–	–	–	–	–	–	(25)
Total financial investments, net of derivative liabilities	3,833	190	23	435	(529)	(34)	11	(224)	3,705
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(323)	(32)	–	9	–	–	–	–	(346)
Total	3,510	158	23	444	(529)	(34)	11	(224)	3,359
UNIT-LINKED AND VARIABLE ANNUITY SEPARATE ACCOUNTS									
Debt securities	40	–	3	2	(4)	(18)	–	(21)	2
Total financial investments, net of derivative liabilities	40	–	3	2	(4)	(18)	–	(21)	2
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(2)	–	–	–	–	–	–	2	–
Total	38	–	3	2	(4)	(18)	–	(19)	2
NON-LINKED SHAREHOLDER-BACKED									
Equity securities and portfolio holdings in unit trusts	179	43	5	30	(95)	–	2	(3)	161
Debt securities	1,068	49	72	46	(213)	(27)	61	(713)	343
Other investments (including derivative assets)	632	15	32	129	(144)	–	–	(101)	563
Derivative liabilities	(195)	(5)	(1)	–	–	–	–	–	(201)
Total financial investments, net of derivative liabilities	1,684	102	108	205	(452)	(27)	63	(817)	866
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(42)	(17)	(1)	(16)	43	–	–	–	(33)
Total	1,642	85	107	189	(409)	(27)	63	(817)	833
GROUP TOTAL									
Equity securities and portfolio holdings in unit trusts	654	37	5	78	(154)	–	2	(46)	576
Debt securities	2,321	(64)	93	63	(375)	(79)	72	(914)	1,117
Other investments (including derivative assets)	2,802	324	37	501	(456)	–	–	(102)	3,106
Derivative liabilities	(220)	(5)	(1)	–	–	–	–	–	(226)
Total financial investments, net of derivative liabilities	5,557	292	134	642	(985)	(79)	74	(1,062)	4,573
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(367)	(49)	(1)	(7)	43	–	–	2	(379)
Total	5,190	243	133	635	(942)	(79)	74	(1,060)	4,194

	At 1 Jan 2009 £m	Total gains/ losses in income statement £m	Total gains/ losses recorded in other compre-hensive income £m	Purchases £m	Sales £m	Settled £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	509	(3)	(1)	26	(56)	–	–	–	475
Debt securities	1,342	(14)	(11)	50	(225)	(17)	142	(54)	1,213
Other investments (including derivative assets)	2,122	(211)	(89)	403	(55)	–	–	–	2,170
Derivative liabilities	–	(2)	–	–	(23)	–	–	–	(25)
Total financial investments, net of derivative liabilities	3,973	(230)	(101)	479	(359)	(17)	142	(54)	3,833
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(381)	9	–	49	–	–	–	–	(323)
Total	3,592	(221)	(101)	528	(359)	(17)	142	(54)	3,510
UNIT-LINKED AND VARIABLE ANNUITY SEPARATE ACCOUNT									
Debt securities	33	2	1	16	–	(8)	–	(4)	40
Total financial investments, net of derivative liabilities	33	2	1	16	–	(8)	–	(4)	40
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	–	–	–	(1)	–	–	(1)	–	(2)
Total	33	2	1	15	–	(8)	(1)	(4)	38
NON-LINKED SHAREHOLDER-BACKED									
Equity securities and portfolio holdings in unit trusts	318	(47)	(34)	21	(55)	–	–	(24)	179
Debt securities	3,996	(15)	(565)	104	(473)	(2)	200	(2,177)	1,068
Other investments (including derivative assets)	692	130	(76)	153	(308)	–	43	(2)	632
Derivative liabilities	(246)	93	–	(64)	23	–	(1)	–	(195)
Total financial investments, net of derivative liabilities	4,760	161	(675)	214	(813)	(2)	242	(2,203)	1,684
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(65)	17	6	–	–	–	–	–	(42)
Total	4,695	178	(669)	214	(813)	(2)	242	(2,203)	1,642
GROUP TOTAL									
Equity securities and portfolio holdings in unit trusts	827	(50)	(35)	47	(111)	–	–	(24)	654
Debt securities	5,371	(27)	(575)	170	(698)	(27)	342	(2,235)	2,321
Other investments (including derivative assets)	2,814	(81)	(165)	556	(363)	–	43	(2)	2,802
Derivative liabilities	(246)	91	–	(64)	–	–	(1)	–	(220)
Total financial investments, net of derivative liabilities	8,766	(67)	(775)	709	(1,172)	(27)	384	(2,261)	5,557
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(446)	26	6	48	–	–	(1)	–	(367)
Total	8,320	(41)	(769)	757	(1,172)	(27)	383	(2,261)	5,190

G: FINANCIAL ASSETS AND LIABILITIES CONTINUED

G1: FINANCIAL INSTRUMENTS – DESIGNATION AND FAIR VALUES > CONTINUED

Of the total gains and losses in the income statement in 2010 of £243 million gains, £315 million relates to financial instruments still held at the end of the year, which can be analysed as £18 million for equity securities, £110 million for debt securities, £243 million for other investments, £(6) million for derivative liabilities and £(50) million for net asset value attributable to unit holders of consolidated unit trusts and similar funds.

Of the total gains and losses in the income statement in 2009 of £41 million losses, £(205) million relates to financial instruments still held at the end of the year, which can be analysed as £41 million losses for equity securities, £44 million losses for debt securities, £221 million losses for other investments, £76 million gains for derivative liabilities and £25 million gains for net asset value attributable to unit holders of consolidated unit trusts and similar funds.

Transfers between level 1 and level 2

During 2010, transfers from level 1 to level 2 amounted to £354 million in respect of certain investment funds held by the Group's participating funds which arose to reflect the change in the observability of the inputs used 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 for the year ended 31 December 2010 from continuing operations was £1,994 million (2009: £1,998 million).

The interest expense on financial liabilities not at fair value through profit and loss for the year ended 31 December 2010 from continuing operations was £427 million (2009: £366 million).

G2: MARKET RISK

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 Group's financial assets or liabilities is 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 £m			
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
FINANCIAL ASSETS				
Cash and cash equivalents	–	–	6,631	6,631
Deposits	887	8,941	124	9,952
Debt securities	110,168	5,824	360	116,352
Loans	6,238	3,001	22	9,261
Other investments (including derivatives)	1,616	448	3,715	5,779
	118,909	18,214	10,852	147,975
FINANCIAL LIABILITIES				
Core structural borrowings of shareholder-financed operations	3,676	–	–	3,676
Operational borrowings attributable to shareholder-financed operations	2,624	377	3	3,004
Borrowings attributable to with-profits funds	679	710	133	1,522
Obligations under funding, securities lending and sale and repurchase agreements	631	3,568	–	4,199
Investment contracts without discretionary participation features	988	894	15,822	17,704
Derivative liabilities	705	431	901	2,037
Other liabilities	121	129	879	1,129
	9,424	6,109	17,738	33,271

	2009 £m			
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
FINANCIAL ASSETS				
Cash and cash equivalents	–	–	5,307	5,307
Deposits	896	11,884	40	12,820
Debt securities	95,817	5,550	384	101,751
Loans	5,923	2,816	15	8,754
Other investments (including derivatives)	1,381	368	3,383	5,132
	104,017	20,618	9,129	133,764
FINANCIAL LIABILITIES				
Core structural borrowings of shareholder-financed operations	3,394	–	–	3,394
Operational borrowings attributable to shareholder-financed operations	2,128	620	3	2,751
Borrowings attributable to with-profits funds	804	312	168	1,284
Obligations under funding, securities lending and sale and repurchase agreements	611	2,871	–	3,482
Investment contracts without discretionary participation features	1,098	867	13,840	15,805
Derivative liabilities	647	286	568	1,501
Other liabilities	79	92	706	877
	8,761	5,048	15,285	29,094

Liquidity analysis

i) Contractual maturities of financial liabilities

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

	2010 £m								
	Total carrying value	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
FINANCIAL LIABILITIES									
Core structural borrowings of shareholder-financed operations[H13]	3,676	164	861	731	1,314	835	1,244	1,469	6,618
Operational borrowings attributable to shareholder-financed operations[H13]	3,004	2,510	561	3	3	3	10	–	3,090
Borrowings attributable to with-profits funds[H13]	1,522	155	1,051	161	2	2	121	182	1,674
Obligations under funding, securities lending and sale and repurchase agreements	4,199	4,199	–	–	–	–	–	–	4,199
Other liabilities	1,129	867	16	50	–	–	–	196	1,129
Net asset value attributable to unit holders of consolidated unit-trusts and similar funds	3,372	3,372	–	–	–	–	–	–	3,372
Other creditors	2,321	2,321	–	–	–	–	–	–	2,321
	19,223	13,588	2,489	945	1,319	840	1,375	1,847	22,403

G: FINANCIAL ASSETS AND LIABILITIES CONTINUED

G2: MARKET RISK > CONTINUED

	2009 £m								
	Total carrying value	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
FINANCIAL LIABILITIES									
Core structural borrowings of shareholder-financed operations[H13]	3,394	148	588	733	1,394	877	1,343	1,422	6,505
Operational borrowings attributable to shareholder-financed operations[H13]	2,751	2,351	435	9	9	9	31	–	2,844
Borrowings attributable to with-profits funds[H13]	1,284	228	882	102	–	–	–	205	1,417
Obligations under funding, securities lending and sale and repurchase agreements	3,482	3,482	–	–	–	–	–	–	3,482
Other liabilities	877	643	11	14	–	–	–	211	879
Net asset value attributable to unit holders of consolidated unit-trusts and similar funds	3,809	3,809	–	–	–	–	–	–	3,809
Other creditors	1,612	1,612	–	–	–	–	–	–	1,612
	17,209	12,273	1,916	858	1,403	886	1,374	1,838	20,548

ii) Maturity analysis of derivatives
The following table provides a maturity analysis of derivative assets and liabilities:

	2010 £m					
	Total carrying value	1 year or less	After 1 year to 3 years	After 3 years to 5 years	After 5 years	Total
Net derivative position	2	1	1	–	–	2

	2009 £m					
	Total carrying value	1 year or less	After 1 year to 3 years	After 3 years to 5 years	After 5 years	Total
Net derivative position	279	340	10	(1)	–	349

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

	2010 £m	2009 £m
Derivative assets	2,039	1,780
Derivative liabilities	(2,037)	(1,501)
Net derivative position	2	279

The majority of derivative assets and liabilities have been included at fair value within the one 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 Group has no cash flow hedges. The only exception is certain identified interest rate swaps which are fully expected to be held until maturity solely for the purposes of matching cash flows on separately held assets and liabilities. For these instruments the undiscounted cash flows (including contractual interest amounts) due to be paid under the swap contract assuming conditions are consistent with those at year end are included in the column relating to the contractual maturity of the derivative.

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 EEV basis results.

	2010 £bn							
	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 undis-counted value	Carrying value
Life assurance investment contracts	3	12	15	14	12	15	71	43

	2009 £bn							
	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 undis-counted value	Carrying value
Life assurance investment contracts	3	11	13	13	11	17	68	41

Most investment contracts have options to surrender early, albeit these are often subject to surrender or other penalties. It is therefore the case that most contracts could be said to have a contractual maturity of less than one year, but in reality the additional charges and term of the contracts means these are unlikely to be exercised in practice and the more useful information is to present information on expected payment.

The maturity profile above excludes certain corporate unit-linked business with gross policyholder liabilities of £11 billion (2009: £9 billion) which has no stated maturity but which is repayable on demand.

This table has been prepared on an undiscounted basis and accordingly the amounts shown for life assurance investment contracts differ from those disclosed on the statement of financial position. Durations of long-term business contracts, covering insurance and investment contracts, on a discounted basis are included in section D.

The vast majority of the Group's financial assets are held to back the Group's policyholder liabilities. Although asset/liability matching is an important component of managing policyholder liabilities (both those classified as insurance and those classified as investments), this profile is mainly relevant for managing market risk rather than liquidity risk. Within each business unit this asset/liability matching is performed on a portfolio by portfolio basis.

In terms of liquidity risk a large proportion of the policyholder liabilities contain discretionary surrender values or surrender charges, meaning that many of the Group's liabilities are expected to be held for the long term. Much of the Group's investment portfolios is in marketable securities, which can therefore be converted quickly to liquid assets.

For the reasons above an analysis of the Group's assets by contractual maturity is not considered necessary to evaluate the nature and extent of the Group's liquidity risk.

Credit risk

The Group's maximum exposure to credit risk of financial instruments before any allowance for collateral or allocation of losses to policyholders is represented by the carrying value of financial instruments on the balance sheet that have exposures to credit risk. These assets comprise cash and cash equivalents, deposits, debt securities, loans and derivative assets, and other debtors, the carrying value of which are disclosed at the start of this note and note G3 for derivative assets. The collateral in place in relation to derivatives is described in G4. Notes D2, D3 and D4, describe the security for these loans held by the Group, as disclosed at the start of this note.

Of the total loans and receivables held £74 million (2009: £64 million) are past their due date but have not been impaired. Of the total past due but not impaired, £26 million is less than one year past their due date and £9 million is more than six months but less than one year past their due date (2009: £64 million and £11 million respectively). The Group expects full recovery of these loans and receivables. No further analysis has been provided of the age of financial assets that are past due at the end of the reporting period but not impaired as the amounts are immaterial.

No further analysis has been provided of the element of loans and receivables that was neither past due nor impaired for the total portfolio. This is on the grounds of immateriality of the difference between the neither past due nor impaired elements and the total portfolio.

Financial assets that would have been past due or impaired had the terms not been renegotiated amounted to £97 million (2009: £55 million).

There was no collateral held against loans that are past due and impaired or that are past due but not impaired at 31 December 2010 (2009: £nil).

In addition, during the year the Group took possession of £22 million (2009: £15 million) of other collateral held as security, which mainly consists of assets that could be readily convertible into cash.

G: FINANCIAL ASSETS AND LIABILITIES CONTINUED

G2: MARKET RISK > CONTINUED

Currency risk

As at 31 December 2010, the Group held 18 per cent (2009: 19 per cent) and 14 per cent (2009: 13 per cent) 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 70 per cent (2009: 74 per cent) are held by the PAC with-profits fund, allow the PAC with-profits fund to obtain exposure to foreign equity markets.

The financial liabilities, of which 28 per cent (2009: 34 per cent) are held by the PAC with-profits fund, mainly relate to foreign currency borrowings.

The exchange risks inherent in these exposures are mitigated through the use of derivatives, mainly forward currency contracts (note G3 below).

The amount of exchange gains recognised in the income statement in 2010, except for those arising on financial instruments measured at fair value through profit and loss, is £82 million (2009: £201 million losses). This constitutes £16 million losses (2009: £41 million losses) on Medium Term Notes (MTN) liabilities and £98 million of net gains (2009: £160 million net losses), mainly arising on investments of the PAC with-profits fund. The gains/losses on MTN liabilities are fully offset by value movements on cross-currency swaps, which are measured at fair value through profit and loss.

G3: DERIVATIVES AND HEDGING

Derivatives

The Group enters into a variety of exchange traded and over-the-counter derivative financial instruments, including futures, options, forward currency contracts and swaps such as interest rate swaps, cross-currency swaps, swaptions and credit default swaps.

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 and relevant counterparties in place under each of these market master agreements.

The total fair value balances of derivative assets and liabilities as at 31 December 2010 were as follows:

	2010 £m					
	UK insurance operations	US insurance operations	Asian insurance operations	Asset management	Unallocated to a segment	Group total
Derivative assets	926	645	310	44	114	2,039
Derivative liabilities	(792)	(799)	(222)	(78)	(146)	(2,037)
	134	(154)	88	(34)	(32)	2

	2009 £m					
	UK insurance operations	US insurance operations	Asian insurance operations	Asset management	Unallocated to a segment	Group total
Derivative assets	910	519	150	48	153	1,780
Derivative liabilities	(709)	(461)	(146)	(49)	(136)	(1,501)
	201	58	4	(1)	17	279

The above derivative assets are included in 'other investments' in the primary statements.

The notional amount of the derivatives, distinguishing between UK insurance and US operations, was as follows:

	2010 £m			
	UK insurance operations Notional amount on which future payments are based		US insurance operations Notional amount on which future payments are based	
As at 31 December 2010	**Asset**	**Liability**	**Asset**	**Liability**
Cross-currency swaps*	808	921	379	173
Equity index put options	–	1,458	–	–
Swaptions	–	18	13,093	3,832
Futures	3,068	7,150	–	2,701
Forwards*	19,668	19,793	–	–
Inflation swaps	3,032	2,945	–	–
Credit default swaps	1,148	20	26	–
Credit derivatives	–	–	–	134
Put options	–	–	8,048	–
Equity options	34	–	3,514	867
Total return swaps	215	215	–	192
Interest rate swaps*	4,035	4,403	7,185	8,495

	2009 £m			
	UK insurance operations Notional amount on which future payments are based		US insurance operations Notional amount on which future payments are based	
As at 31 December 2009	**Asset**	**Liability**	**Asset**	**Liability**
Cross-currency swaps*	808	881	376	168
Swaptions	900	900	12,694	5,263
Futures	2,267	2,987	–	1,534
Forwards*	20,235	20,184	–	–
Inflation swaps	2,337	2,205	–	–
Credit default swaps	90	12	–	–
Credit derivatives	–	–	–	189
Put options	–	–	9,072	–
Equity options	30	552	3,246	562
Total return swaps	420	421	–	–
Interest rate swaps*	5,529	5,710	1,579	3,957

* In addition, the other operations, including the Group Treasury function and the Asian operations, have cross-currency swap assets and liabilities with notional amounts of £492 million (2009: £819 million) and £209 million (2009: £122 million) respectively, forward currency contracts assets and liabilities with notional amounts of £2,619 million (2009: £570 million) and £440 million (2009: £958 million) respectively, interest rate swaps assets and liabilities of £832 million (2009: £793 million) and of £195 million (2009: £522 million), respectively, and cliquet options assets of £nil (2009: £7 million).

These derivatives are used for efficient portfolio management to obtain cost effective and efficient exposure to various markets in accordance with the Group's investment strategies and to manage exposure to interest rate, currency, credit and other business risks. See also note D3 for use of derivatives by the Group's US operations.

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

The UK insurance operations use various currency derivatives in order to limit volatility due to foreign currency exchange rate fluctuations arising on securities denominated in currencies other than sterling. See also note G2 above. In addition, total return swaps and interest rate swaps are held for efficient portfolio management.

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. These contracts are subject to a number of limitations for legal and regulatory reasons.

G: FINANCIAL ASSETS AND LIABILITIES CONTINUED

G3: DERIVATIVES AND HEDGING > CONTINUED

Some of the Group's products, especially those sold in the US, have certain guarantee features linked to equity indexes. A mismatch between product liabilities and the performance of the underlying assets backing them, exposes the Group to equity index risk. In order to mitigate this risk, the relevant business units purchase swaptions, equity options and futures to match asset performance with liabilities under equity-indexed products.

The US operations and some of the UK operations hold large amounts of interest-rate sensitive investments that contain credit risks on which a certain level of defaults is expected. These entities have purchased some swaptions in order to manage the default risk on certain underlying assets and hence reduce the amount of regulatory capital held to support the assets.

Hedging

The Group has formally assessed and documented the effectiveness of the following hedges under IAS 39.

Fair value hedges

The Group used interest rate derivatives to hedge the interest rate exposures on its US$300 million, 6.5 per cent perpetual subordinated capital securities until September 2010. The hedge terminated at this point. The impact on the Group's income statement was immaterial. Where the hedge relationship has been de-designated and re-designated, the fair value adjustment to the hedged item up to the point of de-designation continues to be reported as part of the basis of the hedged item and is amortised to the income statement based on a recalculated effective interest rate over the residual period to the first break clause date of the perpetual subordinated capital securities.

The Group 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 Group's operational borrowings.

The fair value of the derivatives designated as fair value hedges above at 31 December 2010, was an asset of £5 million (2009: asset of £7 million and liability of £1 million). Movements in the fair value of the hedging instruments of a net loss of £1 million (2009: net loss of £11 million) and the hedged items of a net gain of £1 million (2009: net gain of £11 million) are recorded in the income statement in respect of the fair value hedges above.

Cash flow hedges

The Group has no cash flow hedges in place.

Net investment hedges

The Group has designated perpetual subordinated capital securities totalling US$2.3 billion (2009: US$1.55 billion) as a net investment hedge to hedge the currency risks related to the net investment in Jackson. The carrying value of the subordinated capital securities was £1,462 million as at 31 December 2010 (2009: £966 million). The foreign exchange loss of £45 million (2009: gain of £118 million) on translation of the borrowings to pounds sterling at the statement of financial position date is recognised in the translation reserve in shareholders' equity.

This net investment hedge was 100 per cent effective.

G4: DERECOGNITION AND COLLATERAL

Securities lending and reverse repurchase agreements

The Group 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 Group's consolidated statement of financial position, 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 Group had lent £8,708 million (2009: £10,501 million) of which £6,488 million (2009: £7,910 million) was lent by the PAC with-profits fund of securities and held collateral under such agreements of £9,334 million (2009: £10,669 million) of which £6,910 million (2009: £8,086 million) was held by the PAC with-profits fund.

At 31 December 2010, the Group 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 of £1,208 million (2009: £1,587 million), together with accrued interest.

Collateral and pledges under derivative transactions

At 31 December 2010, the Group had pledged £800 million (2009: £644 million) for liabilities and held collateral of £804 million (2009: £586 million) in respect of over-the-counter derivative transactions.

G5: IMPAIRMENT OF FINANCIAL ASSETS

In accordance with the Group's accounting policy set out in note A4, impairment reviews were performed for available-for-sale securities and loans and receivables. In addition, impairment reviews were undertaken for the reinsurers' share of insurance contract liabilities.

During the year ended 31 December 2010, impairment losses of £145 million (2009: £647 million) were recognised for available-for-sale securities and loans and receivables. These were £124 million (2009: £630 million) in respect of available-for-sale securities held by Jackson and £21 million (2009: £17 million) in respect of loans and receivables. The 2010 impairment charge for loans and receivables of £21 million (2009: £17 million) relates to loans held by the UK with-profits fund and mortgage loans held by Jackson.

Impairment losses recognised on available-for-sale securities amounted to £124 million (2009: £630 million). Of this amount, 90 per cent (2009: 86 per cent) has been recorded on structured asset-backed securities, primarily due to reduced cash flow expectations on such securities that are collateralised by diversified pools of primarily below investment grade securities. Of the losses related to the impairment of fixed maturity securities, the top five individual corporate issuers made up 32 per cent (2009: 11 per cent), reflecting a deteriorating business outlook of the companies concerned.

The impairment losses have been recorded in 'investment return' in the income statement.

In 2010, the Group realised gross losses on sales of available-for-sale securities of £160 million (2009: £134 million) with 45 per cent (2009: 60 per cent) of these losses related to the disposal of fixed maturity securities of 15 (2009: five) individual issuers, which were disposed of as part of risk reduction programmes intended to limit future credit loss exposure. Of the £160 million (2009: £134 million), £99 million (2009: £6 million) relates to losses on sales of impaired and deteriorating securities.

The effect of those reasonably likely changes in the key assumptions underlying the estimates that underpin the assessment of whether impairment has taken place depends on the factors described in note A3. A key indicator of whether such impairment may arise in future, and the potential amounts at risk, is the profile of gross unrealised losses for fixed maturity securities accounted for on an available-for-sale basis by reference to the time periods by which the securities have been held continuously in an unrealised loss position and by reference to the maturity date of the securities concerned.

For 2010 the amounts of gross unrealised losses for fixed maturity securities classified as available-for-sale under IFRS in an unrealised loss position was £370 million (2009: £966 million). Notes B1 and D3 provide further details on the impairment charges and unrealised losses of Jackson's available-for-sale securities.

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS

H1: INTANGIBLE ASSETS ATTRIBUTABLE TO SHAREHOLDERS

a Goodwill

	2010 £m	2009 £m
COST		
At 1 January	1,430	1,461
Disposal of Taiwan Agency business	–	(44)
Additional consideration paid on previously acquired businesses	–	13
Acquisition of UOB Life Assurance Limited in Singapore	141	–
Exchange differences	15	–
At 31 December	1,586	1,430
AGGREGATE IMPAIRMENT		
At 1 January and 31 December	(120)	(120)
NET BOOK AMOUNT AT 31 DECEMBER	1,466	1,310

Impairment testing
Goodwill does not generate cash flows independently of other groups of assets and thus is assigned to cash generating units (CGUs) for the purposes of impairment testing. These CGUs are based upon how management monitors the business and represent the lowest level to which goodwill can be allocated on a reasonable basis. An allocation to CGUs of the Group's goodwill attributable to shareholders is shown below:

	2010 £m	2009 £m
M&G	1,153	1,153
Other	313	157
	1,466	1,310

'Other' represents goodwill amounts allocated across CGUs in Asia and US operations. Other goodwill amounts are not individually material. During 2010 £141 million (SGD313 million) of goodwill was recognised upon the acquisition of UOB Life Assurance Limited. Upon translation at the year end exchange rate, the carrying value of this UOB Life Assurance goodwill at 31 December 2010 was £156 million.

Assessment of whether goodwill may be impaired
Goodwill is tested for impairment by comparing the CGU's carrying amount, including any goodwill, with its recoverable amount.

With the exception of M&G, the goodwill attributable to shareholders in the statement of financial position mainly relates to acquired life businesses. The Company routinely compares the aggregate of net asset value and acquired goodwill on an IFRS basis of acquired life business with the value of the business as determined using the EEV methodology, as described in note D1. Any excess of IFRS over EEV carrying value is then compared with EEV basis value of current and projected future new business to determine whether there is any indication that the goodwill in the IFRS statement of financial position may be impaired. The assumptions underpinning the Group's EEV basis of reporting are included in the EEV basis supplementary information in this Annual Report. In particular at 31 December 2010, the EEV of the CGU containing the UOB Life Assurance goodwill (being the Singapore insurance operations) materially exceeded its IFRS net asset value and so no impairment was deemed to arise.

M&G

The recoverable amount for the M&G CGU has been determined by calculating its value in use. This has been calculated by aggregating the present value of future cash flows expected to be derived from the M&G operating segment (based upon management projections).

The discounted cash flow valuation has been based on a three-year plan prepared by M&G, and approved by management, and cash flow projections for later years.

The value in use is particularly sensitive to a number of key assumptions as follows:

i The set of economic, market and business assumptions used to derive the three-year plan. The direct and secondary effects of recent developments, e.g. changes in global equity markets, are considered by management in arriving at the expectations for the financial projections for the plan.

ii The assumed growth rate on forecast cash flows beyond the terminal year of the plan. A growth rate of 2.5 per cent (2009: 2.5 per cent) has been used to extrapolate beyond the plan period representing management's best estimate view of the long-term growth rate of the business after considering the future and past growth rates and external sources of data.

iii The risk discount rate. Differing discount rates have been applied in accordance with the nature of the individual component businesses. For retail and institutional business a risk discount rate of 12 per cent (2009: 12 per cent) has been applied to post-tax cash flows. The pre-tax risk discount rate was 16 per cent (2009: 16 per cent). Management have determined the risk discount rate by reference to an average implied discount rate for comparable UK listed asset managers calculated by reference to risk-free rates, equity risk premiums of five per cent and an average 'beta' factor for relative market risk of comparable UK listed asset managers. A similar approach has been applied for the other component businesses of M&G.

iv That asset management contracts continue on similar terms.

Management believes that any reasonable change in the key assumptions would not cause the recoverable amount of M&G to fall below its carrying amount.

Japanese life company

The aggregate goodwill impairment of £120 million at 31 December 2010 and 2009 relates to the goodwill held in relation to the Japanese life operation which was impaired in 2005.

b Deferred acquisition costs and other intangible assets attributable to shareholders

The deferred acquisition costs and other intangible assets in the Group consolidated statement of financial position attributable to shareholders comprise:

	2010 £m	**2009** £m
Deferred acquisition costs (DAC) related to insurance contracts as classified under IFRS 4	4,316	3,823
Deferred acquisition costs related to investment management contracts, including life assurance contracts classified as financial instruments and investment management contracts under IFRS 4	110	107
	4,426	3,930
Present value of acquired in-force policies for insurance contracts as classified under IFRS 4	70	52
Present value of future profits of acquired investment management contracts, including life assurance contracts classified as financial instruments and investment management contracts under IFRS 4	–	1
Distribution rights	113	66
	183	119
Total of deferred acquisition costs and other intangible assets	4,609	4,049

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H1: INTANGIBLE ASSETS ATTRIBUTABLE TO SHAREHOLDERS > CONTINUED

	Deferred acquisition costs						
	UK £m	US[i] £m	Asia £m	Asset management £m	Other intangibles £m	Total 2010 £m	Total 2009 £m
BALANCE AT 1 JANUARY	124	3,092	706	8	119	4,049	5,349
Additions	19	851	210	5	50	1,135	1,071
Acquisition of UOB Life Assurance Ltd	–	–	–	–	12	12	–
Amortisation to the income statement:							
Operating profit	(20)	(334)	(208)	(4)	(13)	(579)	(469)
Amortisation related to short-term fluctuations in investment returns	–	358	–	–	–	358	153
	(20)	24	(208)	(4)	(13)	(221)	(316)
Exchange differences	–	72	50	–	15	137	(550)
Change in shadow DAC related to movement in unrealised appreciation of Jackson's securities classified as available-for-sale (see note D3(g) for explanation)	–	(496)	–	–	–	(496)	(1,069)
Dilution of holding in PruHealth	(7)	–	–	–	–	(7)	–
DAC movement on sale of Taiwan agency business	–	–	–	–	–	–	(436)
BALANCE AT 31 DECEMBER	116	3,543	758	9	183	4,609	4,049

Note

i The DAC amount in respect of US insurance operations includes £2,834 million (2009: £1,938 million) in respect of variable annuity business, £1,229 million (2009: £1,164 million) in respect of other business and £(520) million (2009: £(10) million) in respect of cumulative shadow DAC.

Deferred acquisition costs related to insurance contracts attributable to shareholders

The movement in deferred acquisition costs relating to insurance contracts attributable to shareholders is as follows:

	2010 £m	2009 £m
DEFERRED ACQUISITION COSTS AT 1 JANUARY	3,823	5,097
Additions	1,064	1,054
Amortisation	(190)	(286)
Exchange differences	122	(537)
Change in shadow DAC related to movement in unrealised appreciation of Jackson's securities classified as available-for-sale	(496)	(1,069)
Dilution of holding in PruHealth	(7)	–
DAC movement on sale of Taiwan agency business	–	(436)
DEFERRED ACQUISITION COSTS AT 31 DECEMBER	4,316	3,823

Deferred acquisition costs related to investment management contracts attributable to shareholders

Incremental costs associated with the origination of investment management contracts written by the Group's insurance and asset management businesses are capitalised and amortised as the related revenue is recognised.

	2010 £m	2009 £m
AT 1 JANUARY		
Gross amount	162	148
Accumulated amortisation	(55)	(40)
NET BOOK AMOUNT	107	108
Additions (through internal development)	21	14
Amortisation	(18)	(15)
AT 31 DECEMBER	110	107
COMPRISING:		
Gross amount	183	162
Accumulated amortisation	(73)	(55)
NET BOOK AMOUNT	110	107

Present value of acquired in-force business of long-term business contracts attributable to shareholders

The present value of acquired in-force business (PVAIF) relating to investment contracts without discretionary participation features represents the contractual right to benefit from providing these investment management services in the future. The fair value is measured as the present value of the future profits of the investment management component of these contracts. These contracts are accounted for under the provisions of IAS 18. The PVAIF balance relating to insurance contracts is accounted for under UK GAAP as permitted by IFRS 4.

The present value of future profits of acquired investment management contracts which was fully amortised during the year related to unit-linked contracts acquired as part of the M&G acquisition in 1999.

Amortisation is charged to the 'acquisition costs and other operating expenditure' line in the income statement over the period of provision of asset management services as those profits emerge.

	2010 £m		2009 £m	
	Insurance business	Investment management	Insurance business	Investment management
AT 1 JANUARY				
Cost	175	12	184	12
Accumulated amortisation	(123)	(11)	(120)	(11)
NET BOOK AMOUNT	52	1	64	1
Acquisition of UOB Life Assurance Ltd(note I1)	12	–	–	–
Exchange differences	10	–	(6)	–
Amortisation charge	(4)	(1)	(6)	–
AT 31 DECEMBER	70	–	52	1
COMPRISING:				
Cost	203	–	175	12
Accumulated amortisation	(133)	–	(123)	(11)
NET BOOK AMOUNT	70	–	52	1

Distribution rights attributable to the Asian insurance operations

Distribution rights relate to facilitation fees paid in respect of the bancassurance partnership arrangements in Asia for the bank distribution of Prudential's insurance products for a fixed period of time. The distribution rights amounts are amortised over the term of the distribution contracts.

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H1: INTANGIBLE ASSETS ATTRIBUTABLE TO SHAREHOLDERS > CONTINUED

	2010 £m	2009 £m
AT 1 JANUARY		
Gross amount	79	84
Accumulated amortisation	(13)	(5)
	66	79
Additions[i]	50	3
Amortisation charge	(8)	(9)
Exchange differences	5	(7)
AT 31 DECEMBER	113	66
COMPRISING:		
Gross amount	136	79
Accumulated amortisation	(23)	(13)
	113	66

Note

i In addition to the acquired assets and liabilities of UOB Life Assurance in 2010, as explained in note I1, the Group entered into distribution agreements with UOB for consideration of SGD 110 million (£50 million). The distribution rights have been accounted for as an intangible asset.

H2: INTANGIBLE ASSETS ATTRIBUTABLE TO WITH-PROFITS FUNDS

a Goodwill in respect of acquired investment subsidiaries for venture fund and other investment purposes

	2010 £m	2009 £m
AT 1 JANUARY	124	174
Additions in the year[note I8(iii)]	42	–
Impairment	–	(50)
AT 31 DECEMBER	166	124

All the goodwill relates to the UK insurance operations segment.

The venture fund investments consolidated by the Group relates to investments by PAC with-profits fund managed by M&G. The goodwill shown in the table above relates to these venture fund investments. Goodwill is tested for impairment for these investments by comparing the investment's carrying value including goodwill with its recoverable amount. The recoverable amount of the investments is determined by calculating their fair value less costs to sell. The fair value is determined by using a discounted cash flow valuation. The valuations are based on cash flow projections to 2015 prepared by management after considering the historical experience and future growth rates of the business. The key assumption applied in the calculations is the risk discount rate ranging from 10 to 14 per cent derived by reference to risk-free rates and an equity premium risk. In 2010, no goodwill was deemed to be impaired following the impairment testing carried out. In 2009, following the impairment testing carried out, £50 million of the goodwill was deemed to be impaired.

In 2009, the impairment charge was recorded under 'acquisition costs and other expenditure' but was also taken account of in determining the charge/credit in the income statement for the transfer to the liability for unallocated surplus of with-profits funds. Accordingly, the charge did not affect shareholders' profits or equity.

b Deferred acquisition costs and other intangible assets

Other intangible assets in the Group consolidated statement of financial position attributable to with-profits funds consist of:

	2010 £m	2009 £m
Deferred acquisition costs related to insurance contracts attributable to the PAC with-profits fund	13	9
Distribution rights attributable to with-profits funds of the Asian insurance operations	97	97
	110	106

Deferred acquisition costs related to insurance contracts attributable to the PAC with-profits fund

The movement in deferred acquisition costs relating to insurance contracts attributable to the PAC with-profits fund is as follows:

	2010 £m	2009 £m
AT 1 JANUARY	9	13
Additions	9	–
Amortisation charge	(5)	(4)
AT 31 DECEMBER	13	9

The above costs relate to non-participating business written by the PAC with-profits sub-fund.

No deferred acquisition costs are established for the participating business.

Distribution rights attributable to with-profit funds of the Asian insurance operations

Distribution rights relate to facilitation fees paid in relation to the bancassurance partnership arrangements in Asia for the bank distribution of Prudential's insurance products for a fixed period of time. The distribution rights amounts are amortised over the term of the distribution contracts.

	2010 £m	2009 £m
AT 1 JANUARY		
Gross amount	103	115
Accumulated amortisation	(6)	(2)
	97	113
Additions	–	–
Amortisation charge	(4)	(4)
Exchange differences	4	(12)
AT 31 DECEMBER	97	97
COMPRISING:		
Gross amount	108	103
Accumulated amortisation	(11)	(6)
	97	97

H3: REINSURERS' SHARE OF INSURANCE CONTRACT LIABILITIES

	2010 £m	2009 £m
Insurance contract liabilities	1,167	1,114
Claims outstanding	177	73
	1,344	1,187

The movement on reinsurers' share of insurance contract liabilities is as follows:

	2010 £m	2009 £m
AT 1 JANUARY	1,114	1,176
Movement in the year	31	24
Foreign exchange translation differences	22	(86)
AT 31 DECEMBER	1,167	1,114

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H4: TAX ASSETS AND LIABILITIES

Assets

Of the £555 million (2009: £636 million) current tax recoverable, the majority is expected to be recovered in one year or less.

Deferred tax asset

	2010 £m	2009 £m
Unrealised losses on investments	449	1,156
Balances relating to investment and insurance contracts	11	20
Short-term timing differences	1,152	1,228
Capital allowances	16	18
Unused deferred tax losses	560	286
Total	2,188	2,708

The deferred tax asset at 31 December 2010 and 2009 arises in the following parts of the Group:

	2010 £m	2009 £m
UK insurance operations:		
SAIF	2	2
PAC with-profits fund (including PAL)	108	141
Other	104	149
US insurance operations	1,391	1,944
Asian insurance operations	98	132
Other operations	485	340
Total	2,188	2,708

The decrease in deferred tax asset primarily relates to the reduction in unrealised losses on investments due to the improved investment markets.

Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable taxable profits from which the future reversal of the underlying temporary differences can be deducted.

The taxation regimes applicable across the Group apply separate rules to trading and capital profits and losses. The distinction between temporary differences that arise from items of either a trading or capital nature may affect the recognition of deferred tax assets. Accordingly, for the 2010 results and statement of financial position at 31 December 2010, the possible tax benefit of approximately £143 million (2009: £257 million), which may arise from capital losses valued at approximately £0.5 billion (2009: £1.2 billion), is sufficiently uncertain that it has not been recognised. In addition, a potential deferred tax asset of £298 million (2009: £607 million), which may arise from tax losses and other potential temporary differences totalling £1.2 billion (2009: £2.1 billion) is sufficiently uncertain that it has not been recognised. Forecasts as to when the tax losses and other temporary differences are likely to be utilised indicate that they may not be utilised in the short-term.

Liabilities

The current tax liability decreased to £831 million (2009: £1,215 million) due to an exceptional tax credit which primarily relates to the impact of a settlement agreed with the UK tax authorities together with the ability to recognise a tax credit on costs incurred in relation to the terminated AIA transaction.

Deferred tax liability

	2010 £m	2009 £m
Unrealised gains on investments	1,678	1,744
Balances relating to investment and insurance contracts	1,057	961
Short-term timing differences	1,477	1,159
Capital allowances	12	8
Total	4,224	3,872

The increase in deferred tax liability primarily relates to the rise in deferred acquisition costs (shown within short-term timing differences above) as a result of the increase in insurance new business during the year.

Unprovided deferred income tax liabilities on temporary differences associated with investments in subsidiaries, associates and interests in joint ventures are considered to be insignificant due to the availability of various UK tax exemptions and reliefs.

The UK government's tax rate change to 27 per cent has had the effect of reducing the UK with-profits and shareholder-backed business elements of the net deferred tax balances as at 31 December 2010 by £11 million. The tax change to 27 per cent is effective from 1 April 2011 but enacted at 31 December 2010.The subsequent proposed phased rate changes to 24 per cent are expected to have the effect of reducing the UK with-profits and shareholder-backed business elements of the net deferred tax balances at 31 December 2010 by £65 million.

H5: ACCRUED INVESTMENT INCOME AND OTHER DEBTORS

	2010 £m	2009 £m
ACCRUED INVESTMENT INCOME		
Interest receivable	1,844	1,718
Other	824	755
Total	2,668	2,473
OTHER DEBTORS		
Premiums receivable:		
From policyholders	141	148
From intermediaries	28	17
From reinsurers	27	82
Other	707	515
Total	903	762
TOTAL ACCRUED INVESTMENT INCOME AND OTHER DEBTORS	3,571	3,235

Of the £3,571 million (2009: £3,235 million) of accrued investment income and other debtors, £151 million (2009: £134 million) is expected to be settled after one year or more.

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H6: PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment comprise Group occupied properties, development property (until 2009) and tangible assets. A reconciliation of the carrying amount of these items from the beginning of the year to the end of the year is as follows:

	Group occupied property £m	Development property £m	Tangible assets £m	Total £m
AT 1 JANUARY 2009				
Cost	292	131	717	1,140
Accumulated depreciation	(29)	–	(476)	(505)
NET BOOK AMOUNT	263	131	241	635
YEAR ENDED 31 DECEMBER 2009				
Opening net book amount	263	131	241	635
Exchange differences	(9)	–	(31)	(40)
Depreciation charge	(4)	–	(70)	(74)
Additions	2	–	89	91
Disposals (including amounts disposed of with the Taiwan agency business)	(99)	–	(15)	(114)
Reclassified as investment property*	–	(131)	–	(131)
CLOSING NET BOOK AMOUNT	153	–	214	367
AT 1 JANUARY 2010				
Cost	173	–	661	834
Accumulated depreciation	(20)	–	(447)	(467)
Net book amount	153	–	214	367
YEAR ENDED 31 DECEMBER 2010				
Opening net book amount	153	–	214	367
Exchange differences	5	–	9	14
Depreciation charge	(4)	–	(68)	(72)
Additions	19	–	74	93
Arising on acquisitions of subsidiaries	–	–	220	220
Disposals	–	–	(10)	(10)
CLOSING NET BOOK AMOUNT	173	–	439	612
AT 31 DECEMBER 2010				
Cost	197	–	908	1,105
Accumulated depreciation	(24)	–	(469)	(493)
NET BOOK AMOUNT	173	–	439	612

* In line with the 2008 IASB Annual Improvements Project, all development properties were reclassified as investment properties with effect from 1 January 2009.

The total property, plant and equipment relates to continuing operations only.

Capital expenditure: property, plant and equipment by segment

	2010 £m	2009 £m
Insurance operations:		
UK	23	5
US	25	12
Asia	28	65
Asset management operations:		
M&G	2	–
US	1	1
Asia	4	2
TOTAL SEGMENT	83	85
Unallocated corporate	10	6
TOTAL	93	91

H7: INVESTMENT PROPERTIES

Investment properties principally relate to the PAC with-profits fund and are carried at fair value. A reconciliation of the carrying amount of investment properties at the beginning and end of the year is set out below:

	2010 £m	2009 £m
AT 1 JANUARY	10,905	11,992
Reclassification of development property*	–	131
Additions:		
Resulting from acquisitions	267	184
Resulting from expenditure capitalised	44	133
Resulting from acquisitions through business combinations	–	1
Disposals (including amounts disposed of with the Taiwan agency business)	(390)	(1,220)
Net gain (loss) from fair value adjustments	636	(203)
Net foreign exchange differences	38	(113)
Transfers to held for sale assets	(254)	–
Transfers to owner occupied properties	1	–
AT 31 DECEMBER	11,247	10,905

* In line with changes issued by the IASB as part of its Annual Improvement Project in May 2008 (as shown in note H6) all development properties with a total cost of £131 million have been reclassified as investment properties at 1 January 2009. At this date these investments had a fair value of £152 million. The initial gain of £21 million is included as part of 'net loss from fair value adjustments'.

The income statement includes the following items in respect of investment properties:

	2010 £m	2009 £m
Rental income from investment properties	625	755
Direct operating expenses (including repairs and maintenance expenses) arising from investment properties that generated rental income during the year	125	131

Further information on the investment property held by the UK insurance operations is included in note D2(a).

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H7: INVESTMENT PROPERTIES > CONTINUED

Investment properties of £3,435 million (2009: £3,177 million) are held under finance leases. A reconciliation between the total of future minimum lease payments at the statement of financial position date and their present value is shown below:

	2010 £m	**2009** £m
Future minimum lease payments at 31 December	1,107	1,683
Future finance charges on finance leases	(972)	(1,517)
Present value of minimum lease payments	135	166
Future minimum lease payments are due as follows:		
Less than 1 year	7	9
1 to 5 years	28	38
Over 5 years	1,072	1,636
Total	1,107	1,683
The present values of these minimum lease payments are:		
Less than 1 year	7	8
1 to 5 years	24	38
Over 5 years	104	120
Total	135	166

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future value of a factor that changes other than with the passage of time. There was no contingent rent recognised as income or expense in 2010 and 2009.

The Group's policy is to rent investment properties to tenants through operating leases. Minimum future rentals to be received on non-cancellable operating leases are receivable in the following periods:

	2010 £m	**2009** £m
Less than 1 year	601	662
1 to 5 years	2,121	2,282
Over 5 years	5,616	7,792
Total	8,338	10,736

The total minimum future rentals to be received on non-cancellable sub-leases for land and buildings at 31 December 2010 are £3,366 million (2009: £3,684 million).

H8: INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

Investments in associates

The Group had three associates at 31 December 2010 (2009: three) that are accounted for using the equity method. The Group's associates are a 30 per cent interest in The Nam Khang, a Vietnamese property developer, a 30 per cent interest in Apollo Education and Training Organisation Vietnam and a 25 per cent interest in PruHealth, following the loss of joint control in the period (see note I2). OYO Developments Limited a 25 per cent associate was disposed during the year.

The Group also has investments in associates which meet the IAS 28 criteria for measurement at fair value through profit and loss in accordance with IAS 39.

Associates accounted for using the equity method

A summary of the movements in investments in associates accounted for using the equity method in 2010 and 2009 is set out below:

	Share of capital £m	Share of reserves £m	Share of net assets £m	Goodwill £m	Total carrying value £m
BALANCE AT 1 JANUARY 2009	12	(4)	8	2	10
Exchange translations and other movements	(7)	4	(3)	(1)	(4)
Share of loss for the year after tax	–	–	–	–	–
BALANCE AT 31 DECEMBER 2009	5	–	5	1	6
Transfer of PruHealth to associates (note I2)	1	65	66	–	66
Acquisition/capital injection in PruHealth	9	–	9	–	9
Exchange translation and other movements	(3)	(1)	(4)	–	(4)
Share of loss for the year after tax	–	(6)	(6)	–	(6)
BALANCE AT 31 DECEMBER 2010	12	58	70	1	71

There have been no changes recognised in the other comprehensive income of associates that would also be recognised in the other comprehensive income by the Group.

The Group's share of the assets, liabilities, revenues and profit and loss of associates accounted for using the equity method at 31 December 2010 and 2009 is as follows:

	2010 £m	2009 £m
FINANCIAL POSITION		
Total assets (excluding goodwill)	70	5
Total liabilities	–	–
Net assets	70	5
RESULTS OF OPERATIONS		
Revenue*	39	1
Loss in the year*	(6)	–

* The 2010 amounts include the Group's share of PruHealth's revenue and profit and loss for the five months ended 31 December 2010. Prior to August 2010, PruHealth was accounted for as a joint venture (see note I2 and the note below).

Associates carried at fair value through profit and loss

The Group's associates that are carried at fair value through profit and loss comprise investments in OEICs, unit trusts, funds holding collateralised debt obligations, property unit trusts, and venture capital investments of the PAC with-profits fund where the Group has significant influence. These investments are incorporated both in the UK and overseas, and some have year ends which are non-coterminous with that of the Group. In these instances, the investments are recorded at fair value at 31 December 2010 based on valuations or pricing information at that specific date. The aggregate fair value of associates carried at fair value through profit and loss where there are published price quotations is approximately £5 billion (2009: £6 billion) at 31 December 2010.

The aggregate assets of these associates are approximately £6 billion (2009: £9 billion). Aggregate liabilities, excluding liabilities to unit holders and shareholders for unit trusts and OEICs, are approximately £1 billion (2009: £2 billion). Fund revenues, with revenue arising in unit trusts and OEICs deemed to constitute the investment return for these vehicles, were approximately £0.4 billion (2009: £0.8 billion) and net loss in the year, excluding unit trusts and OEICs where all investment returns accrue to unit holders or shareholders respectively, was approximately £0.1 billion (2009: profit of £0.2 billion).

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H8: INVESTMENTS IN ASSOCIATES AND JOINT VENTURES > CONTINUED

Investments in joint ventures

Joint ventures represent activities over which the Group exercises joint control through contractual agreement with one or more parties. The Group's significant joint ventures, which are accounted for using proportionate consolidation, comprise various joint ventures relating to property investments where the Group has a 50 per cent interest as well as the following interests:

Investment	% held	Principal activity	Country
CITIC Prudential Life Insurance Company Limited	50	Life assurance	China
CITIC Prudential Fund Management Company Limited	49	Asset management	China
Prudential ICICI Asset Management Company Limited	49	Asset management	India
Prudential BSN Takaful Berhad	49	General and life insurance	Malaysia
BOCI Prudential Asset Management Limited	36	Asset management	China
ICICI Prudential Life Insurance Company Limited	26	Life assurance	India

The investments noted in the table above have the same accounting year end as the Group, except for ICICI Prudential Life Insurance Company Limited and Prudential ICICI Asset Management Company Limited. Although these investments have reporting periods ending 31 March, 12 months of financial information up to 31 December is recorded. Accordingly, the information covers the same period as that of the Group.

The summarised financial data for the Group's share of investments in joint ventures is as follows:

	2010 £m	2009 £m
FINANCIAL POSITION		
Current assets	327	386
Non-current assets	3,386	2,462
Total assets	3,713	2,848
Current liabilities	(329)	(150)
Non-current liabilities	(3,093)	(2,392)
Total liabilities	(3,422)	(2,542)
Net equity	291	306
RESULTS OF OPERATIONS		
Revenues*	1,195	974
Expenses*	(1,135)	(945)
Net profit (loss)	60	29

* The 2010 amounts include the Group's share of PruHealth's results for the seven months ended 31 July 2010. On 1 August 2010 the Group's interest in PruHealth was diluted and the Group's investment was reclassified as an associate (see note I2 and the note above).

There are several minor service agreements in place between the joint ventures and the Group. During 2010, the aggregate amount of the transactions was £29.7 million (2009: £14.1 million) and the balance outstanding as at 31 December 2010 was £69.5 million (2009: £54.6 million).

The joint ventures have no significant contingent liabilities to which the Group is exposed nor does the Group have any significant contingent liabilities in relation to its interest in the joint ventures.

H9: PROPERTIES HELD FOR SALE

Investment properties are classified as held for sale when contracts have been exchanged but the sale has not been completed at the period end. At 31 December 2010 the value of assets held for sale was £257 million (2009: £3 million).

Gains on disposal of held for sale assets are recorded in 'investment return' within the income statement.

H10: CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of cash at bank and in hand, deposits held at call with banks, treasury bills and other short-term highly liquid investments with less than 90 days maturity from the date of acquisition. Cash and cash equivalents included in the cash flow statement comprise the following statement of financial position amounts:

	2010 £m	2009 £m
Cash	6,167	5,071
Cash equivalents	464	236
TOTAL CASH AND CASH EQUIVALENTS	6,631	5,307

Cash and cash equivalents held centrally are considered to be available for general use by the Group. These funds amount to £523 million and £895 million at 31 December 2010 and 2009, respectively. The remaining funds are considered not to be available for general use by the Group, and include funds held for the benefit of policyholders.

H11: SHAREHOLDERS' EQUITY: SHARE CAPITAL, SHARE PREMIUM AND RESERVES

	2010 £m	2009 £m
SHARE CAPITAL AND SHARE PREMIUM		
Share capital	127	127
Share premium	1,856	1,843
RESERVES		
Retained earnings	4,982	3,964
Translation reserve	454	203
Available-for-sale reserve	612	134
TOTAL SHAREHOLDERS' EQUITY	8,031	6,271

A summary of the ordinary shares in issue is set out below:

Share capital and share premium

	2010		
	Number of ordinary shares	Share capital £m	Share premium £m
Issued shares of 5p each fully paid:			
At 1 January 2010	2,532,227,471	127	1,843
Shares issued under share option schemes	2,455,227	–	13
Shares issued in lieu of cash dividends	10,911,808	–	62
Reserve movements in respect of shares issued in lieu of cash dividends	–	–	(62)
At 31 December 2010	2,545,594,506	127	1,856

	2009		
	Number of ordinary shares	Share capital £m	Share premium £m
Issued shares of 5p each fully paid:			
At 1 January 2009	2,496,947,688	125	1,840
Shares issued under share option schemes	605,721	–	3
Shares issued in lieu of cash dividends	34,674,062	2	136
Reserve movements in respect of shares issued in lieu of cash dividends	–	–	(136)
At 31 December 2009	2,532,227,471	127	1,843

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H11: SHAREHOLDERS' EQUITY: SHARE CAPITAL, SHARE PREMIUM AND RESERVES > CONTINUED

Amounts recorded in share capital represent the nominal value of the shares issued. The difference between the proceeds received on issue of shares, net of issue costs, and the nominal value of shares issued is credited to the share premium account. Shares issued in lieu of cash dividends are considered to take the legal form of bonus issue shares and have been accounted for as such.

At 31 December 2010, there were options outstanding under Save As You Earn schemes to subscribe for 12,802,482 (2009: 12,230,833) shares at prices ranging from 288 pence to 572 pence (2009: 266 pence to 572 pence) and exercisable by the year 2016 (2009: 2016).

The cost of own shares of £75 million as at 31 December 2010 (2009: £75 million) is deducted from retained earnings. The Company has established trusts to facilitate the delivery of shares under employee incentive plans and savings-related share option schemes. At 31 December 2010, 4.5 million (2009: 5.3 million) Prudential plc shares with a market value of £30 million (2009: £34 million) were held in such trusts. Of this total, 4.4 million (2009: 4.8 million) shares were held in trusts under employee incentive plans. In 2010, the Company purchased 5.7 million (2009: 3.4 million) shares in respect of employee incentive plans at a cost of £32 million (2009: £17 million). The maximum number of shares held in the year was 5.3 million which was at the beginning of the year.

Of the total shares held in trust, 0.1 million (2009: 0.5 million) shares were held by a qualifying employee share ownership trust. These shares are expected to be fully distributed in the future on maturity of savings-related share option schemes.

The shares purchased each month are as follows:

		Share Price		
2010	**Number of shares**	**Low £**	**High £**	**Cost £**
January	9,338	6.38	6.38	59,530
February	11,638	5.68	5.68	66,046
March	3,908,274	5.16	6.09	20,884,460
April	11,129	5.63	5.63	62,601
May	14,638	5.59	5.59	81,753
June	190,991	5.26	5.66	1,075,712
July	13,457	5.14	5.14	69,102
August	10,016	5.86	5.86	58,644
September	13,727	5.25	5.84	78,539
October	11,634	6.37	6.37	74,108
November	385,321	5.74	6.49	2,244,770
December	1,153,611	6.04	6.65	7,445,358
TOTAL	5,733,774			32,200,623

2009	Number of shares	Share Price Low £	Share Price High £	Cost £
January	19,852	3.83	3.94	76,575
February	19,926	3.52	3.52	70,140
March	1,112,209	2.02	3.50	3,837,968
April	22,164	3.38	3.38	74,859
May	32,416	4.45	6.59	173,242
June	26,594	4.44	7.31	145,230
July	342,062	3.86	4.30	1,374,929
August	14,059	4.85	4.85	68,144
September	12,435	5.50	5.50	68,393
October	10,332	6.34	6.34	65,453
November	10,576	6.04	6.04	63,879
December	1,739,591	6.06	6.35	10,941,847
TOTAL	3,362,216			16,960,659

The Group has consolidated a number of authorised investment funds where it is deemed to control these funds under IFRS. Some of these funds hold shares in Prudential plc. The total number of shares held by these funds at 31 December 2010 was 9.8 million (2009: 10.6 million) and the cost of acquiring these shares of £47 million (2009: £50 million) is included in the cost of own shares. The market value of these shares as at 31 December 2010 was £65 million (2009: £67 million).

During 2010 and 2009 respectively, these funds made 833,618 net disposals and 1,414,263 net acquisitions of Prudential shares for a net decrease of £3 million and a net increase of £3 million to book cost.

All share transactions were made on an exchange other than the Stock Exchange of Hong Kong.

The Company did not buy back any of its own shares during 2010 or 2009.

Reserves

The translation reserve represents cumulative foreign exchange translation differences taken directly to equity in accordance with IFRS, net of related tax. In accordance with IFRS 1, cumulative translation differences are deemed to be zero at 1 January 2004, the date of transition to IFRS.

The available-for-sale reserve represents gains or losses arising from changes in the fair value of available-for-sale securities of Jackson, net of the related change in amortisation of deferred income and acquisition costs and of the related tax.

H12: INSURANCE CONTRACT LIABILITIES AND UNALLOCATED SURPLUS OF WITH-PROFITS FUNDS

Movement in year

	Insurance contract liabilities £m	Unallocated surplus of with-profits funds £m
At 1 January 2009	136,030	8,414
Income and expense included in the income statement	19,765	1,559
Foreign exchange translation differences	(6,574)	46
Disposal of Taiwan agency business	(3,508)	–
AT 1 JANUARY 2010	145,713	10,019
Income and expense included in the income statement	22,412	245
Foreign exchange translation differences	3,193	(11)
Dilution of holding in PruHealth	(27)	–
AT 31 DECEMBER 2010	171,291	10,253

Notes B6, D2c, D3c and D4c provide further analysis of the movement in the year of the Group's policyholder liabilities and unallocated surplus of the with-profits funds.

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H13: BORROWINGS

Core structural borrowings of shareholder-financed operations

	2010 £m				2009 £m
	Innovative Tier 1*	Innovative Tier 2*	Senior†	Total	Total
CENTRAL OPERATIONS					
Subordinated debt:					
€500m 5.75% Subordinated Notes 2021 note i		428		428	443
€20m Medium-Term Subordinated Notes 2023 note ii		17		17	18
£435m 6.125% Subordinated Notes 2031		428		428	428
£400m 11.375% Subordinated Notes 2039		382		382	380
US$1,000m 6.5% Perpetual Subordinated Capital Securities	639			639	619
US$250m 6.75% Perpetual Subordinated Capital Securities note iii	160			160	155
US$300m 6.5% Perpetual Subordinated Capital Securities note iii	192			192	192
US$750m 11.75% Perpetual Subordinated Capital Securities	472			472	456
	1,463	1,255	–	2,718	2,691
Senior debt:					
£300m 6.875% Bonds 2023			300	300	300
£250m 5.875% Bonds 2029			249	249	249
	–	–	549	549	549
TOTAL CENTRAL OPERATIONS	1,463	1,255	549	3,267	3,240
PRUCAP					
£250m bank loan note iv			250	250	–
JACKSON					
US$250m 8.15% Surplus Notes 2027 note v		159		159	154
TOTAL notes vi, vii	1,463	1,414	799	3,676	3,394

* These debt classifications are consistent with the treatment of capital for regulatory purposes, as defined in the FSA Handbook.
† The senior debt ranks above subordinated debt in the event of liquidation.

Notes

i The €500 million 5.75 per cent borrowings have been swapped into borrowings of £333 million with interest payable at six month £LIBOR plus 0.962 per cent.

ii The €20 million borrowings were issued at 20-year Euro Constant Maturity Swap (capped at 6.5 per cent). These have been swapped into borrowings of £14 million with interest payable at three month £LIBOR plus 1.2 per cent.

iii The US$250 million 6.75 per cent borrowings and the US$300 million 6.5 per cent borrowings can be converted, in whole or in part, at the Company's option and subject to certain conditions, on any interest payment date falling on or after 23 March 2010 and 23 March 2011 respectively, into one or more series of Prudential preference shares.

iv The £250 million PruCap bank loan was made in two tranches: £135 million maturing in June 2014, currently drawn at a cost of six month £LIBOR plus 1.2 per cent and £115 million maturing in August 2012, currently drawn at a cost of twelve month £LIBOR plus 1.41 per cent.

v The Jackson borrowings are unsecured and subordinated to all present and future indebtedness, policy claims and other creditor claims of Jackson.

vi Maturity analysis
The following table sets out the contractual maturity analysis of the Group's core structural borrowings:

	2010 £m	2009 £m
Less than 1 year	–	–
1 to 2 years	115	–
2 to 3 years	–	–
3 to 4 years	135	–
4 to 5 years	–	–
Over 5 years	3,426	3,394
Total	3,676	3,394

vii Management analyses the net core structural borrowings position as follows:

	2010 £m	2009 £m
Total core structural borrowings (as above)	3,676	3,394
Less: Holding company cash and short-term investments (recorded within the consolidated statement of financial position)	(1,232)	(1,486)
Net core structural borrowings of shareholder-financed operations	2,444	1,908

Operational borrowings attributable to shareholder-financed operations

	2010 £m	2009 £m
BORROWINGS IN RESPECT OF SHORT-TERM FIXED INCOME SECURITIES PROGRAMMES		
Commercial paper	2,311	2,031
Medium-Term Notes 2010	–	7
Bank Notes 2013	249	–
	2,560	2,038
NON-RECOURSE BORROWINGS OF US OPERATIONS[note i]		
Jackson[note ii]	10	–
Investment subsidiaries	20	20
Piedmont and CDO funds[note iii]	60	183
	90	203
OTHER BORROWINGS		
Bank loans and overdrafts	5	148
Obligations under finance leases	2	3
Other borrowings[note iv]	347	359
	354	510
TOTAL[notes v, vi]	3,004	2,751

Notes

i In all instances the holders of the debt instruments issued by these subsidiaries and funds do not have recourse beyond the assets of those subsidiaries and funds.

ii This represents senior debt issued through the Federal Home Loan Bank of Indianapolis and was secured on collateral posted with FHLB by Jackson.

iii Piedmont is an investment trust investing in certain asset-backed and mortgage-backed securities in the US. These borrowings pertain to debt instruments issued to external parties.

iv Other borrowings represents amounts whose repayment to the lender is contingent on future surpluses emerging from certain contracts specified under the arrangement. If insufficient surplus emerges on the contracts, there is no recourse to other assets of the Group and the liability is not payable to the degree of shortfall.

v In addition to the listed debt above, £200 million Floating Rate Notes were issued by Prudential plc in October 2010 which mature in April 2011. These Notes have been wholly subscribed by a Group subsidiary and accordingly have been eliminated on consolidation in the Group financial statements. These Notes were originally issued in October 2008 and have been reissued upon their maturity.

vi Maturity analysis
The following table sets out the contractual maturity analysis of the Group's operational borrowings attributable to shareholder-financed operations:

	2010 £m	2009 £m
Less than 1 year	2,496	2,183
1 to 2 years	98	121
2 to 3 years	401	239
3 to 4 years	–	172
4 to 5 years	–	6
Over 5 years	9	30
Total	3,004	2,751

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H13: BORROWINGS > CONTINUED

Borrowings attributable to with-profits operations

	2010 £m	2009 £m
Non-recourse borrowings of consolidated investment funds[note i]	1,287	1,016
£100m 8.5% Undated Subordinated Guaranteed Bonds of Scottish Amicable Finance plc[note ii]	100	100
Other borrowings (predominantly obligations under finance leases)	135	168
TOTAL[note iii]	1,522	1,284

Notes

i In all instances the holders of the debt instruments issued by these funds do not have recourse beyond the assets of those funds.

ii The interests of the holders of the bonds issued by Scottish Amicable Finance plc, a subsidiary of the Scottish Amicable Insurance Fund, are subordinate to the entitlements of the policyholders of that fund.

iii Maturity analysis
The following table sets out the contractual maturity analysis of the Group's borrowings attributable to with-profits operations:

	2010 £m	2009 £m
Less than 1 year	96	33
1 to 2 years	635	77
2 to 3 years	99	706
3 to 4 years	74	1
4 to 5 years	1	1
Over 5 years	617	466
Total	1,522	1,284

H14: PROVISIONS AND CONTINGENCIES

Provisions

	2010 £m	2009 £m
Provision in respect of defined benefit pension schemes:[I3]		
Deficit, gross of deferred tax, based on scheme assets held, including investments in Prudential insurance policies:		
Attributable to PAC with-profits fund (i.e. absorbed by the liability for unallocated surplus)	106	122
Attributable to shareholder-financed operations (i.e. to shareholders' equity)	114	128
	220	250
Add back: Investments in Prudential insurance policies	227	187
Provision after elimination of investments in Prudential insurance policies and matching policyholder liability from Group statement of financial position	447	437
Other provisions (see below)	282	206
TOTAL PROVISIONS	729	643

Analysis of other provisions:

	2010 £m	2009 £m
At 1 January	206	155
Charged to income statement:		
Additional provisions	182	148
Unused amounts released	(10)	(13)
Used during the year	(106)	(75)
Exchange differences	10	(9)
At 31 December	282	206
Comprising:		
Legal provisions	20	15
Restructuring provisions	26	17
Other provisions	236	174
TOTAL	282	206

Of the other provisions balance of £282 million (2009: £206 million), £141 million (2009: £148 million) is expected to be settled within one year. Employer contributions expected to be paid into defined benefit pension schemes within one year are shown in note I3.

Legal provisions
Of the legal provisions of £20 million (2009: £15 million), £19 million (2009: £11 million) relates to Jackson. Jackson has been named in civil proceedings, which appear to be substantially similar to other class action litigation brought against many life insurers in the US, alleging misconduct in the sale of insurance products. During 2010 and 2009, £1 million and £9 million was paid respectively. In 2010, Jackson established an additional £9 million reserve for potential litigation. We expect the provision balance to be utilised over the next six years.

Restructuring provisions
Restructuring provisions of £26 million (2009: £17 million) primarily relate to restructuring activities of UK insurance operations. The provisions pertain to property liabilities resulting from the closure of regional sales centres and branches and staff terminations and other transformation costs to enable streamlining of operations.

These activities resulted in additional provisions in 2010 of £14 million. During 2010, £2 million (2009: £1 million) of unused provision was released, and £3 million (2009: £3 million) was paid.

We expect the provision balance to be paid out within the next six years.

Other provisions
Other provisions of £236 million (2009: £174 million) include provisions of £200 million (2009: £143 million) relating to staff benefit schemes which are mostly benefits that will generally be paid out within the next three years. During 2010, another £148 million (2009: £112 million) was provided (including exchange movement of £2 million (2009: £6 million)), £6 million (2009: £10 million) of unused provision was released and £92 million (2009: £54 million) was paid. Other provisions also include £28 million (2009: £27 million) relating to various onerous contracts where, in 2010, an additional £10 million (2009: £15 million) was provided and £8 million (2009: £4 million) was used. Other provisions also include £4 million (2009: £4 million) of regulatory provisions, where £nil (2009: £9 million) was provided, £1 million (2009: £2 million) of unused provision was released and £nil (2009: £3 million) was paid.

Contingencies and related obligations
Litigation regarding the Prudential Staff Pension Scheme (PSPS) and other matters
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 IAS 19 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.

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H14: PROVISIONS AND CONTINGENCIES > CONTINUED

The impact of such changes on the deficit funding obligations of the shareholders' funds of the Group 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 not recognised for IAS 19 Group accounting purposes under IFRIC 14, 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 PAC life fund and shareholder-backed operations 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 the Prudential Staff Pension Scheme and these features are included in note I3.

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 addition to the legal proceedings relating to Jackson mentioned under the legal provisions section above, and PSPS, the Group is involved in other litigation and regulatory issues.

Whilst the outcome of each of the above matters cannot be predicted with certainty, the Company believes that the ultimate outcome of such litigation and regulatory issues will not have a material adverse effect on the Group's financial condition, results of operations, or cash flows.

Pension mis-selling review

The pensions review by the UK insurance regulator of past sales of personal pension policies required all UK life insurance companies to review their cases of potential mis-selling and record a provision for the estimated costs. The Group met the requirement of the FSA to issue offers to all cases by 30 June 2002.

The table below summarises the change in the pension mis-selling provision for the years ended 31 December 2010 and 2009. The change in the provision is included in benefits and claims in the income statement and the movement in unallocated surplus of with-profits funds has been determined accordingly.

	2010 £m	2009 £m
Balance at beginning of year	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 year	314	322

The pension mis-selling provision is included within the liabilities in respect of investment contracts with discretionary participation features under IFRS 4.

The pension mis-selling provision at 31 December 2010 set out above of £314 million is stochastically determined on a discounted basis. The average discount rate implied in the movement in the year is four per cent. The undiscounted amounts at 31 December 2010 expected to be paid in each of the years ending 31 December are as follows:

	2010 £m
Year ended 31 December	
2011	40
2012	10
2013	9
2014	10
2015	9
Thereafter	441
Total undiscounted amount	519
Aggregate discount	(205)
Discounted pension mis-selling provision at 31 December 2010	314

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 including administration costs. 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 (see below). 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.

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

Mortgage endowment products review

In common with several other UK insurance companies, the Group 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. Because of a decrease in expected future investment returns since these products were sold, the FSA is concerned that the maturity value of some of these products will be less than the mortgage debt. 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 Group is exposed to mortgage endowment products in respect of policies issued by Scottish Amicable Life plc (SAL) and the Scottish Amicable Life Assurance Society (SALAS) which were transferred into SAIF. At 31 December 2010, provisions of £2 million (2009: £4 million) in respect of the SAL policies and £20 million (2009: £35 million) in SAIF were held within policyholder liabilities to cover potential compensation in respect of mortgage endowment product mis-selling claims. As SAIF is a separate sub-fund of the Prudential Assurance long-term business fund, wholly attributable to the policyholders of the fund, this provision has no impact on shareholders.

In addition, in the year ended 31 December 2010 Prudential Assurance's main with-profits fund paid compensation of £2 million (2009: £2 million) in respect of mortgage endowment products mis-selling claims and at 31 December 2010 held a provision of £32 million (2009: £47 million) in respect of further compensation. The movement in this provision has no impact on the Group's profit before tax.

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

Guaranteed annuities

Prudential Assurance used to sell guaranteed annuity products in the UK and at 31 December 2010 held a provision of £24 million (2009: £31 million) within the main with-profits fund within policyholder liabilities to honour guarantees on these products. The Group's main exposure to guaranteed annuities in the UK is through SAIF and at 31 December 2010 a provision of £336 million (2009: £284 million) was held in SAIF to honour the guarantees. As SAIF is a separate sub-fund of the Prudential Assurance long-term business fund, wholly attributable to the policyholders of the fund, the movement in this provision has no impact on shareholders.

Other matters

Inherited estate of the PAC long-term fund

The assets of the with-profits sub-fund (WPSF) within the long-term insurance fund of The Prudential Assurance Company Limited (PAC) comprise the amounts that it expects to pay out to meet its obligations to existing policyholders and an additional amount used as working capital. The amount payable over time to policyholders from the 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 PAC to support with-profits business by providing the benefits associated with smoothing and guarantees, by providing investment flexibility for the fund's assets, by meeting the regulatory capital requirements that demonstrate solvency and by absorbing the costs of certain 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.

H: OTHER INFORMATION ON STATEMENT OF FINANCIAL POSITION ITEMS CONTINUED

H14: PROVISIONS AND CONTINGENCIES > CONTINUED

Support for long-term business funds by shareholders' funds

As a proprietary insurance company, PAC 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 Group'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 SALAS, a mutual society, was transferred to PAC. In effecting the transfer, a separate sub-fund, SAIF, was established within PAC'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 SAIF policies. With the exception of certain amounts in respect of the unitised 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 attributable to the policyholders of the fund. Shareholders have no interest in the profits of SAIF but are entitled to the asset management fees paid on this business. With the exception of certain guaranteed annuity products mentioned earlier in this note, and certain products which include a minimum guaranteed rate of accumulation, the majority of SAIF with-profits policies do not guarantee minimum rates of return to policyholders.

Should the assets of SAIF be inadequate to meet the guaranteed benefit obligations to the policyholders of SAIF, the PAC 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 PAC long-term fund or the Group's shareholders' funds having to contribute to SAIF is remote.

Guarantees and commitments

Guarantee funds in both the UK and the US provide for payments to be made to policyholders on behalf of insolvent life insurance companies. These guarantee funds are financed by payments assessed on solvent insurance companies based on location, volume and types of business. The Group estimated its reserve for future guarantee fund assessments for Jackson, included within other liabilities to be £16 million at 31 December 2010 (2009: £15 million). Similar assessments for the UK businesses were not significant. The directors believe that the reserve is adequate for all anticipated payments for known insolvencies.

At 31 December 2010, Jackson has unfunded commitments of £363 million (2009: £339 million) related to its investments in limited partnerships and of £88 million (2009: £89 million) related to commercial mortgage loans. These commitments were entered into in the normal course of business and the directors do not expect a material adverse impact on the operations to arise from them.

Jackson owns debt instruments issued by securitisation trusts managed by PPM America. At 31 December 2010, the support provided by certain forbearance agreements Jackson entered into with the counterparty to certain of these trusts could potentially expose Jackson to maximum losses of £332 million, if circumstances allowed the forbearance period to cease. Jackson believes that, so long as the forbearance period continues, the risk of loss under the agreements is remote.

The Group has provided other guarantees and commitments to third-parties entered into in the normal course of business but the Company does not consider that the amounts involved are significant.

H15: OTHER LIABILITIES

	2010 £m	2009 £m
Creditors arising from direct insurance and reinsurance operations	821	615
Interest payable	66	83
Other items	242	179
TOTAL	1,129	877

I: OTHER NOTES

I1: ACQUISITION OF UNITED OVERSEAS BANK LIFE ASSURANCE LIMITED

On 1 February 2010, the Group acquired from United Overseas Bank (UOB) its 100 per cent interest in UOB Life Assurance Limited in Singapore for total cash consideration, after post-completion adjustments of SGD67 million (£32 million), of SGD495 million (£220 million). As part of the transaction the Group also entered into a long-term strategic partnership to develop a major regional bancassurance business with UOB.

In addition to the amounts above, the Group incurred £2 million of acquisition-related costs (excluding integration costs). These have been excluded from the consideration transferred and have been recognised as an expense in the period, in the consolidated income statement.

Goodwill arising on acquisition

	£m
Cash consideration	220
Less: fair value of identifiable net assets acquired	(79)
Goodwill arising on acquisition	141

Goodwill arose on the acquisition of UOB Life Assurance Limited in Singapore because the acquisition included revenue and cost synergies. These synergies could not be recognised as assets separately from goodwill because they are not capable of being separated from the Group and sold, transferred, licensed, rented or exchanged, either individually or together with any related contracts and did not arise from contractual or other legal rights.

None of the goodwill arising on this transaction is expected to be deductible for tax purposes.

Assets acquired and liabilities assumed at the date of acquisition

	£m
Assets:	
Intangible assets attributable to shareholders: present value of acquired in-force business	12
Other non-investment and non-cash assets	16
Investments of long-term business and other operations	1,004
Cash and cash equivalents	89
Total assets	1,121
Liabilities:	
Policyholder liabilities	968
Other non-insurance liabilities	74
Total liabilities	1,042
FAIR VALUE OF IDENTIFIABLE NET ASSETS ACQUIRED	79

Total assets include loans and receivables with a fair value of £15 million. This value represents the gross contractual amount and all amounts have been collected.

The consolidated statement of cash flows contains a £133 million net cash outflow in respect of this acquisition representing cash consideration of £220 million, acquisition related costs paid of £2 million less cash and cash equivalents acquired of £89 million.

Impact of acquisition on the results of the Group

Included in the Group's consolidated profit before tax for the year is £8 million attributable to UOB Life Assurance Limited in Singapore. Consolidated revenue, including investment returns, for the year includes £125 million in respect of UOB Life Assurance Limited in Singapore.

Had the acquisition been effected at 1 January 2010, the revenue and profit of the Group from continuing operations for the year ended 31 December 2010 would not have been materially different.

I: OTHER NOTES
CONTINUED

I2: DILUTION OF THE GROUP'S HOLDING IN PRUHEALTH IN 2010 AND SALE OF TAIWAN AGENCY BUSINESS IN 2009

a Dilution of the Group's holding in PruHealth in 2010

On 1 August 2010, Discovery Holdings of South Africa, the Group's joint venture partner in its investment in PruHealth, completed the acquisition of the entire share capital of Standard Life Healthcare, a wholly-owned subsidiary of the Standard Life Group, for £138 million. Discovery funded the purchase of the Standard Life Healthcare transaction, and contributed Standard Life Healthcare to PruHealth as a capital investment on completion. As a result of the transaction, Discovery have increased their shareholding in PruHealth from the previous level of 50 per cent to 75 per cent, and Prudential's shareholding has been reduced from 50 per cent of the previous joint venture structure to 25 per cent of the new structure with the much enlarged business.

As a result of this dilution in holding and the consequential loss of control, PruHealth has been reclassified from a joint venture to an associate and the entity is no longer proportionally consolidated from the date of the transaction. In accordance with IAS 31 'Interests in joint ventures' a gain of £30 million arises upon the dilution, representing the difference between the fair value of the enlarged 25 per cent investment still held and the book value of the original 50 per cent investment holding.

b Sale of Taiwan agency business in 2009

In 2009, the Company sold the assets and liabilities of its agency distribution business and its agency force in Taiwan to China Life Insurance Company Ltd of Taiwan for the nominal sum of NT$1. In addition, the Company invested £45 million to purchase a 9.99 per cent stake in China Life through a share placement. The business transferred represented 94 per cent of Prudential's in-force liabilities in Taiwan and included Prudential's legacy interest rate guaranteed products. The sale was completed on 19 June 2009.

The Company retains its interest in life insurance business in Taiwan through its retained bank distribution partnerships and its direct investment in China Life made in 2009. At 31 December 2010 the Company's interest in China Life was 8.66 per cent (2009: 9.99 per cent).

The effect on the IFRS income statement was a pre-tax loss of £621 million comprising a loss on sale of £559 million and trading losses before tax up to the date of sale of £62 million. After allowing for tax and other adjustments, the reduction to shareholders' equity was £607 million.

The loss on disposal of £559 million includes cumulative foreign exchange gains of £9 million recycled through the profit and loss account as required by IAS 21.

Cash and cash equivalents disposed of were £388 million and restructuring and other costs incurred in cash in the year were £64 million. In addition, the Company invested £45 million in China Life as described above. Accordingly, the cash outflow for the Group arising from the sale of the Taiwan agency business, as shown in the consolidated statement of cash flows, was £497 million.

I3: STAFF AND PENSION PLANS

a Staff and employment costs

The average number of staff employed by the Group during the year was:

	2010	2009
Business operations:		
Asian operations	17,988	19,502
US operations	3,545	3,371
UK operations	4,459	4,516
TOTAL	25,992	27,389

The costs of employment were:

	2010 £m	2009 £m
Business operations:		
Wages and salaries	1,052	878
Social security costs	69	61
Other pension costs (see below)	95	95
Pension actuarial and other losses (gains) charged to income statement	26	138
	121	233
TOTAL	1,242	1,172

Other pension costs comprises £58 million (2009: £57 million) relating to defined benefit schemes and £37 million (2009: £38 million) relating to defined contribution schemes of continuing operations. Of the defined contribution scheme costs, £26 million (2009: £27 million) related to overseas defined contribution schemes. The £58 million (2009: £57 million) relating to defined benefit schemes comprises a charge of £27 million (2009: £29 million) relating to PSPS and a charge of £31 million (2009: £28 million) for other schemes.

Consistent with the derecognition of the Company's interest in the underlying IAS 19 surplus of PSPS as described in note (b)(i)1 below, the £27 million (2009: £29 million) for PSPS represents the cash cost of contributions for ongoing service of active members and the unwind of discount on the opening provision for deficit funding for PSPS. The charge of £31 million (2009: £28 million) for other schemes comprises £18 million (2009: £19 million) charge on an economic basis, reflecting the total assets of the schemes, and a further £13 million (2009: £9 million) charge to adjust for amounts invested in Prudential insurance policies to arrive at the IAS 19 basis charge.

The loss of £26 million (2009: £138 million) for actuarial and other gains comprises a loss of £15 million (2009: £155 million) for actuarial and other losses on an economic basis and £11 million actuarial gains (2009: £17 million) to adjust for amounts invested in Prudential insurance policies. The derivation of these amounts is shown in note (b)(i)7.

b Pension plans

i Defined benefit plans

1 Summary

The Group business operations operate a number of pension schemes. The specific features of these plans vary in accordance with the regulations of the country in which the employees are located, although they are, in general, funded by the Group and based either on a cash balance formula or on years of service and salary earned in the last year or years of employment. The largest defined benefit scheme is the principal UK scheme, namely the Prudential Staff Pension Scheme (PSPS); 86 per cent (2009: 86 per cent) of the underlying scheme liabilities of the Group defined benefit schemes are accounted for within PSPS.

The Group also operates two smaller defined benefit schemes for UK employees in respect of Scottish Amicable and M&G. For all three schemes the projected unit method was used for the most recent full actuarial valuations. There is also a small defined benefit scheme in Taiwan but as part of the sale of the Taiwan agency business completed in June 2009, the Group settled the majority of the obligations under the scheme as a significant number of employees transferred out.

Defined benefit schemes in the UK are generally required to be subject to full actuarial valuation every three years in order to assess the appropriate level of funding for schemes in relation 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 2008. 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. No formal deficit funding plan was required. However, in recognition of the fall in value of the Scheme's investments between 5 April 2008 and the completion of the actuarial valuation, an additional funding akin to deficit funding was agreed with the Trustees. This is subject to a reassessment when the next valuation is completed. The total contribution being currently made by the Group into the scheme, representing the annual accrual cost and deficit fundings, are £50 million per annum. Deficit funding for PSPS is apportioned in the ratio of 70/30 between the PAC life fund and shareholder-backed operations following detailed consideration in 2005 of the sourcing of previous contributions. Employer contributions for ongoing service of current employees are apportioned in the ratio relevant to current activity. In 2010, total contributions for the year including expenses and augmentations were £55 million at 31 December (2009: £67 million). The market value of scheme assets as at 5 April 2008 was £4,759 million.

The actuarial assumptions used in determining benefit obligations and the net periodic benefit costs for the purposes of the valuation were as follows:

Rate of increase in salaries	Nil
Rate of inflation	3.5%
Rate of increase of pensions in payment for inflation:	
Guaranteed (maximum 5%)	3.5%
Guaranteed (maximum 2.5%)	2.5%
Discretionary	Nil
Expected returns on plan assets	4.55%

Mortality assumptions

The tables used for PSPS pensions in payment at 5 April 2008 were:

Base post retirement mortality:

For current male (female) pensioners 108.6 per cent (103.4 per cent) of the mortality rates of the 2000 series mortality tables, published by the Continuous Mortality Investigation Bureau. For male (female) non-pensioners 113.4 per cent (97.4 per cent) of the 2000 series rates.

Allowance for future improvements to post retirement mortality:

For males (females) 100 per cent (75 per cent) of Medium Cohort subject to a minimum rate of improvement of 1.75 per cent (1 per cent) up to the age of 90, decreasing linearly to zero by age of 120.

I: OTHER NOTES
CONTINUED

I3: STAFF AND PENSION PLANS > CONTINUED

The valuation of the Scottish Amicable Pension Scheme as at 31 March 2008 demonstrated the scheme to be 91 per cent funded, with a shortfall of actuarially determined liabilities of nine per cent, representing a deficit of £38 million. Based on this valuation, deficit funding amounts designed to eliminate the actuarial deficit over a seven year period were made from July 2009 of £7.3 million per annum. Since the valuation date, there has been deterioration in the funding level. During 2010, the Group agreed to pay additional funding of £5.8 million 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. The IAS 19 deficit of the Scottish Amicable Pension Scheme at 31 December 2010 of £146 million (2009: £139 million) has been allocated approximately 50 per cent to the PAC with-profits fund and 50 per cent to the shareholders' fund.

The valuation of the M&G Pension Scheme as at 31 December 2008 was finalised in January 2010 and demonstrated the scheme to be 76 per cent funded. Based on this valuation, deficit funding amounts designed to eliminate the actuarial deficit over a five year period are being made from January 2010 of £14.1 million per annum for the first two years and £9.3 million per annum for the subsequent three years. The IAS 19 deficit of the M&G Pension Scheme on an economic basis at 31 December 2010 was £27 million (2009: £36 million) and is wholly attributable to shareholders.

The next triennial valuations for the PSPS, Scottish Amicable and M&G pension schemes are scheduled to take place by 5 April 2011, 31 March 2011 and 31 December 2011.

Under the IAS 19 valuation basis, the Group applies IFRIC 14, 'IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'. Under IFRIC 14, for PSPS, where the Group does not have unconditional right of refund to any surplus in the scheme, the surplus is not recognised. Additionally, the Group has to recognise a liability for committed deficit funding obligation to PSPS. At 31 December 2010, the Group has not recognised the underlying PSPS surplus of £485 million gross of deferred tax (2009: £513 million) and has recognised a liability for deficit funding to 30 June 2012 for PSPS of £47 million, gross of deferred tax (2009: £75 million).

The asset and liabilities of PSPS are unaffected by the impact of the application of IFRIC 14. PSPS is managed on an economic basis for the longer-term benefit of its current and deferred pensioners and active members. The surplus in PSPS is available to absorb future adverse asset value movements and, if required, strengthening in mortality assumptions.

As at 31 December 2010, after the effect of the application of IFRIC 14, the shareholders' share of the pension liability for PSPS deficit funding obligation and the deficits of the defined benefit pension schemes amounted to a £83 million liability net of related tax relief (2009: £92 million). These amounts are determined after including amounts invested by the M&G scheme in Prudential policies as explained later in this note.

On the economic basis (including investments of the M&G scheme in Prudential policies as assets), for 2010, a £27 million (2009: £32 million) pre-tax shareholder charge to operating results based on longer-term returns arises. In addition, outside the operating result but included in total profits is a pre-tax shareholder loss of £10 million (2009: £74 million) for shareholders' share of actuarial and other gains and losses.

In addition, also on the economic basis, the PAC with-profits sub-fund was charged £18 million (2009: charge of £16 million) for its share of the pension charge of PSPS and Scottish Amicable and charged with £5 million (2009: £81 million) for its share of net actuarial and other losses on the scheme assets and liabilities. As shareholder profits for the PAC with-profits sub-fund reflects the surplus for distribution, these amounts are effectively absorbed by an increased credit in the income statement for the transfer to the liability for unallocated surplus.

At 31 December 2010, after the effect of the application of IFRIC 14, the total share of the liability for deficit funding on PSPS and the deficit on the smaller Scottish Amicable Scheme attributable to the PAC with-profits fund amounted to a liability of £99 million (2009: £110 million) net of related tax relief.

2 Corporate governance

The rules of the Group's largest pension arrangement, 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 asset 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 Prudential Assurance 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 two UK defined benefit schemes, the M&G Group Pension Scheme and the Scottish Amicable Staff Pension Scheme, which are both final salary schemes, follow similar principles, but have different target allocations reflecting the particular requirements of the schemes.

3 Assumptions

The actuarial assumptions used in determining benefit obligations and the net periodic benefit costs for the years ended 31 December were as follows:

	2010 %	2009 %
Discount rate*	5.45	5.8
Rate of increase in salaries	5.55	5.7
Rate of inflation	3.55	3.7
Rate of increase of pensions in payment for inflation:		
Guaranteed (maximum 5%)	3.55	3.7
Guaranteed (maximum 2.5%)†	2.5	2.5
Discretionary†	2.5	2.5
Expected returns on plan assets	5.9	4.5

* The discount rate has been determined by reference to an 'AA' corporate bond index adjusted, where applicable, to allow for the difference in duration between the index and the pension liabilities.
† The rates of 2.5 per cent shown are those for PSPS. Assumed rates of increase of pensions in payment for inflation for all other schemes are 3.55 per cent in 2010 (2009: 3.7 per cent).

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 was 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 PNMA00 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 PNFA00 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: 108.6 per cent PNMA00 with medium cohort improvements subject to a floor of 1.75 per cent up to the age of 90, decreasing linearly to zero by age of 120; and
Female: 103.4 per cent PNFA00 with 75 per cent medium cohort improvements subject to a floor of 1.00 per cent up to the age of 90 and decreasing linearly to zero by 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 scheme actuaries being Towers Watson for the valuation of PSPS, Aon Consulting Limited for the M&G scheme, and Xafinity Consulting for the Scottish Amicable scheme, the most recent full valuations have been updated to 31 December 2010, applying the principles prescribed by IAS 19.

I: OTHER NOTES
CONTINUED

I3: STAFF AND PENSION PLANS > CONTINUED

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 that 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 Group's UK 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.

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. Using the underlying information as at 31 December 2010, the estimated effect of such a change would give rise to an accounting benefit of approximately £30 million to the Group's operating profit based on longer-term investment returns and profit attributable to shareholders before tax and £20 million shareholders' equity.

4 Summary financial position

The Group liability in respect of defined benefit pension schemes is as follows:

	2010 £m	**2009** £m
Economic position:		
Deficit, gross of deferred tax, based on scheme assets held, including investments in Prudential insurance policies:		
Attributable to the PAC with-profits fund (i.e. absorbed by the liability for unallocated surplus)	(106)	(122)
Attributable to shareholder-backed operations (i.e. to shareholders' equity)	(114)	(128)
Economic deficit – as explained in note 5 below	(220)	(250)
Exclude: investments in Prudential insurance policies (offset on consolidation in the Group financial statements against insurance liabilities)	(227)	(187)
Deficit under IAS 19 included in provisions in the statement of financial position – as explained in note 7 below	(447)	(437)

The following disclosures explain the economic position and IAS 19 basis of accounting after eliminating investment in Prudential insurance policies on consolidation.

5 Group economic financial position

The following tables illustrate the movement on the financial position of the Group's defined benefit pension schemes on an economic basis. The underlying position on an economic basis reflects the assets (including investments in Prudential policies that are offset against liabilities to policyholders on the Group consolidation) and the liabilities of the schemes. At 31 December 2010, the investments in Prudential policies comprise £118 million (2009: £101 million) for PSPS and £227 million (2009: £187 million) for the M&G scheme.

Separately, the economic financial position also includes the effect of the application of IFRIC 14, 'IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'. For PSPS, where there are constraints in the trust deed to prevent the company access, the surplus is not recognised and a liability to additional funding is established (as described earlier).

Estimated pension scheme deficit – economic basis

Movements on the pension scheme deficit (determined on the 'economic basis') are as follows, with the effect of the application of IFRIC 14 being shown separately:

	2010 £m				
		(Charge) credit to income statement			
	Surplus (deficit) in scheme at 1 January 2010	Operating results (based on longer-term investment returns) note a	Actuarial and other gains and losses note b	Contributions paid	Surplus (deficit) in scheme at 31 Dec 2010 note c
ALL SCHEMES					
UNDERLYING POSITION (WITHOUT THE EFFECT OF IFRIC 14)					
Surplus (deficit)	338	(7)	(109)	90	312
Less: amount attributable to PAC with-profits fund	(285)	(11)	71	(39)	(264)
Shareholders' share:					
Gross of tax surplus (deficit)	53	(18)	(38)	51	48
Related tax	(15)	5	11	(14)	(13)
Net of shareholders' tax	38	(13)	(27)	37	35
EFFECT OF IFRIC 14					
Surplus (deficit)	(588)	(38)	94	–	(532)
Less: amount attributable to PAC with-profits fund	407	29	(66)	–	370
Shareholders' share:					
Gross of tax surplus (deficit)	(181)	(9)	28	–	(162)
Related tax	51	2	(9)	–	44
Net of shareholders' tax	(130)	(7)	19	–	(118)
WITH THE EFFECT OF IFRIC 14					
Surplus (deficit)	(250)	(45)	(15)	90	(220)
Less: amount attributable to PAC with-profits fund	122	18	5	(39)	106
Shareholders' share:					
Gross of tax surplus (deficit)	(128)	(27)	(10)	51	(114)
Related tax	36	7	2	(14)	31
Net of shareholders' tax	(92)	(20)	(8)	37	(83)

I: OTHER NOTES CONTINUED

I3: STAFF AND PENSION PLANS > CONTINUED

	2009 £m					
		(Charge) credit to income statement				
	Surplus (deficit) in scheme at 1 January 2009	Operating results (based on longer-term investment returns) note a	Actuarial and other gains and losses note b	Contributions paid	Disposal of Taiwan agency business*	Surplus (deficit) in scheme at 31 Dec 2009 note c
ALL SCHEMES UNDERLYING POSITION (WITHOUT THE EFFECT OF IFRIC 14)						
Surplus (deficit)	644	(71)	(337)	85	17	338
Less: amount attributable to PAC with-profits fund	(483)	33	207	(42)	–	(285)
Shareholders' share:						
Gross of tax surplus (deficit)	161	(38)	(130)	43	17	53
Related tax	(47)	11	36	(11)	(4)	(15)
Net of shareholders' tax	114	(27)	(94)	32	13	38
EFFECT OF IFRIC 14						
Surplus (deficit)	(793)	23	182	–	–	(588)
Less: amount attributable to PAC with-profits fund	550	(17)	(126)	–	–	407
Shareholders' share:						
Gross of tax surplus (deficit)	(243)	6	56	–	–	(181)
Related tax	68	(2)	(15)	–	–	51
Net of shareholders' tax	(175)	4	41	–	–	(130)
WITH THE EFFECT OF IFRIC 14						
Surplus (deficit)	(149)	(48)	(155)	85	17	(250)
Less: amount attributable to PAC with-profits fund	67	16	81	(42)	–	122
Shareholders' share:						
Gross of tax surplus (deficit)	(82)	(32)	(74)	43	17	(128)
Related tax	21	9	21	(11)	(4)	36
Net of shareholders' tax	(61)	(23)	(53)	32	13	(92)

* Including the effect of exchange translation difference.

a The components of the (charge) credit to operating results (gross of allocation of the share attributable to the PAC with-profits fund) are as follows:

	2010 £m	2009 £m
Service cost	(38)	(34)
Finance (expense) income:		
Interest on pension scheme liabilities	(294)	(277)
Expected return on assets	325	240
Total (charge) credit without the effect of IFRIC 14	(7)	(71)
Effect of IFRIC 14 for pension schemes	(38)	23
Total charge after the effect of IFRIC 14	(45)	(48)

The net charge to operating profit (gross of the share attributable to the PAC with-profits fund) of £45 million (2009: £48 million) is made up of a charge of £27 million (2009: £29 million) relating to PSPS and a charge of £18 million (2009: £19 million) for other schemes. This net charge represents:

	2010 £m	**2009** £m
Underlying IAS 19 charge for other pension schemes	(18)	(19)
Cash costs for PSPS	(23)	(25)
Unwind of discount on opening provision for deficit funding for PSPS	(4)	(4)
	(45)	(48)

Consistent with the derecognition of the Company's interest in the underlying IAS 19 surplus of PSPS, the charge to operating profit on longer-term investment returns for PSPS reflects the cash cost of contributions for ongoing service of active members. In addition, the charge to the operating results also includes a charge for the unwind of discount on the opening provision for deficit funding for PSPS.

b The components of the credit (charge) for actuarial and other gains and losses (gross of allocation of the share attributable to the PAC with-profits fund but excluding the charge relating to the sold Taiwan agency business) are as follows:

	2010 £m	**2009** £m
Actual less expected return on assets	306	108
Losses on changes of assumptions for plan liabilities	(411)	(521)
Experience (losses) gains on liabilities	(4)	76
Total charge without the effect of IFRIC 14	(109)	(337)
Effect of IFRIC 14 for pension schemes	94	182
Actuarial and other gains and losses after the effect of IFRIC 14	(15)	(155)

The net charge for actuarial and other gains and losses is recorded within the income statement but, within the segmental analysis of profit, the shareholders' share of actuarial and other gains and losses (i.e. net of allocation of the share to the PAC with-profits funds) is excluded from operating profit based on longer-term investment returns.

The 2010 actuarial losses of £109 million primarily reflects the effect of decrease in risk discount rates and the change in economic assumptions underlying PSPS commutation factors partially offset by the effect of decreases in inflation rates and the excess of market returns over long-term assumptions.

Consistent with the derecognition of the Company's interest in the underlying IAS 19 surplus of PSPS, the actuarial gains and losses do not include those of PSPS. In addition, as a result of applying IFRIC 14, the Group has recognised a provision for deficit funding in respect of PSPS. The change in 2010 in relation to this provision recognised above as other gains and losses on defined benefit pension schemes was £nil (2009: £48 million).

I: OTHER NOTES CONTINUED

I3: STAFF AND PENSION PLANS > CONTINUED

c On the 'economic basis', after including the underlying assets represented by the investments in Prudential insurance policies as scheme assets, the underlying statements of financial position of the schemes at 31 December were:

	2010				2009			
	PSPS £m	Other schemes note iii £m	Total £m	%	PSPS £m	Other schemes note iii £m	Total £m	%
Equities	548	277	825	14	830	266	1,096	20
Bonds	3,864	339	4,203	70	3,406	280	3,686	67
Properties	199	29	228	4	272	15	287	5
Cash-like investments[note i]	740	8	748	12	441	2	443	8
Total value of assets	5,351	653	6,004	100	4,949	563	5,512	100
Present value of benefit obligations	(4,866)	(826)	(5,692)		(4,436)	(738)	(5,174)	
	485	(173)	312		513	(175)	338	
Effect of the application of IFRIC 14 for pension schemes:								
Derecognition of PSPS surplus	(485)	–	(485)		(513)	–	(513)	
Adjust for deficit funding for PSPS	(47)	–	(47)		(75)	–	(75)	
Pre-tax deficit[note ii]	(47)	(173)	(220)		(75)	(175)	(250)	

Notes

i The PSPS has entered into a derivatives based strategy to match the duration and inflation profile of its liabilities. This involved a reallocation from other investments to cash-like investments with an interest and inflation swap overlay. In broad terms, the scheme is committed to making a series of payments related to LIBOR on a nominal amount and in return the scheme receives a series of fixed and inflation-linked payments which match a proportion of its liabilities. As at 31 December 2010, the nominal value of the interest and inflation-linked swaps amounted to £1.1 billion (2009: £1.1 billion) and £1.8 billion (2009: £1.9 billion) respectively.

ii The resulting scheme deficit arising from the excess of liabilities over assets at 31 December 2010 of £220 million (2009: £250 million) comprised a deficit of £106 million (2009: £122 million) attributable to the PAC with-profits fund and deficit of £114 million (2009: £128 million) attributable to shareholder operations.

iii In addition to PSPS, there are two smaller schemes in the UK, the Scottish Amicable Pension Scheme, and the M&G Pension Scheme, with a combined deficit at 31 December 2010 of £173 million (2009: £175 million), gross of tax. There is also a small scheme in Taiwan, with a negligible amount of deficit at 31 December 2010 and 2009. As part of the sale of the Taiwan agency business in June 2009 the Group has settled the majority of the obligations under the Taiwan scheme relating to the employees who were transferred out.

The movements in the deficit on the 'economic basis' between scheme assets and liabilities were:

	2010 £m	2009 £m
Current service cost	(13)	(11)
Other finance income	(5)	(8)
Cash costs and unwind of discount on opening provision for deficit funding for PSPS	(27)	(29)
Contributions	90	85
Actuarial and other gains and losses	(15)	(155)
Movement due to the sold Taiwan agency business and exchange translation difference	–	17
Net increase (decrease) in deficit	30	(101)

6 Movement in IAS 19 basis financial position

The change in the present value of the benefit obligation and the change in fair value of the assets for the total of the PSPS, Scottish Amicable, M&G and Taiwan schemes over the period were as follows:

	2010 £m					
	PSPS	Other schemes				Total
	Provision for deficit funding	IAS 19 basis: change in fair value of plan assets	Investments in Prudential insurance policies	Economic basis: total assets	IAS 19 basis: change in present value of benefit obligations	Economic basis: net obligations
Fair value of plan assets, beginning of year		376	187	563		563
Present value of benefit obligation, beginning of year					(738)	(738)
Provision for deficit funding for PSPS	(75)					(75)
	(75)	376	187	563	(738)	(250)
Service cost – current charge only					(13)	(13)
Interest cost					(43)	(43)
Expected return on plan assets		25	13	38		38
Employee contributions			1	1	(1)	–
Employer contributions	55	15	20	35		90
Actuarial gains (losses)		20	11	31	(46)	(15)
Benefit payments		(10)	(5)	(15)	15	
Cash costs and unwind of discount on the opening provision for deficit funding for PSPS	(27)					(27)
Fair value of plan assets, end of year		426	227	653		653
Present value of benefit obligation, end of year					(826)	(826)
Provision for deficit funding of PSPS	(47)					(47)
Economic basis deficit						(220)

I: OTHER NOTES
CONTINUED

I3: STAFF AND PENSION PLANS > CONTINUED

	2009 £m					
	PSPS	Other schemes				Total
	Provision for deficit funding	IAS 19 basis: change in fair value of plan assets	Investments in Prudential insurance policies	Economic basis: total assets	IAS 19 basis: change in present value of benefit obligations	Economic basis: net obligations
Fair value of plan assets, beginning of year		357	157	514		514
Present value of benefit obligation, beginning of year					(598)	(598)
Provision for deficit funding for PSPS	(65)					(65)
	(65)	357	157	514	(598)	(149)
Service cost – current charge only					(11)	(11)
Interest cost					(35)	(35)
Expected return on plan assets		18	9	27		27
Employee contributions			1	1	(1)	–
Employer contributions	67	9	9	18		85
Actuarial gains (losses)		6	17	23	(130)	(107)
Benefit payments		(11)	(6)	(17)	17	–
Cash costs and unwind of discount on the opening provision for deficit funding for PSPS	(29)					(29)
Movement in the provision for deficit funding for PSPS	(48)					(48)
Disposal of Taiwan agency business, including exchange translation difference		(3)		(3)	20	17
Fair value of plan assets, end of year		376	187	563		563
Present value of benefit obligation, end of year					(738)	(738)
Provision for deficit funding of PSPS	(75)					(75)
Economic basis deficit						(250)

7 IAS 19 basis financial position as consolidated

The IAS 19 basis pensions deficit can be summarised as follows:

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Fair value of plan assets, end of year	**5,659**	5,224	5,057	5,150	4,988
Present value of funded benefit obligation	**(5,438)**	(4,951)	(4,493)	(4,826)	(5,023)
Funded status	**221**	273	564	324	(35)
Present value of unfunded obligations (M&G scheme)*	**(254)**	(223)	(180)	(189)	(187)
	(33)	50	384	135	(222)
Effect of the application of IFRIC 14 for pension schemes					
Derecognition of PSPS' surplus	**(485)**	(513)	(728)	(528)	(141)
Set up obligation for deficit funding for PSPS	**(47)**	(75)	(65)	(102)	(143)
Adjustment in respect of investment of PSPS in Prudential policies	**118**	101	103	140	126
Deficit recognised in the statement of financial position	**(447)**	(437)	(306)	(355)	(380)

* The M&G pension scheme assets are invested in Prudential insurance policies. For IFRS accounting purposes, the M&G scheme is in effect unfunded. Please see above for more details.

	2010 £m	2009 £m
COMPONENTS OF NET PERIODIC PENSION COST		
Current service cost	(38)	(34)
Interest cost	(294)	(277)
Expected return on assets – economic basis	325	240
Less: expected return on investments of scheme assets in Prudential insurance policies	(21)	(16)
Expected return on assets – IAS 19 basis†	304	224
	(28)	(87)
Effect of the application of IFRIC 14	(30)	30
Pension cost (as referred to in note I3a)	(58)	(57)
Actuarial gains and losses – economic basis	(109)	(337)
Less: actuarial gains on investments of scheme assets in Prudential insurance policies	(20)	8
	(129)	(329)
Effect of the application of IFRIC 14	103	191
Actuarial gains and losses – IAS 19 basis* (as referred to in note I3a)	(26)	(138)
Net periodic pension cost (included within acquisition and other operating expenditure in the income statement)	(84)	(195)

* Consistent with the derecognition of the Company's interest in the underlying IAS 19 surplus of PSPS, the effect on the net periodic pension cost for PSPS was to replace the usual IAS 19 pension charges and credits with the cash cost of contribution for ongoing services of active members and also not to report the actuarial gains and losses.

† In determining the expected return on scheme assets for 2010, the 5.9 per cent (2009: 4.5 per cent) rate shown below has been applied to the opening assets.

The long-term expected rate of return has been taken to be the weighted average (by market value) of the long-term expected rates of return on each major asset class shown below:

	2010		2009		2008		2007		2006	
	£m	%	£m	%	£m	%	£m	%	£m	%
SCHEME ASSETS (IAS 19 BASIS BEFORE EFFECT OF IFRIC 14)										
Equity	610	11	917	18	875	17	1,332	26	1,432	29
Bonds	4,095	72	3,587	69	2,619	52	1,299	25	2,185	44
Properties	206	4	278	5	290	6	583	11	621	12
Cash-like investments	748	13	442	8	1,273	25	1,936	38	750	15
Total	5,659	100	5,224	100	5,057	100	5,150	100	4,988	100

	Prospectively for 2011 %	2010 %	2009 %
LONG-TERM EXPECTED RATE OF RETURN			
Equity	8.2	8.5	6.8
Bonds	4.6	5.3	4.8
Properties	6.9	6.75	6.05
Cash-like investments	4.75	4.75	2.0
Weighted average long-term expected rate of return	5.1	5.9	4.5

The expected rates of return have been determined by reference to long-term expectations, the carrying value of the assets and equity and other market conditions at the statement of financial position date.

The actual return on scheme assets was a gain of £631 million (2009: £348 million) on an IAS 19 basis.

I: OTHER NOTES CONTINUED

I3: STAFF AND PENSION PLANS > CONTINUED

None of the scheme assets included shares in Prudential plc or property occupied by the Prudential Group.

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
Fair value of scheme assets, end of year (IAS 19 basis)	5,659	5,224	5,057	5,150	4,988
Present value of the benefit obligation, end of year	(5,692)	(5,174)	(4,673)	(5,015)	(5,210)
Underlying scheme assets in surplus (deficit) of benefit obligation, before the effect of IFRIC 14	(33)	50	384	135	(222)
Experience adjustments on scheme liabilities	(4)	76	145	(14)	18
Percentage of scheme liabilities at 31 December	(0.07)%	1.47%	3.10%	0.28%	(0.35)%
Experience adjustments on scheme assets (IAS 19 basis)	287	100	(277)	(7)	140
Percentage of scheme assets at 31 December	5.07%	1.91%	(5.48)%	(0.14)%	2.81%

The experience adjustments on scheme liabilities in 2008 of a gain of £145 million related mainly to the 'true up' reflecting improvements in data consequent upon the 2008 triennial valuation of PSPS.

Total employer contributions expected to be paid into the Group defined benefit schemes for the year ending 31 December 2011 amounts to £94 million (2010: £88 million).

8 Sensitivity of the pension scheme liabilities of the PSPS, Scottish Amicable and M&G pension schemes to key variables

The table below shows the sensitivity of the underlying PSPS, Scottish Amicable and M&G pension scheme liabilities at 31 December 2010 of £4,866 million, £572 million and £254 million respectively (2009: £4,436 million, £515 million and £223 million) to changes in discount rates and inflation rates. In addition, the table below shows the sensitivity of the underlying PSPS, Scottish Amicable and M&G pension scheme liabilities at 31 December 2010 to changes to mortality rate assumptions.

2010

Assumption	Change in assumption	Impact on scheme liabilities on IAS 19 basis	
Discount rate	Decrease by 0.2% from 5.45% to 5.25%	Increase in scheme liabilities by:	
		PSPS	3.6%
		Scottish Amicable	5.2%
		M&G	5.1%
Discount rate	Increase by 0.2% from 5.45% to 5.65%	Decrease in scheme liabilities by:	
		PSPS	3.5%
		Scottish Amicable	4.9%
		M&G	4.8%
Rate of inflation	Decrease by 0.2% from 3.55% to 3.35% with consequent reduction in salary increases	Decrease in scheme liabilities by:	
		PSPS	1.0%
		Scottish Amicable	5.0%
		M&G	4.5%
Mortality rate	Increase life expectancy by one year	Increase in scheme liabilities by:	
		PSPS	2.1%
		Scottish Amicable	2.5%
		M&G	2.9%

2009

Assumption	Change in assumption	Impact on scheme liabilities on IAS 19 basis	
Discount rate	Decrease by 0.2% from 5.8% to 5.6%	Increase in scheme liabilities by:	
		PSPS	3.5%
		Scottish Amicable	5.2%
		M&G	4.9%
Discount rate	Increase by 0.2% from 5.8% to 6.0%	Decrease in scheme liabilities by:	
		PSPS	3.2%
		Scottish Amicable	4.8%
		M&G	4.9%
Rate of inflation	Decrease by 0.2% from 3.7% to 3.5% with consequent reduction in salary increases	Decrease in scheme liabilities by:	
		PSPS	0.9%
		Scottish Amicable	4.9%
		M&G	4.5%

The sensitivity of the underlying pension scheme liabilities to changes in discount, inflation and mortality rates as shown above does not directly equate to an impact on the profit or loss attributable to shareholders or shareholders' equity due to the effect of the application of IFRIC 14 on PSPS and the allocation of a share of the interest in financial position of the PSPS and Scottish Amicable schemes to the PAC with-profits fund as described above.

The sensitivity to the changes in the key variables as shown in the table above has no significant impact on the pension costs included in the Group's operating results. This is due to the pension costs charged in each of the periods presented being derived largely from market conditions at the beginning of the period. After applying IFRIC 14 and to the extent attributable to shareholders, any residual impact from the changes to these variables is reflected as actuarial gains and losses on defined benefit pension schemes within the supplementary analysis of profits. The relevance of this to each of the three UK schemes is described further below.

For PSPS, the underlying surplus of the scheme of £485 million (2009: £513 million) has not been recognised under IFRIC 14. Any change in the underlying scheme liabilities to the extent that it is not sufficient to alter PSPS into a liability in excess of the deficit funding provision will not have an impact on the Group's results and financial position. Based on the underlying financial position of PSPS as at 31 December 2010, none of the changes to the underlying scheme liabilities for the changes in the variables shown in the table above have had an impact on the Group's 2010 results and financial position.

In the event that a change in the PSPS scheme liabilities results in a deficit position for the scheme which is recognisable, the deficit recognised affects the Group's results and financial position only to the extent of the amounts attributable to shareholder operations. The amounts attributable to the PAC with-profits fund are absorbed by the liability for unallocated surplus and have no direct effect on the profit or loss attributable to shareholders or shareholders' equity.

The deficit of the Scottish Amicable pension scheme has been allocated approximately 50 per cent to the PAC with-profits fund and 50 per cent to the shareholders. Accordingly, half of the changes to the scheme liabilities for the changes in the variables shown in the table above would have had an impact on the Group's shareholder results and financial position. The M&G pension scheme is wholly attributable to shareholders.

9 Transfer value of PSPS scheme

At 31 December 2010, it is estimated that the assets of the scheme are broadly sufficient to cover the liabilities of PSPS on a 'buyout' basis including an allowance for expenses. The 'buyout' basis refers to a basis that might apply in the circumstance of a transfer to another appropriate financial institution. In making this assessment it has been assumed that a more conservative investment strategy applies together with a more prudent allowance for future mortality improvements and no allowance for discretionary pension increases.

ii Other pension plans

The Group operates various defined contribution pension schemes including schemes in Jackson and Asia. The cost of the Group's contributions for continuing operations to these schemes in 2010 was £37 million (2009: £38 million).

I4: SHARE-BASED PAYMENTS

The Group maintains 10 main 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 Group 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. Beginning in 2010, newly issued shares will be used in settling the awards that vest and are released.

The RSP was, until March 2006, the Group's 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.

I: OTHER NOTES CONTINUED

I4: SHARE-BASED PAYMENTS > CONTINUED

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 in the UK, Jackson and Asia including the Chief Executive Officers. 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 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.

The Group maintains four share option schemes satisfied by the issue of new shares. UK-based executive directors are eligible to participate in the Prudential HM Revenue & 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. Dublin-based employees are eligible to participate in the Prudential International Assurance Sharesave Plan, and Hong Kong-based agents can participate in the Non-employee Savings Related Share Option Scheme. The schemes allow participants 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. Participants 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.

UK-based executive directors are also eligible to participate in the Company's HMRC approved Share Incentive Plan 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.

Jackson operates a performance-related share award which, subject to the prior approval of the Jackson Remuneration Committee, may grant share awards to eligible Jackson employees in the form of a contingent right to receive shares or a conditional allocation of shares. These share awards have vesting periods of four years and are at nil cost to the employee. Award holders do not have any right to dividends or voting rights attaching to the shares. The shares are held in the employee share trust in the form of American Depository Receipts which are tradable on the New York Stock Exchange.

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). 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 except for countries where share awards are not feasible due to securities and/or tax reasons, where awards will be replaced by the cash value of the shares that would otherwise have been transferred.

Certain senior executives have annual incentive plans with awards paid in cash up to the target level of their plan. The portion of any award for above target performance is made in the form of awards of shares deferred for three years, with the release of shares subject to close periods. The shares are held in the employee share trust and shares equivalent to dividends otherwise payable will accumulate for the benefit of award holders during the deferral period up to the release date.

In addition, there are other share awards including the Prudential Corporation Asia Deferred Bonus Plan (PCA DBP), Prudential Capital Deferred Bonus Plan (PruCap DBP) 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 in order to secure their appointment or ensure retention.

Options outstanding under SAYE schemes	2010 Number of options millions	2010 Weighted average exercise price £	2009 Number of options millions	2009 Weighted average exercise price £
Beginning of year:	12.2	3.20	6.8	4.54
Granted	2.2	4.61	10.7	2.96
Exercised	(0.6)	3.15	(0.4)	3.98
Forfeited	(0.2)	3.44	(0.5)	3.87
Cancelled	(0.5)	3.37	(3.8)	4.58
Lapsed	(0.3)	3.89	(0.6)	4.42
End of year	12.8	3.40	12.2	3.20
Options immediately exercisable, end of year	0.2	5.52	0.3	4.45

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:

Awards outstanding under incentive plans including conditional options	2010 Number of awards millions	2009 Number of awards millions
Beginning of year:	19.2	14.5
Granted	11.2	11.1
Exercised	(4.7)	(3.4)
Forfeited	(1.2)	(1.0)
Expired	(0.6)	(2.0)
End of year	23.9	19.2

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

Range of exercise prices	Outstanding: Number outstanding millions	Outstanding: Weighted average remaining contractual life years	Outstanding: Weighted average exercise prices £	Exercisable: Number exercisable millions	Exercisable: Weighted average exercise prices £
Between £0 and £1	–	–	–	–	–
Between £1 and £2	–	–	–	–	–
Between £2 and £3	9.0	2.6	2.88	–	–
Between £3 and £4	0.1	1.3	3.59	–	3.67
Between £4 and £5	3.3	3.3	4.51	–	4.07
Between £5 and £6	0.4	1.0	5.59	0.2	5.63
Between £6 and £7	–	–	–	–	–
Between £7 and £8	–	–	–	–	–
	12.8	2.8	3.40	0.2	5.52

I: OTHER NOTES CONTINUED

I4: SHARE-BASED PAYMENTS > CONTINUED

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

Range of exercise prices	Outstanding: Number outstanding millions	Outstanding: Weighted average remaining contractual life years	Outstanding: Weighted average exercise prices £	Exercisable: Number exercisable millions	Exercisable: Weighted average exercise prices £
Between £0 and £1	–	–	–	–	–
Between £1 and £2	–	–	–	–	–
Between £2 and £3	10.0	3.6	2.88	–	–
Between £3 and £4	0.1	1.0	3.62	0.1	3.43
Between £4 and £5	1.5	3.0	4.37	0.2	4.73
Between £5 and £6	0.6	1.9	5.60	0.0	5.65
Between £6 and £7	–	–	–	–	–
Between £7 and £8	–	–	–	–	–
	12.2	3.4	3.20	0.3	4.45

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 £ Weighted average fair value			2009 £ Weighted average fair value		
	GPSP	SAYE Options	Awards	GPSP	SAYE Options	Awards
	2.74	2.91	5.14	3.52	1.55	4.67

The fair value amounts relating to all options including conditional nil cost options above 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 (%)	42.69	64.65	56.21	60.55
Risk-free interest rate (%)	1.70	1.07	1.92	2.15
Expected option life (years)	3.00	3.49	3.00	3.67
Weighted average exercise price (£)	–	4.61	–	2.96
Weighted average share price (£)	5.70	6.38	4.83	3.82

Under IFRS, 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 are valued using the share price at the date of grant. The compensation costs for all awards and options are recognised in net income over the plans' respective vesting periods. The Group uses the Black-Scholes model to value all options and awards other than the GPSP, for which the Group uses a Monte Carlo model in order to allow for the impact of the TSR performance conditions. These models are used to calculate fair values for share options and awards at the grant date 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 and five-year terms to match corresponding vesting periods. Dividend yield is determined as the average yield over the year of grant and expected dividends are not incorporated into the measurement of fair value. For the GPSP, volatility and correlation between Prudential and an index constructed from a simple average of the TSR growth of 11 companies is required. For grants in 2010, an average index volatility and correlation of 35 per cent and 82 per cent 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.

During the year, the Group granted share options to certain non-employee independent financial advisors. Those options were measured using the Black-Scholes option pricing model with assumptions consistent with those of other share options. These transactions were measured using an option model because the Group does not receive a separate and measurable benefit from those non-employees in exchange for the options granted. As such, the fair value of the options themselves is more readily determinable than the services received in return.

c Total share-based payment expense

Total expense recognised in the year in the consolidated financial statements related to share-based compensation is as follows:

	2010 £m	2009 £m
Share-based compensation expense	47	37
Amount accounted for as equity-settled	37	29
Carrying value at 31 December of liabilities arising from share-based payment transactions	17	13
Intrinsic value of above liabilities for which rights had vested at 31 December	6	7

I5: KEY MANAGEMENT REMUNERATION

Key management constitutes the directors of Prudential plc as they have authority and responsibility for planning, directing and controlling the activities of the Group.

Total key management remuneration amounts to £21,677,000 (2009: £20,989,000). This comprises salaries and short-term benefits of £9,594,000 (2009: £11,570,000), post-employment benefits of £926,000 (2009: £1,132,000), leaving benefits of £ nil (2009: £915,000) and share-based payments of £11,157,000 (2009: £7,372,000).

Post-employment benefits comprise the change in the transfer value of the accrued benefit relating to directors' defined benefit pension schemes in the year and the total contributions made to directors' other pension arrangements.

The share-based payments charge is the sum of £7,320,000 (2009: £5,270,000), which is determined in accordance with IFRS 2, 'Share-Based Payments' (see note I4) and £3,837,000 (2009: £2,102,000) of deferred share awards.

Total key management remuneration includes total directors' emoluments of £14,225,000 (2009: £15,090,000) as shown in the directors' remuneration table and related footnotes in the directors' remuneration report, and additional amounts in respect of pensions and share-based payments. Further information on directors' remuneration is given in the directors' remuneration report.

I6: FEES PAYABLE TO AUDITOR

	2010 £m	2009 £m
Fees payable to the Company's auditor for the audit of the Company's annual accounts	1.9	1.8
Fees payable to the Company's auditor and its associates for other services:		
Audit of subsidiaries and associates pursuant to legislation	6.1	5.5
Other services supplied pursuant to legislation	2.4	2.7
Other services relating to taxation	0.4	0.6
Valuation and actuarial services	0.1	0.1
Services relating to other corporate finance transactions	0.1	0.7
All other services	1.0	1.0
Services relating to the AIA transaction	5.5	–
Total	17.5	12.4

In addition, there were fees incurred of £0.1 million (2009: £0.2 million) for the audit of pension schemes.

I: OTHER NOTES
CONTINUED

I6: FEES PAYABLE TO AUDITOR > CONTINUED

The fees for services relating to the AIA transaction of £5.5 million were primarily comprised of the following services:

- Accountants' Report on historical financial information on Prudential Group
- Consulting Actuaries' Report on AIA EEV information
- Technical accounting advice
- Financial due diligence
- Working capital review
- Synergies review
- Extraction comfort

All services were specifically approved by the Prudential Group Audit Committee.

The Audit Committee regularly monitors the non-audit services provided to the Group by its auditor and has developed a formal Auditor Independence Policy which sets out the types of services that the auditor may provide, consistent with the guidance in Sir Robert Smith's report 'Audit Committees – Combined Code Guidance' and with the provisions of the US Sarbanes-Oxley Act.

The Audit Committee annually reviews the auditor's objectivity and independence. More information on these issues is given in the corporate governance report within this Annual Report.

I7: RELATED PARTY TRANSACTIONS

Transactions between the Company and its subsidiaries are eliminated on consolidation.

In addition, the Company has transactions and outstanding balances with certain unit trusts, OEICs, collateralised debt obligations and similar entities which are not consolidated and where a Group company acts as manager. These entities are regarded as related parties for the purposes of IAS 24. The balances are included in the Group's statement of financial position sheet at fair value or amortised cost in accordance with their IAS 39 classifications. The transactions are included in the income statement and include amounts paid on issue of shares or units, amounts received on cancellation of shares or units and paid in respect of the periodic charge and administration fee. Further details of the aggregate assets, liabilities, revenues, profits or losses and reporting dates of entities considered to be associates under IFRS are disclosed in note H8.

Executive officers and directors of the Company may from time to time purchase insurance, asset management or annuity products marketed by Group companies in the ordinary course of business on substantially the same terms as those prevailing at the time for comparable transactions with other persons.

Apart from the transactions with directors referred to below, no director had interests in shares, transactions or arrangements that require disclosure, other than those given in the directors' remuneration report. Key management remuneration is disclosed in note I5.

In 2010 and 2009, other transactions with directors were not deemed to be significant both by virtue of their size and in the context of the directors' financial positions. As indicated above, all of these transactions are on terms broadly equivalent to those that prevail in arm's length transactions.

I8: SUBSIDIARY UNDERTAKINGS

i Principal subsidiaries

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

	Main activity	Country of incorporation
The Prudential Assurance Company Limited	Insurance	England and Wales
Prudential Annuities Limited*	Insurance	England and Wales
Prudential Retirement Income Limited (PRIL)*	Insurance	Scotland
M&G Investment Management Limited*	Asset management	England and Wales
Jackson National Life Insurance Company*	Insurance	US
Prudential Assurance Company Singapore (Pte) Limited*	Insurance	Singapore

* Owned by a subsidiary undertaking of the Company.

Each subsidiary has one class of ordinary shares and operates mainly in its country of incorporation, except for PRIL which operates mainly in England and Wales.

Details of all Prudential subsidiaries, joint ventures and associates will be annexed to the next Annual Returns of Prudential plc filed with the UK Registrar of Companies and the Registrar of Companies in Hong Kong.

ii Dividend restrictions and minimum capital requirements

Certain Group subsidiaries are subject to restrictions on the amount of funds they may transfer in the form of cash dividends or otherwise to the parent company. UK insurance companies are required to maintain solvency margins which must be supported by capital reserves and other resources, including unrealised gains on investments. Jackson can pay dividends on its capital stock only out of earned surplus unless prior regulatory approval is obtained. Furthermore, without the prior regulatory approval, dividends cannot be distributed if all dividends made within the preceding 12 months exceed the greater of Jackson's statutory net gain from operations or 10 per cent of Jackson's statutory surplus for the prior year. In 2010, the maximum amount of dividends that could be paid by Jackson without prior regulatory approval is US$377 million (£241 million) (in 2009: US$454 million (£281 million)). The Group's Asian subsidiaries may remit dividends to the Group, in general, provided the statutory insurance fund meets the capital adequacy standard required under local statutory regulations.

The Group capital position statement for life assurance businesses is set out in note D5, showing the available capital reflecting the excess of regulatory basis over liabilities for each fund or group of companies determined by reference to the local regulation of the subsidiaries. In addition, disclosure is also provided in note D5 of the local capital requirement of each of the fund or group of companies.

iii Acquisition and disposal of subsidiaries

During 2010, the Group acquired a 100 per cent interest in United Overseas Bank Life Assurance Limited (UOB) in Singapore. Further details are set out in note I1.

On 1 October 2010, the PAC with-profits fund, via its venture fund holdings and as part of its investment portfolio, acquired control of Meterserve (North West) Limited and Meterserve (North East) Limited (together referred to as 'Meterserve'), increasing its 50 per cent stake to 100 per cent.

As this transaction is within the with-profits fund it has no impact on shareholders' profit or equity for the period ended 31 December 2010. The impact on the Group's consolidated revenue, including investment returns, is not material. Had the acquisition been effected at 1 January 2010, the revenue and profit of the Group from continuing operations for the year ended 31 December 2010 would not have been materially different.

A summary of the consideration, goodwill and net assets acquired relating to Meterserve is provided in the table below:

	2010 £m
Cash consideration paid	22
Fair value of existing stake	25
Total consideration	47
Net assets acquired:	
Property, plant and equipment	219
Derivative assets	(35)
Other non-investment and non-cash assets	11
Cash and cash equivalents	10
Borrowings attributable to with-profits funds	(194)
Other non-insurance liabilities	(6)
Fair value of net assets acquired	5
Total goodwill arising on acquisition attributable to the with-profits fund	42

The acquisition costs associated with this transaction were expensed as incurred and totalled less than £1 million. Goodwill represents management's expectation of future income streams and is not allowable for tax.

As noted above the transaction increased the previously held stake from 50 per cent to 100 per cent. The fair value of the existing stake at the date of the transaction was £25 million. As the investment was held in the Group's balance sheet as a financial instrument classified as at fair value through profit and loss no gain or loss arises as a result of the transaction.

There were no new acquisitions or disposals by the PAC with-profits fund in 2009. However, during 2009, the holding in the voting equity interest of Red Funnel increased from 90 per cent to 100 per cent. Red Funnel is a venture capital holding owned by the PAC with-profits fund managed by M&G.

Other than the above there were no other material acquisitions or disposals of subsidiaries during 2010 or 2009.

I: OTHER NOTES
CONTINUED

I9: COMMITMENTS

i Operating leases
The Group leases various offices to conduct its business. Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

	2010 £m	2009 £m
Future minimum lease payments for non-cancellable operating leases fall due during the following periods:		
Not later than 1 year	70	63
Later than 1 year and not later than 5 years	236	178
Later than 5 years	120	104

The total minimum future sublease rentals to be received on non-cancellable operating leases for land and buildings for the year ended 31 December 2010 were £nil (2009: £nil).

Minimum lease rental payments for the year ended 31 December 2010 of £92 million (2009: £105 million) are included in the consolidated income statement.

ii Capital commitments
The Group has provided, from time to time, certain guarantees and commitments to third-parties including funding the purchase or development of land and buildings and other related matters. The contractual obligations to purchase or develop investment properties at 31 December 2010 was £28 million (2009: £nil).

I10: DISCONTINUED OPERATIONS

The charge of £14 million in 2009, which is net of £nil tax, reflects completion adjustments for a previously disposed business.

I11: CASH FLOWS

Structural borrowings of shareholder-financed operations comprise core debt of the parent company and Jackson surplus notes. Core debt excludes borrowings to support short-term fixed income securities programmes, non-recourse borrowings of investment subsidiaries of shareholder-financed operations and other borrowings of shareholder-financed operations. Cash flows in respect of these borrowings are included within cash flows from operating activities.

Structural borrowings of with-profits operations relate solely to the £100 million 8.5 per cent undated subordinated guaranteed bonds which contribute to the solvency base of the Scottish Amicable Insurance fund (SAIF) a ring-fenced sub-fund of the PAC with-profits fund. Cash flows in respect of other borrowings of with-profits funds, which principally relate to consolidated investment funds, are included within cash flows from operating activities.

I12: POST BALANCE SHEET EVENTS

In January 2011, the Company issued US$550 million 7.75 per cent Tier 1 subordinated debt, primarily to retail investors. The proceeds, net of costs, were US$539 million and are intended to finance the repayments of the €500 million Tier 2 subordinated notes in December 2011.

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