Risk and capital management

As a provider of financial services, including insurance, we recognise that the managed acceptance of risk lies at the heart of our business. As a result, effective risk management capabilities represent a key source of competitive advantage for our Group.

The Group's risk appetite framework sets out our tolerance to risk exposures as well as our approach to risk management and return optimisation. Under this approach, we monitor our risk profile continuously against agreed limits. Our main strategies for managing and mitigating risk include asset liability management, using derivatives to hedge relevant market risks, and implementing reinsurance and corporate insurance programmes.

Our risk exposure and approach to risk management were described in detail in our 2009 year-end report and remain valid.

1 Financial risks

a Market risk

i Equity risk

In the UK business, most of our equity exposure is incurred in the with-profits fund, which includes a large inherited estate estimated at £5.9 billion as at 30 June 2010 (30 June 2009: £5.0 billion), which can absorb market fluctuations and protect the fund's solvency. The inherited estate itself is partially protected against falls in equity markets through an active hedging policy.

In Asia, a high proportion of our in-force book is made up of unit-linked products with limited shareholder exposure to equities. We have minimal direct shareholder exposure to Asian equity markets outside our unit-linked holdings.

In the US, where we are a leading provider of variable annuities, there are well-understood risks associated with the guarantees embedded in our products. We provide guarantees for minimum death benefits (GMDB) on all policies in this class, minimum withdrawal benefits (GMWB) on 59 per cent of the book, and minimum income benefits (GMIB) on only seven per cent. To protect the shareholders against the volatility induced by these embedded options, we use both a comprehensive hedging programme and reinsurance. Due to the inability to economically reinsure or hedge the GMIB, Jackson ceased offering this benefit in 2009.

In our variable annuity sales activities, we focus on meeting the needs of conservative and risk averse customers who are seeking reliable income in retirement, and who display little tendency to arbitrage their guarantees. These customers generally select conservative investment options. We are able to meet the needs of these customers because our unique and market leading operational platform allows us to tailor more than 1,700 product combinations.

It is our philosophy not to compete on price. Our individual guarantees tend to be more expensive than the market average because we seek to sell at a price capable of funding the cost we incur to hedge or reinsure our risks.

We use a macro approach to hedging that covers the entire risk in the US business. Within this macro approach we make use of the natural offsets that exist between the variable annuity guarantees and the fixed index annuity book, and then use a combination of OTC options and futures to hedge the residual risk, allowing for significant market shocks and limiting the amount of capital we are putting at risk. Internal positions are generally netted before any external hedge positions are considered. The hedging programme also covers the fees on variable annuity guarantees.

Jackson hedges the economics of its products rather than the accounting result. Accordingly, while its hedges are effective on an economic basis, due to different accounting treatment for the hedges and some of the underlying hedged items on an IFRS basis, the reported income effect is more variable. As previously highlighted this resulted in recognition of £123 million of equity hedge gains in the period (net of related DAC amortisation) as compared to £23 million of losses recognised in the first half of 2009.

ii Interest rate risk

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

In the US there is interest rate risk across the portfolio. With its large fixed annuity and fixed index annuity books, Jackson has natural offsets for its variable annuity interest rate related risks. Jackson manages fixed annuity interest rate exposure though 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.

In the UK the investment policy for the shareholder-backed annuity business is to match the cash flow from investments with the annuity payments. As a result, assets and liabilities are closely matched by duration. The impact on profit of any residual cash flow mismatching can be adversely affected by changes in interest rates, therefore the mismatching position is regularly monitored.

The exposure to interest rate risk arising from Asia is at modest levels.

iii Foreign exchange risk

Prudential principally operates in the UK, the US, and in 13 countries in Asia. The geographical diversity of our businesses means that we are inevitably subject to the risk of exchange rate fluctuations. Prudential's international operations in the US and Asia, which represent a significant proportion of our operating profit and shareholders' funds, generally write policies and invest in assets denominated in local currency. Although this practice limits the effect of exchange rate fluctuations on local operating results, it can lead to significant fluctuations in our consolidated financial statements when results are expressed in pounds sterling.

We do 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.

b Credit risk

In addition to business unit operational limits on credit risk, we monitor closely our counterparty exposures at Group level, highlighting those that are large or of concern. Where appropriate, we will reduce our exposure, purchase credit protection or make use of collateral arrangements to control our levels of credit risk.

Debt portfolio

Our debt portfolio on an IFRS basis was £113.3 billion at 30 June 2010. £53.1 billion of these assets backed shareholder business, of which 95 per cent were investment grade, compared to 93 per cent at 30 June 2009. Sovereign debt backing shareholder business represented 16.5 per cent of the portfolio, or £8.75 billion at 30 June 2010. Exposures to sovereign debt have increased since December due mainly to an enlarged position in US Treasuries, of which 75 per cent was rated AAA and 93 per cent investment grade. Eurozone sovereign exposures backing shareholder business were £3.6 billion at 30 June 2010, of which 98 per cent were AAA rated. Of the remaining two per cent, the highest exposure was in respect of Italy (£53 million) and Spain (less than £1 million) whilst there was no exposure to Greece, Portugal or Ireland. In addition, sovereign exposure to Thailand is £122 million.

Asia

Asia's debt portfolio totalled £12.4 billion at 30 June 2010. Of this, approximately 70 per cent was in unit-linked and with-profits funds with minimal shareholders' risk. The remaining 30 per cent is shareholder exposure and is invested predominantly (79 per cent) in investment grade bonds. For Asia, the portfolio has performed very well, and did not experience any default losses in the first half of 2010.

UK

The UK's debt portfolio on an IFRS basis is £72.1 billion as at 30 June 2010, including £45.9 billion within the UK with-profits fund. Shareholders' risk exposure to the with-profits fund is limited as the solvency is protected by the large inherited estate. Outside the with-profits fund there is £5.6 billion in unit-linked funds where the shareholders' risk is limited, with the remaining £20.5 billion backing the shareholders' annuity business and other non-linked business (of which 79 per cent is rated AAA to A, 17 per cent BBB and four per cent non-investment grade).

On a statutory (Pillar 1) basis we have held prudent credit reserves within the UK shareholder annuity funds of £1.7 billion to allow for future credit risk. For Prudential Retirement Income Limited (PRIL) this allowance is set at 67bps at 30 June 2010 (31 December 2009: 71bps). This now represents 39 per cent of the portfolio spread over swaps compared to 41 per cent as at 31 December 2009. No defaults were reported on the debt portfolio held by the UK shareholder-backed annuity business in the first half of 2010.

During the first half of 2010 we continued to materially reduce our holdings in subordinated financial debt backing our annuity business, improving the overall credit quality of our bond portfolios. This has resulted in gross losses of £85 million on shareholder-backed business and £37 million on policyholder-backed business in the period. On a Pillar I basis these losses have been fully offset by a reduction in long-term default reserves of £85 million shareholder/£31 million policyholder that arose as a result of the improvement in the quality of our remaining bond portfolios and a further £6 million policyholder release of short-term default reserves which were allocated to the assets sold. On an IFRS basis, the gross costs less the reduction in long-term and short-term default reserves resulted in a small overall pre-tax loss to the policyholders (£4 million) and had no impact on IFRS pre-tax shareholder operating profit.

US

The most significant area of exposure to credit risk for the shareholders is Jackson in the US. At 30 June 2010 Jackson's fixed income portfolio totalling £27.4 billion, comprised £20.5 billion corporate and government debt, £3.3 billion of Residential Mortgage Backed Securities (RMBS), £2.5 billion of Commercial Mortgage Backed Securities (CMBS) and £1.1 billion of other instruments.

The US corporate and government debt portfolio of £20.5 billion is comprised of £17.8 billion of corporate debt and £2.7 billion of government debt. Of the £17.8 billion of corporate debt, 95 per cent is investment grade. Concentration risk within the corporate debt portfolio is low, with the top ten holdings accounting for approximately eight per cent of the portfolio. The non-investment grade corporate debt portfolio is also well diversified with an average holding of £8 million. Our largest sector exposures in the investment grade corporate debt portfolio are Utilities and Energy at 16 per cent and 15 per cent respectively. We actively manage the portfolio and will sell exposures as events dictate.

Within the RMBS portfolio of £3.3 billion, the agency guaranteed portion is 57 per cent. Another 21 per cent of the portfolio is non-agency prime and Alt-A investments with pre-2006/2007 vintages, where experience has been much more positive than later vintages. Our exposure to the 2006/2007 vintages totals £429 million of which £412 million is invested in the senior part of the capital structure, thereby significantly reducing the risk of defaults and the magnitude of loss if a shortfall does occur. The actual exposure to non-senior 2006/2007 Prime and Alt-A RMBS is only £17 million. The total RMBS portfolio has an average fair value price of 87 cents on the dollar.

The CMBS £2.5 billion portfolio is performing strongly, with 33 per cent of the portfolio rated AAA and less than one per cent rated below investment grade. The entire portfolio has an average credit enhancement level of 30 per cent. This level provides significant protection, since it means the bond has to incur a 30 per cent loss, net of recoveries, before we are at risk.

In Jackson, total amounts charged to profits relating to debt securities were £ 161 million (2009: £366 million). This is net of recoveries/reversals recognised in the year of £3 million (2009: £2 million).

In the first half of 2010, Jackson's total defaults were nil (2009: less than one million). In addition, as part of our active management of the book, we incurred losses net of recoveries and reversals of £97 million (2009: £42 million) on the sale of impaired bonds.

IFRS write-downs excluding defaults for the half year were £64 million compared to £324 million in the equivalent period of 2009. Of this amount £39 million (2009: £239 million) was in respect of RMBS securities.

The impairment process reflects a rigorous review of every single bond and security in our portfolio. Our accounting policy requires us to book full mark-to-market losses on impaired securities through our income statement. However we would expect only a proportion of these losses eventually to turn into defaults, and some of the impaired securities to recover in price over time.

Unrealised gains and losses on debt securities in the US

Jackson's net unrealised gains from debt securities has steadily improved from negative £2,897 million at 31 December 2008 to positive £4 million at 31 December 2009 to £1.2 billion at 30 June 2010. The gross unrealised loss position moved from £966 million at 31 December 2009 to £521 million at 30 June 2010. Gross unrealised losses on securities priced at less than 80 per cent of face value totalled £340 million at 30 June 2010 compared to £594 million at 31 December 2009.

Asset management

The debt portfolio of the Group's asset management operations of £1.5 billion as at 30 June 2010 is principally related to Prudential Capital operations. Of this amount, substantially all were rated AAA to A- by S&P or AAA by Moody's.

Loans

Of the total Group loans of £9.6 billion at 30 June 2010, £7.5 billion are held by shareholder-backed operations comprised of £5.0 billion commercial mortgage loans and £2.5 billion of other loans.

Of this total held by shareholder-backed operations, the Asian insurance operations held £0.5 billion of other loans, the majority of which are commercial loans held by the Malaysian operation that are rated investment grade by two local rating agencies. The US insurance operations held £4.5 billion of loans, comprising £3.9 billion of commercial mortgage loans, all of which are collateralised by properties, and £0.6 billion of policy loans. The US commercial mortgage loan portfolio does not include any single-family residential mortgage loans and therefore is not exposed to the risk of defaults associated with residential sub-prime mortgage loans. The UK insurance operations held £1.1 billion of loans, the majority of which are mortgage loans collateralised by properties.

The balance of the total shareholder loans amounts to £1.4 billion and relates to bridging loan finance managed by Prudential Capital.

c Insurance risk

The processes of determining the price of our products and reporting the results of our long-term business operations require us to make a number of assumptions. In common with other industry players, the profitability of our businesses depends on a mix of factors including mortality and morbidity trends, persistency, investment performance, unit cost of administration and new business acquisition expenses. We continue to conduct rigorous research into longevity risk using data from our substantial annuitant portfolio. Prudential's persistency assumptions reflect recent experience for each relevant line of business, and any expectations of future persistency. Where appropriate, allowance is also made for the relationship – either assumed or historically observed – between persistency and investment returns, and for the resulting additional risk.

d Liquidity risk

The holding company has significant internal sources of liquidity which are sufficient to meet all of our expected requirements for the foreseeable future without having to make use of external funding. In aggregate the Group has £2.2 billion of undrawn committed facilities, including £1.7 billion of syndicated and bilateral committed banking facilities, expiring between 2011 and 2013, and an annually renewable £500 million committed securities lending facility. In addition the Group has access to liquidity via the debt capital markets. Recent issues include two hybrid instruments for approximately £850 million in 2009 and a £250 million senior three-year MTN in 2010. Prudential also has in place an unlimited commercial paper programme and has maintained a consistent presence as an issuer in this market for the last 10 years. Liquidity uses and sources have been assessed at a business unit level under base case and stressed assumptions. The liquidity resources available and the subsequent Liquidity Coverage Ratio (LCR) have been assessed to be sufficient under both sets of assumptions.

2 Non-financial risk

Prudential is exposed to operational, business environment and strategic risk in the course of running its businesses. We process a large number of complex transactions across numerous and diverse products, and are subject to a number of different legal and regulatory, including tax regimes. We also have a significant number of third-party relationships that are important to the distribution and processing of our products, both as market counterparties and as business partners.

We use the qualitative and quantitative analysis of operational risk exposures material to the Group to support business decisions, to inform overall levels of capital held and to assess the adequacy of the corporate insurance programme.

3 Risk factors and contingencies

Our disclosures covering risk factors can be found at the end of this document. Note AC of the IFRS basis condensed consolidated financial statements gives an update on the position for contingencies of the Group since those published in the 2009 Annual Report.

Capital management

Regulatory capital (IGD)

Prudential is subject to the capital adequacy requirements of the European Union (EU) Insurance Groups Directive (IGD) as implemented by the Financial Services Authority (FSA) in the UK. 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.

Our capital position remains strong. We have continued to place emphasis on maintaining the Group's financial strength through optimising the balance between writing profitable new business, conserving capital and generating cash. We estimate that our Insurance Groups Directive (IGD) capital surplus was £3.4 billion at 30 June 2010 (before taking into account the 2010 interim dividend), covering our capital requirements 2.7 times. This compares to a capital surplus of £3.4 billion at the end of 2009 (before taking into account the 2009 second interim dividend).

The movements during 2010 mainly comprise:

- Net capital generation mainly through operating earnings (in-force releases less investment in new business) of £0.8 billion;
- Foreign exchange movements of £0.2 billion;

Offset by:

- Final 2009 dividends, net of scrip, of £0.3 billion;
- Inadmissible assets arising on the purchase of UOB's life insurance subsidiary in Singapore of £0.2 billion;
- Impact of costs incurred in relation to the terminated AIA acquisition of £0.3 billion; and
- External financing costs and other central costs of £0.2 billion.

We continue to have further options available to us to manage available and required capital. These could take the form of increasing available capital (for example, through financial reinsurance) or reducing required capital (for example, through the mix and level of new business) and the use of other risk mitigation measures such as hedging and reinsurance.

In addition to our strong capital position, on a statutory (Pillar 1) basis the total credit reserve for the UK shareholder annuity funds also protects our capital position in excess of the IGD surplus. This credit reserve as at 30 June 2010 was £1.7 billion. This represents 39 per cent of the portfolio spread over swaps, compared to the 41 per cent as at 31 December 2009.

Stress testing

As at 30 June 2010 stress testing of our IGD capital position to various events has the following results:

- An instantaneous 20 per cent fall in equity markets from 30 June 2010 levels would reduce the IGD surplus by £250 million;
- A 40 per cent fall in equity markets (comprising an instantaneous 20 per cent fall followed by a further 20 per cent fall over a four-week period) would reduce the IGD surplus by £650 million;
- A 150bps reduction (subject to a floor of zero) in interest rates would reduce the IGD surplus by £350 million;
- Credit defaults of ten times the expected level would reduce IGD surplus by £550 million.

We believe that the results of these stress tests, together with our Group's strong underlying earnings capacity, our established hedging programmes and our additional areas of financial flexibility, demonstrate that we are in a position to withstand significant deterioration in market conditions.

We also use an economic capital assessment to monitor our capital requirements across the Group, allowing for realistic diversification benefits and continue to maintain a strong position. This assessment provides valuable insights into our risk profile.

Solvency II

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

Having assessed the high-level requirements of Solvency II, an implementation programme was initiated with dedicated teams to manage the required work across the Group. The activity of the local Solvency II teams is being coordinated by Group Head Office to achieve consistency in the understanding and application of the requirements.

Over the coming months we will be progressing our implementation plans further and remaining in regular contact with the FSA as we prepare for the initial stage of the approval process for the internal model.