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 Asia, the US and the UK. 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.

In Asia, the Group has operations in Hong Kong, Malaysia, Singapore, Indonesia and other Asian countries. The life insurance products offered by the Group's operations in Asia include with-profits (participating) and non-participating term, whole life and endowment and unit-linked policies. In Asia, unit-linked policies are usually sold with insurance riders such as health covers.

In the US, the Group's principal subsidiary is Jackson National Life Insurance Company (Jackson). The principal products written by Jackson are fixed annuities (interest-sensitive, fixed indexed and immediate annuities), variable annuities (VA), life insurance and institutional products.

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. Long-term business products written in the UK 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 written in the UK also includes unit-linked products.

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

Laurence Pountney Hill
London
EC4R 0HH
UK Companies House 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 315 to 323. 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 2012. The Group has applied the same accounting policies in preparing the 2012 results as for 2011 except for the adoption of altered US GAAP reporting requirements for Group IFRS reporting, which is described in note A5.

A3: Accounting policies

1 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 2012, there were no unendorsed standards effective for the two years ended 31 December 2012 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 2012 is prepared in accordance with IFRS as issued by the IASB. Prudential adopts mandatory requirements of new or altered EU-adopted IFRS standards when required, and may consider earlier adoption 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, 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 and the fair value of assets.

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 those that 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, as described elsewhere in these financial statements.

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, 'Insurance Contracts', 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) in 2003 has been applied.

- With-profits funds
  With-profits funds are those in which the policyholder has a contractual right to receive at the discretion of the insurer, additional benefits based on factors such as the performance of a pool of assets held within the fund as a supplement to any guaranteed benefits.

- UK regulated with-profits funds
  For Group IFRS reporting, UK regulated with-profits funds are accounted for by the voluntary application of the UK accounting standard FRS 27, 'Life Assurance'. Under this standard, for such funds, policyholder liabilities are measured on a 'realistic basis' as discussed in section 2(a) of this note.

- Unallocated surplus of with-profits funds
  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 elected 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. The unallocated surplus is shown separately in the statement of financial position.

Overseas operations:
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 India, Japan, Taiwan and, until 2012, Vietnam (as discussed in note A5), the local GAAP is not appropriate in the context of the previously applied MSB. For these countries the insurance assets and liabilities are measured principally by reference to US GAAP. For participating business the liabilities include provisions for the policyholders' interest in investment gains and other surpluses that 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 section 2(a) below. For other operations a market consistent basis is not applied under the accounting basis described in section 2(a) below. Details of the guarantees, basis of setting assumptions and sensitivity to altered assumptions are described in notes D3 and D4.

Additional details on the Group's accounting policies for insurance assets and liabilities are shown in section 2 below.

Valuation and accounting presentation of fair value movements of derivatives and debt securities of Jackson
These policies are critical because of their significance to the volatility of the income statement result and shareholders' equity. Under IAS 39, 'Financial Instruments: Recognition and Measurement', 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.

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 occasional circumstances, 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. This volatility is reflected in the level of short-term fluctuations in investment returns, as shown in note B1.

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.

A: Background and accounting policies continued

A3: Accounting policies continued

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. Reported profit before the total tax charge is not representative of pre-tax profits attributable to shareholders. Accordingly, 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 section 2(d) below.

For shareholder-backed business, with the exception of debt securities held by Jackson and assets classified as loans and receivables at amortised cost, all financial investments and investment property are designated as assets at fair value through profit and loss. The short-term fluctuations affect the result for the year and the Group provides additional analysis of results before and after short-term fluctuations in investment returns, together with other items that are of a short-term volatile or one-off nature. 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 a liability 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.

2 Other significant accounting policies

a Long-term business contracts

Income statement treatment

Insurance contracts and investment contracts with discretionary participation features (DPF)

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.

Acquisition costs are deferred and amortised as described in note A4.

Investment contracts other than those with DPF

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.

Under IFRS, investment contracts (excluding those with discretionary participation features) accounted for as financial liabilities in accordance with IAS 39 which also offer investment management services, require the application of IAS 18, 'Revenue', for the revenue attached to these services. 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 to the with-profits fund 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 which 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. Asset shares broadly reflect the policyholders' share of the with-profits fund assets attributable to their policies.

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 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 (ie contracts which contain significant insurance risk as defined under IFRS 4)

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

i 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 benefits are based on published mortality tables adjusted to reflect actual experience.

ii 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 under US GAAP principles with the locked in assumptions 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. Acquisition costs are accounted for as explained in note A4.

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 deferred acquisition costs (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.

A: Background and accounting policies continued

A3: Accounting policies continued

Asia operations
Except for the operations in India, Japan, Taiwan and, until 2012, Vietnam, 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. Refinements to the local reserving methodology are generally treated as change in estimates, dependent on the nature of the change.

For the Asia operations referred to above 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 operations the business written is primarily non-participating linked and participating 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 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, where relevant, present value of acquired in-force business is sufficient to cover current estimates of future cash flows. Any deficiency is immediately charged to the income statement.

Reinsurance
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, 'Revenue'.

For those investment contracts in the US with fixed and guaranteed terms, the Group uses the amortised cost model to measure the 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. Where the contract includes a surrender option its carrying value is subject to a minimum carrying value equal to its surrender value.

b Financial instruments other than financial instruments classified as long-term business contracts
Investment classification
Under IAS 39, subject to specific criteria, financial instruments are required to 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. These IAS 39 classifications have been changed by IFRS 9 'Financial Investments: Classification and Measurement' which is not required to be adopted until 2015 and is still subject to EU endorsement. In addition, the International Accounting Standards Board (IASB) continues to consult on future possible changes to IFRS 9. This standard has not been adopted by the Group in 2012. 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 return in the income statement;

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. The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset.

   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. Upon disposal or impairment, accumulated unrealised gains and losses are transferred from other comprehensive income to the income statement as realised gains or losses; and iii Loans and receivables – except for those designated as at fair value through profit and loss or available-for-sale, these instruments comprise non-quoted investments that have fixed or determinable payments. 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 those loans and receivables, carried at amortised cost, and debt securities accounted for on an available-for-sale basis by Jackson. 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

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.

For 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 is recognised in other comprehensive income. 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 is recognised directly in other comprehensive income while the foreign operation is held.

For fair value hedges, movements in the fair value of the hedged item attributable to the hedged risk are recognised in the income statement.

The Group does not regularly seek to apply fair value or cash flow hedging treatment under IAS 39. The exceptions, where hedge accounting has been applied in 2012 and 2011, are summarised in note G3.

All derivatives that are not designated as hedging instruments 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 UK with-profits funds the derivative programme derivatives are used for the purposes of efficient portfolio management or reduction in investment risk.

For shareholder-backed 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.

For Jackson an extensive derivative programme is maintained. Value movements on the derivatives held can be very significant in their effect on shareholder results. Further details on this aspect of the Group's financial reporting are described in notes B1 and D3.

Embedded derivatives

Embedded derivatives are present in host contracts issued by various Group companies, in particular 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 option 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(e).

A: Background and accounting policies continued

A3: Accounting policies continued

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 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.

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. 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.

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 (i) 50 per cent or greater, and (ii) where the Group's ownership of internally managed funds declines marginally below 50 per cent and the decline in ownership is expected to be temporary.

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, 'Investments in Associates', 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.

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 guidelines. Each property is externally valued at least once every three years. Fair value is based on active market prices. 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.

Pension 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 such that the financial position recorded for the scheme reflects the higher of any underlying IAS 19, 'Employee Benefits', deficit and the obligation for deficit funding.

The Group utilises the projected unit credit method to calculate the defined benefit obligation. This method sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final 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.

Share-based payments

The Group offers share award and option plans for certain key employees and a Save As You Earn plan for all UK and certain overseas employees. 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. The Company has established trusts to facilitate the delivery of Prudential plc shares under employee incentive plans and savings-related share option schemes. The cost to the Company of acquiring these treasury shares held in trusts is shown as a deduction from shareholders' equity.

Tax

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. 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. 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.

The tax charge for long-term business includes tax expense 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.

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.

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. Income and expenses of acquired entities are included in the income statement from the date of acquisition.

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.

Intangible assets

Intangible assets acquired on the purchase of a subsidiary or portfolio of contracts are fair valued at acquisition. Other intangible assets, such as software, are valued at the price paid to acquire them. Intangible assets are 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.

A: Background and accounting policies continued

A3: Accounting policies continued

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.

Segments

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

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 to support 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 determined in accordance with IFRS 8, 'Operating Segments', are as follows:

Insurance operations

- Asia
- US (Jackson)
- UK

Asset management operations

- M&G (including Prudential Capital)
- Eastspring Investments
- US broker-dealer and asset management (including Curian)

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

The performance measure of operating segments utilised by the Company is IFRS operating profit attributable to shareholders based on longer-term investment returns, as described below. 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 2012 this measure excluded a gain arising upon the dilution of the Group's holding in PPM South Africa and the amortisation of the acquisition accounting adjustments arising on the purchase of REALIC as described further in note I1. 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.

Segment results that are reported to the Group Executive Committee 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 the Asia Regional Head Office.

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.

Except in the case of the assets backing the UK annuity business, unit-linked and US variable annuity separate account liabilities, operating profit based on longer-term investment returns for shareholder-financed business is determined on the basis of expected longer-term investment returns. In the case of assets backing the UK annuity business, unit-linked and US variable annuity separate account liabilities, the basis of determining operating profit based on longer-term investment returns is as follows:

- Assets backing UK annuity business liabilities. 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; and
- Assets backing unit-linked and US variable annuity business separate account liabilities. For such business, the policyholder unit liabilities are directly reflective of the asset value movements. Accordingly, the operating results based on longer-term investment returns reflect the current period value movements in unit liabilities and the backing assets.

In the case of other shareholder-financed business, the measurement of operating profit based on longer-term investment returns 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 of life businesses exclusive of the effects of short-term fluctuations in market conditions. In determining the profit on this basis, the following key elements are applied to the results of the Group's shareholder-financed operations as reflected in the segment results shown in note B1.

i Debt, equity-type securities and loans

Longer-term investment returns for both debt, equity-type securities and loans comprise longer-term actual income receivable for the period (interest/dividend income) and longer-term capital returns.

In principle, for debt securities and loans, the longer-term capital returns comprise two elements. The first element is a risk margin reserve (RMR) based charge for the expected level of defaults for the period, which is determined by reference to the credit quality of the portfolio. The difference between impairment losses in the reporting period and the RMR charge to the operating result is reflected in short-term fluctuations in investment returns. The second element is for the 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.

Jackson is the shareholder-backed operation for which the distinction between impairment losses and interest-related realised gains and losses is in practice relevant to a significant extent. Jackson has used the ratings by Nationally Recognised Statistical Ratings Organisations (NRSRO) or ratings resulting from the regulatory ratings detail issued by the National Association of Insurance Commissioners (NAIC) developed by external third parties such as PIMCO or BlackRock Solutions to determine the average annual RMR to apply to debt securities held to back general account business. Debt securities held to back separate account and reinsurance funds withheld are not subject to RMR charge. Further details of the RMR charge, as well as the amortisation of interest-related realised gains and losses, for Jackson are shown in note B1(iv) to the consolidated financial statements.

For debt securities backing non-linked shareholder-financed business of the UK insurance operations (other than the annuity business) and of the Asia insurance operations, the realised gains and losses are principally interest related. Accordingly, all realised gains and losses to date for these operations are being amortised over the period to the date those securities would otherwise have matured, with no explicit RMR charge.

At 31 December 2012, the level of unamortised interest-related realised gains and losses related to previously sold bonds for the Group was a net gain of £498 million (31 December 2011: £462 million).

For equity-type securities, the longer-term rates of return are estimates of the long-term trend investment return for income and capital having regard to past performance, current trends and future expectations. Equity-type securities held for shareholder-financed operations other than the UK annuity business, unit-linked and US variable annuity are of significance for the US and Asia insurance operations. Different rates apply to different categories of equity-type securities.

As at 31 December 2012, the equity-type securities for US insurance non-separate account operations amounted to £1,004 million (31 December 2011: £902 million). For these operations, the longer-term rates of return for income and capital applied in 2012 reflects the combination of risk free rates and appropriate risk premium are as follows:

	2012	2011
Equity-type securities such as common and preferred stock and portfolio holdings in mutual funds	5.5% to 6.2%	5.9% to 7.5%
Other equity-type securities such as investments in limited partnerships and private equity funds	7.5% to 8.2%	7.9% to 9.5%

For Asia insurance operations, investments in equity securities held for non-linked shareholder-financed operations amounted to £659 million as at 31 December 2012 (31 December 2011: £590 million). The rates of return applied in the years 2012 and 2011 ranged from 1.0 per cent to 13.8 per cent, with the rates applied varying by territory. The investment amounts for 2011 of £590 million included the Group's investment in China Life Insurance Company of Taiwan (China Life (Taiwan)) of £88 million which was sold in 2012, as described in note B1.

The longer-term rates of return discussed above for equity-type securities are determined after consideration by the Group's in-house economists of long-term expected real government bond returns, equity risk premium and long-term inflation. These rates are broadly stable from period to period but may be different between countries reflecting, for example, differing expectations of inflation in each territory. The assumptions are for returns expected to apply in equilibrium conditions. The assumed rates of return do not reflect any cyclical variability in economic performance and are not set by reference to prevailing asset valuations.

A: Background and accounting policies continued

A3: Accounting policies continued

ii US variable and fixed index annuity business

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 (see note);
- Movements in accounts carrying value of Guaranteed Minimum Death Benefit (GMDB) and GMWB 'for life' liabilities, for which, under the 'grandfathered' US GAAP applied under IFRS for Jackson's insurance assets and liabilities, the measurement basis gives rise to a muted impact of current period market movements;
- Fee assessments and claim payments, in respect of guarantee liabilities; and
- Related changes to amortisation of deferred acquisition costs for each of the above items.

Note: US operations – embedded derivatives for variable annuity guarantee features

The 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 Other derivative value movements

Generally, derivative value movements are excluded from operating results based on longer-term investment returns (unless those derivative value movements broadly offset changes in the accounting value of other assets and liabilities included in operating profit). The principal example of non-equity based derivatives (for example interest rate swaps and swaptions) whose value movements are excluded from operating profit arises in Jackson. 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), product liabilities (for which US GAAP accounting as 'grandfathered' under IFRS 4 does not fully reflect the economic features being hedged), and the interest rate exposure attaching to equity-based embedded derivatives.

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 (ie after allocated investment return and change for policyholder benefits) the operating result reflects longer-term market returns.

Examples where such bifurcation is necessary are:

Asia

i Hong Kong

For certain non-participating business, the economic features are more akin to asset management products with policyholder liabilities reflecting asset shares over the contract term. For these products, the charge for policyholder benefits in the operating results should reflect the asset share feature rather than volatile movements that would otherwise be reflected if the local regulatory basis (which is applied for IFRS balance sheet purposes) was used.

For other Hong Kong non-participating business, longer-term interest rates are used to determine the movement in policyholder liabilities for determining operating results. Similar principles apply for other Asia operations;

ii Japan 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;

UK shareholder-backed annuity business
The operating result based on longer-term investment returns reflects the impact of value movements on policyholder liabilities for annuity business in PRIL and the PAC non-profit sub-fund after adjustments to allocate the following elements of the movement to the category of 'short-term fluctuations in investment returns' in the Group's supplementary analysis of profit:

- The impact on credit risk provisioning of actual upgrades and downgrades during the period;
- Credit experience compared to assumptions; and
- Short-term value movements on assets backing the capital of the business.

Credit experience reflects the impact of defaults and other similar experience, such as asset exchanges arising from debt restructuring by issuers that include effectively an element of permanent impairment of the security held. Negative experience compared to assumptions is included within short-term fluctuations in investment returns without further adjustment. This is to be contrasted with positive experience where surpluses are retained in short-term allowances for credit risk for IFRS reporting purposes. 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.

v 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 in investment returns. 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.

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.

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, ie 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.

A: Background and accounting policies continued

A4: Critical accounting estimates and judgements

In determining the measurement of the Group's assets and liabilities estimates and judgements are required. The critical aspects are described below.

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 eg 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 (ie derived from prices); and
Level 3: Significant inputs for the asset or liability that are not based on observable market data (unobservable inputs).

At 31 December 2012, £6,660 million (2011: £4,565 million) of the financial investments (net of derivative liabilities) valued at fair value were classified as level 3. Of these £861 million (2011: £800 million) are held to back shareholder non-linked business and so changes to these valuations will directly impact shareholders' equity. Further details of the level 3 investments and the classification of financial instruments are given in note G1.

Determining impairments relating to financial assets

i Available-for-sale securities

The majority of Jackson's debt securities portfolio are accounted for on available-for-sale basis. 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 to 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; and
- 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 effects. 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 shortfalls. If a shortfall applies an impairment charge is recorded. The difference between the fair value and book cost for unimpaired securities designated as available-for-sale, is accounted for as unrealised gains or losses, with the movements in the accounting period being included 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. Additional details on the impairments of the available-for-sale securities of Jackson are described in notes D3 and G5.

ii Assets held at amortised cost

Except for certain loans of the UK insurance operations and Jackson National Life, which are accounted for on a fair value through profit and loss basis, and as described below, financial assets classified as loans and receivables under IAS 39 are carried at amortised cost using the effective interest rate method. 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.

Certain mortgage loans of the UK insurance operations and, consequent upon the purchase of REALIC in 2012, policy loans held to back funds withheld under reinsurance arrangements have been designated at fair value through profit and loss as these loan portfolios are managed and evaluated on a fair value basis.

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.

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 in section A3(2)(a), 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,'Revenue', apply measurement principles to assets and liabilities attaching to the contract.

Valuation assumptions

i Contracts of with-profits funds

For UK regulated with-profits funds, the contract liabilities are valued by reference to the UK Financial Services Authority's (FSA) realistic basis as described in section A3(2)(a). 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. An explanation of the basis of liability measurement is contained in section A3(2)(a).

The Group's other with-profits contracts are written in with-profits funds that operate in some of the Group's Asian subsidiaries. The liabilities for these contracts and those of Prudential Annuities Limited, which is a subsidiary company of the PAC with-profits fund, 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.

A: Background and accounting policies continued

A4: Critical accounting estimates and judgements continued

ii Other contracts

Contracts, other than those of with-profits funds, are written by 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.

UK insurance operations

From the perspective of shareholder results the key sensitivity for UK insurance operations are the assumptions for allowance for credit risk and mortality for UK annuity business.

Jackson

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, ie 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 traditional life insurance contracts, provisions for future policy benefits are determined using 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.

Asia operations

The insurance products written in the Group's Asia 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 Asia unit-linked business are also relatively insensitive to changes in estimates or assumptions due to the matching of asset value and liability movements. For other Asia non-participating business the degree of sensitivity of results to changes in interest rates depends upon the degree to which the liabilities under the 'grandfathered' IFRS 4 measurement basis reflects market interest rates from period to period for example, for those countries, such as those applying US GAAP, the results can be more sensitive as the effect of interest rate movements on the backing investments may not be offset by liability movements due to the US GAAP basis of measurement of insurance contracts.

Deferred acquisition costs for insurance contracts

Except for acquisition costs of with-profits contracts of the UK regulated with-profits funds, which are accounted for under the realistic FSA regime, costs of acquiring new insurance business are accounted for in a way that is consistent with the principles of the ABI SORP with deferral and amortisation against margins in future revenues on the related insurance policies. Costs of acquiring new insurance business, principally commissions, marketing and advertising and certain other costs associated with policy insurance and underwriting that are not reimbursed by policy charges, are specifically identified and capitalised as part of deferred acquisition costs (DAC). In general, this deferral is presentationally shown by an explicit carrying value for DAC in the balance sheet. However, in some Asia operations the deferral is implicit through the reserving methodology. The recoverability of the explicitly and implicitly deferred acquisition costs is measured and are deemed impaired if the projected margins are less than the carrying value. To the extent that the future margins differ from those anticipated, then an adjustment to the carrying value will be necessary.

For UK regulated with-profits funds where the realistic FSA regime is applied, the basis of setting liabilities is such that it would be inappropriate for acquisition costs to be deferred, therefore these costs are expensed as incurred. The majority of the UK shareholder-backed business is individual and group annuity business where the incidence of acquisition costs is negligible.

The deferral and amortisation of acquisition costs is of most relevance to the Group's results for Jackson and Asia operations. The DAC for Jackson and some Asia operations is determined with reference to US GAAP principles.

Jackson

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 profits. For interest-sensitive 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. 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 mortality, lapse and expenses experience is performed using internally developed experience studies.

For US variable annuity business the key assumption is the investment return from the separate accounts, which for 2012 and 2011 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(e). These returns affect the level of future expected profits through their effects on the fee income with consequential impact on the amortisation of DAC.

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(e) and H1.

As explained in note A5, the Group has adopted the US Financial Accounting Standards Board measurement and recognition requirements in Accounting Standards update No 2010-26 on 'Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts' (the 'Update') from 1 January 2012 into its IFRS reporting for the results of Jackson and those Asia operations whose IFRS insurance assets and liabilities are measured principally by reference to US GAAP principles. Under the Update insurers are required to capitalise only those incremental costs directly relating to acquiring a contract from 1 January 2012. For Group IFRS reporting Prudential has chosen to apply this new basis retrospectively for the results of these operations.

On adoption of the new DAC policy for Jackson the deferred costs balance for business in force at 31 December 2011 was retrospectively reduced from £3,880 million to £3,095 million (31 December 2010: DAC balance reduced from £3,543 million to £2,829 million).

Asia operations

For those territories applying US GAAP to insurance assets and liabilities, as permitted by the ABI SORP, principles similar to those set out in the Jackson paragraph above are applied to the deferral and amortisation of acquisition costs. For other territories in Asia, the general principles of the ABI SORP are applied with, as described above, deferral of acquisition costs being either explicit or implicit through the reserving basis.

A: Background and accounting policies continued

A5: New accounting pronouncements

The following standards, interpretations and amendments have either been adopted for the first time in 2012 or have been issued but are not yet effective in 2012, 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 could have an impact upon the Group's financial statements have been discussed.

a Accounting pronouncements adopted in 2012

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

The amendments introduce new disclosure requirements about transfers of financial assets which include disclosures for financial assets that are not derecognised in their entirety and financial assets that are derecognised in their entirety but for which the entity retains continuing involvement. The adoption of these amendments did not have a significant impact on the Group's disclosures.

Amendments to IAS 12, 'Income taxes'

These 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. The adoption of these amendments did not have a material effect on the Group's financial statements.

b Adoption of updated US GAAP reporting requirements for Group IFRS reporting in 2012

Background

In October 2010, the Emerging Issues Task Force of the US Financial Accounting Standards Board issued update No 2010-26 on 'Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts' (the 'Update'). The Update was issued to address perceived diversity in practices by companies preparing financial statements in accordance with US GAAP as regards the types of acquisition costs being deferred. Under US GAAP, costs that can be deferred and amortised are those that 'vary with and are primarily related to the acquisition of insurance contracts'. The Update requires insurers to capitalise only those incremental costs directly relating to acquiring a contract for financial statements for reporting periods beginning after 15 December 2011. All other indirect acquisition expenses are required to be charged to the income statements as incurred expenses. Accordingly, the main impact of the Update is to disallow insurers from deferring costs that are not directly related to successful sales.

The Group's IFRS accounting policies include that under IFRS 4, 'Insurance Contracts', insurance assets and liabilities other than those for UK regulated with-profits funds, are measured using the GAAP basis applied prior to IFRS adoption in 2005. On this basis insurance assets and liabilities are measured under the UK Modified Statutory Basis (MSB) which was codified by the Statement of Recommended Practice (SORP) on accounting for insurance business issued by the Association of British Insurers (ABI) in 2003. The SORP also permits the use of local GAAP subject to the requirement for adjustments to be made to ensure sufficient consistency of measurement under the UK GAAP framework under which the SORP was developed.

In applying this overarching basis, the Group has chosen to apply US GAAP for measuring the insurance assets and liabilities of Jackson. In addition, for the Group's operations in India, Japan, Taiwan and, until 2012, Vietnam*, where the local GAAP basis would not be appropriate as the start point for deriving MSB insurance asset and liabilities, the measurement has been determined substantially by reference to US GAAP requirements.

For 2012, the Group had the option to either continue with its current basis of measurement or improve its accounting policy under IFRS 4 to acknowledge the issuance of the Update. Prudential has chosen to improve its accounting policy in 2012 to apply the US GAAP update, on a retrospective basis, to the results of Jackson and the affected Asia operations.

The 2011 comparatives in these consolidated financial statements have been adjusted accordingly for the retrospective application of this Update.

* Separately from the DAC change noted above, in Vietnam, the Company has improved its estimation basis for liabilities in 2012 from one determined substantially by reference to US GAAP requirements. After making this change, the estimation basis for Vietnam is aligned substantially with that used in Singapore, Malaysia and some other Asia operations.

Effect of the change in accounting policy

(a) The effect of the change in accounting policy for deferred acquisition costs (DAC) on the income statement, earnings per share, comprehensive income, changes in equity and statement of financial position is shown in the tables below:

Consolidated income statement

	2012 £m			2011 £m		
Year ended 31 December	**Under previous policy**	**Effect of change**	**Under new policy**	**As reported under previous policy**	**Effect of change**	**Under new policy**
Total revenue, net of reinsurance	55,476	–	55,476	36,506	–	36,506
Acquisition costs and other expenditure	(5,908)	(147)	(6,055)	(5,005)	(115)	(5,120)
Total other charges, net of reinsurance	(46,233)	–	(46,233)	(29,575)	–	(29,575)
Profit before tax *(being tax attributable to shareholders' and policyholders' returns)*	3,335	(147)	3,188	1,926	(115)	1,811
(Less) Add tax (charge) credit attributable to policyholders' returns	(378)	–	(378)	17	–	17
Profit before tax attributable to shareholders	2,957	(147)	2,810	1,943	(115)	1,828
Total tax charge attributable to policyholders and shareholders	(1,039)	48	(991)	(432)	40	(392)
Adjustment to remove tax charge (credit) attributable to policyholders' returns	378	–	378	(17)	–	(17)
Tax charge attributable to shareholders' returns	(661)	48	(613)	(449)	40	(409)
Profit for the year	2,296	(99)	2,197	1,494	(75)	1,419
Profit for the year attributable to equity holders of the Company	2,296	(99)	2,197	1,490	(75)	1,415
Earnings per share (in pence)						
Based on profit attributable to the equity holders of the Company:						
Basic	90.4p	(3.9)p	86.5p	58.8p	(3.0)p	55.8p
Diluted	90.3p	(3.9)p	86.4p	58.7p	(3.0)p	55.7p

A: Background and accounting policies continued

A5: New accounting pronouncements continued

Consolidated statement of comprehensive income and statement of changes in equity

	2012 £m			2011 £m		
Year ended 31 December	Under previous policy	Effect of change	Under new policy	As reported under previous policy	Effect of change	Under new policy
Profit for the year	2,296	(99)	2,197	1,494	(75)	1,419
Exchange movements on foreign operations and net investment hedges, net of related tax	(236)	20	(216)	(100)	(5)	(105)
Unrealised valuation movements on securities of US insurance operations classified as available-for-sale	862	–	862	811	–	811
Related change in amortisation of deferred income and acquisition costs	(314)	44	(270)	(331)	56	(275)
Related tax	(190)	(15)	(205)	(168)	(19)	(187)
Net unrealised gains	358	29	387	312	37	349
Total comprehensive income for the year	2,418	(50)	2,368	1,706	(43)	1,663
Total comprehensive income for the year attributable to equity holders of the Company	2,418	(50)	2,368	1,702	(43)	1,659
Shareholders' equity:						
Net increase in shareholders' equity	1,845	(50)	1,795	1,086	(43)	1,043
At beginning of year	9,117	(553)	8,564	8,031	(510)	7,521
At end of year	10,962	(603)	10,359	9,117	(553)	8,564

Consolidated statement of financial position

	2012 £m			2011 £m		
Year ended 31 December	Under previous policy	Effect of change	Under new policy	As reported under previous policy	Effect of change	Under new policy
Assets						
Deferred acquisition costs and other intangible assets attributable to shareholders	5,173	(906)	4,267	5,069	(835)	4,234
Total other assets	305,986	–	305,986	268,511	–	268,511
Total assets	311,159	(906)	310,253	273,580	(835)	272,745
Liabilities						
Deferred tax liabilities	4,273	(303)	3,970	4,211	(282)	3,929
Total other liabilities	295,919	–	295,919	260,209	–	260,209
Total liabilities	300,192	(303)	299,889	264,420	(282)	264,138
Equity						
Shareholders' equity	10,962	(603)	10,359	9,117	(553)	8,564
Non-controlling interests	5	–	5	43	–	43
Total equity	10,967	(603)	10,364	9,160	(553)	8,607

(b) The effect of the change in accounting policy for deferred acquisition costs on the Group's supplementary analysis of profit is shown in the table below:

Segment disclosure – profit before tax

	2012 £m			2011 £m		
Year ended 31 December	Under previous policy	Effect of change	Under new policy	As reported under previous policy	Effect of change	Under new policy
Operating profit based on longer-term investment returns						
Asia insurance operations[note (i)]	922	(9)	913	704	–	704
US insurance operations[note (ii)]	1,081	(117)	964	694	(43)	651
Other operations	656	–	656	672	–	672
Total	2,659	(126)	2,533	2,070	(43)	2,027
Short-term fluctuations in investment returns on shareholder-backed business	225	(21)	204	(148)	(72)	(220)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	50	–	50	21	–	21
Gain on dilution of Group's holdings	42	–	42	–	–	–
Amortisation of acquisition accounting adjustments arising on the purchase of REALIC	(19)	–	(19)	–	–	–
Profit before tax attributable to shareholders	2,957	(147)	2,810	1,943	(115)	1,828
Basic EPS from operating profit based on longer-term investment returns after tax and non-controlling interests	80.2p	(3.4)p	76.8p	63.9p	(1.1)p	62.8p
Basic EPS based on total profit after tax and non-controlling interests	90.4p	(3.9)p	86.5p	58.8p	(3.0)p	55.8p

Notes on the effect of the change in the accounting policy on operating profit based on longer-term investment returns

(i) Asia insurance operations

	Effect of change	
	2012 £m	2011 £m
New business		
Acquisition costs on new contracts not deferred under the new policy	(14)	(16)
Business in force at beginning of period		
Reduction in amortisation on reduced DAC balance under the new policy	5	16
Total	(9)	–

(ii) US insurance operations

	Effect of change	
	2012 £m	2011 £m
New business		
Acquisition costs on new contracts not deferred under the new policy	(174)	(156)
Business in force at beginning of period		
Reduction in amortisation on reduced DAC balance under the new policy	57	113
Total	(117)	(43)

A: Background and accounting policies continued

A5: New accounting pronouncements continued

c 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 2012 year end.

Amendments to IAS 19, 'Employee benefits'

In June 2011, the IASB published amendments to IAS 19 on accounting for pensions and other post-employment benefits effective from annual periods beginning on or after 1 January 2013. The key revisions to the standard are:

- The removal of the corridor option for actuarial gains and losses
  The Group does not apply the corridor option, therefore, its removal has no impact to the Group;
- Presentation of actuarial gains and losses
  The Group currently presents actuarial gains and losses in the income statement. Under the revised standard actuarial gains and losses will be presented in 'other comprehensive income'. Details of the 2012 and 2011 actuarial gains and losses on the current basis are shown in note I3;
- The replacement of the expected return on plan assets with an amount based on the liability discount rate in the determination of pension costs
  This revision alters the pension costs included in the Group's income statement with a corresponding equal and opposite effect on the actuarial gains and losses included in other comprehensive income. The effect of this change for Prudential is not expected to be significant; and
- Enhanced disclosures, specifically on risks arising from defined benefit plans.

Adoption of the revised IAS 19 standard will have no impact on shareholders' equity.

Standards on joint arrangements and disclosures: IFRS 11, 'Joint arrangements', IFRS 12, 'Disclosures of interest in other entities' and IAS 28, 'Investments in associates and joint ventures'

In May 2011, the IASB issued IFRS 11, 'Joint arrangements' to replace IAS 31, 'Interests in Joint Ventures'. The standard also incorporates the guidance contained in related interpretation in SIC 13, Jointly Controlled Entities – Non-Monetary Contributions by Venturers. The standard requires a joint venture to be recognised as an investment and be accounted for using the equity method in accordance with IAS 28. The attaching changes to disclosure requirements for parties to joint arrangements are specified in IFRS 12, 'Disclosures of interest in other entities', which replaces the disclosure requirements of IAS 28, 'Investments in associates and joint ventures' and IAS 31, 'Interests in Joint Ventures'.

The standards are effective from annual periods beginning on or after 1 January 2013 for IFRS as issued by the IASB and 1 January 2014 for IFRS as endorsed by the EU but with early adoption permitted. The Group's investments in joint ventures are currently accounted for using proportionate consolidation. At 31 December 2012, this approach gave rise to consolidated gross assets and liabilities for the joint ventures of £3,946 million and £ 3,595 million respectively. With the application of IFRS 11, the Group's investments in joint ventures will be accounted for on a single line equity method thus giving rise at 31 December 2012 to a net interest of £351 million included within gross assets.

Similarly, the 2012 gross revenue and charges of £1,040 million and £942 million respectively, which are currently included on a line-by-line basis within the income statement will, after adoption of the standard, be presented as a single net contribution of £98 million. As a consequence, the standard will also have a small impact on profit before tax as the tax on the profits of the joint ventures will no longer be presented in the tax line, instead the tax charges will be required to be netted against the Group's share of joint ventures' income included in profit before tax. The tax charges for 2012 for the Group's share of joint ventures' income was £19 million. Adoption of the standard will have no impact on net of tax profits or shareholders' equity.

Standards on consolidation and disclosures: IFRS 10, 'Consolidated financial statements', IFRS 12, 'Disclosures of interest in other entities' and IAS 27, 'Separate financial statements'

In May 2011, the IASB issued these three standards to replace IAS 27, 'Consolidated and separate financial statements' and SIC 12, 'Consolidation – Special Purpose Entities'.

The standards are effective from annual periods beginning on or after 1 January 2013. The standards are expected to have a minor impact on the Group's assessment of its interests in investment funds (including OEICs and unit trusts) and is likely to increase the number of funds consolidated. The Group is currently determining those additional funds that will require consolidation under the requirements of IFRS 10 and the effect of retrospective adjustment to comparative results. The principal effect will be to 'gross up' the consolidated balance sheet for:

(i) The difference between the net value of the newly consolidated assets and liabilities and the previous carrying value for the Group's interest; and
(ii) The equal and opposite liability or minority interest for the external parties' interests in the funds.

The grossing up effect on the 2012 statement of financial position is not expected to exceed £1 billion. Adoption of the standard is expected to have an insignificant effect on the retrospectively adjusted comparative 2012 profit and shareholders' equity in the 2013 results.

IFRS 13, 'Fair value measurement'

In May 2011, the IASB issued IFRS 13, 'Fair value measurement' standard which creates a uniform framework to explain how to measure fair value and aims to enhance fair value disclosures, but it does not change when to measure fair value or require additional fair value measurements. The standard requires additional disclosure on the fair value of non-financial assets and liabilities and enhanced disclosures of recurring level 3 fair value measurements.

The standard is effective from annual periods beginning on or after 1 January 2013, with no adjustment to comparative results. The Group is currently assessing the impact of the standard but it is not expected to have a material impact on the fair value measurement of the Group's assets and liabilities. Disclosures will be enhanced in providing detail of the methodology and underlying assumptions used to determine fair value of the Group's assets and liabilities, in line with the new requirements.

Amendments to IAS 1, 'Presentation of financial statements'

These amendments, effective on or after 1 January 2013, change the requirement for the disclosure of items presented in other comprehensive income, requiring items to be presented separately based on whether or not they may be recycled to profit or loss in the future. The Group is expecting the amendments to be purely presentational with no significant impact on the Group's results and financial position.

Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32, 'Financial instruments: Presentation' and IFRS 7, 'Financial instruments: Disclosures')

The two amendments, effective on or after 1 January 2013 and 2014, respectively clarifies the offsetting criteria for financial assets and financial liabilities in the statement of financial position. The Group is currently assessing the impact of these amendments.

d Accounting pronouncements not yet endorsed by the EU

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

IFRS 9, 'Financial instruments: Classification and measurement'

The new standard, effective on or after 1 January 2015, will automatically replace IAS 39, 'Financial Instruments – Recognition and measurement'. Under the new requirements the classification and hence measurement of financial assets would be on two bases, either amortised cost or fair value through profit or loss, rather than the existing four bases of classification. These requirements maintain the existing amortised cost measurement for most liabilities but 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. On 28 November 2012, the IASB released an Exposure Draft proposing amendments to IAS 9. The proposed changes would introduce a fair value through other comprehensive income (FVOCI) category which would include certain financial assets that contain contractual cash flows that are solely payments of principal and interest and are held in a business model in which assets are managed both in order to collect contractual cash flows and for sale. The Group is still assessing the full impact of this standard.

B: Summary of results

B1: Segment disclosure – profit before tax

The determination of the operating segments and performance measure of the operating segments of the Group are as detailed in note A3(2)(d). Further segmentation of the income statement is provided in note F1 of these financial statements.

	Note	2012 £m	2011* £m
Asia operations			
Insurance operations notes (i),(ii)			
Operating result before gain on sale of stake in China Life of Taiwan		869	709
Gain on sale of stake in China Life of Taiwan		51	–
Total Asia insurance operations		920	709
Development expenses		(7)	(5)
Total Asia insurance operations after development expenses		913	704
Eastspring Investments		75	80
Total Asia operations		988	784
US operations			
Jackson (US insurance operations) notes (i),(ii),(iii)		964	651
Broker-dealer and asset management		39	24
Total US operations		1,003	675
UK operations			
UK insurance operations: notes (i),(ii)			
Long-term business		703	683
General insurance commission note (v)		33	40
Total UK insurance operations		736	723
M&G		371	357
Total UK operations		1,107	1,080
Total segment profit		3,098	2,539
Other income and expenditure			
Investment return and other income		13	22
Interest payable on core structural borrowings		(280)	(286)
Corporate expenditure		(231)	(219)
Total		(498)	(483)
RPI to CPI inflation measure change on defined benefit pension schemes note (vi)		–	42
Solvency II implementation costs		(48)	(55)
Restructuring costs note (vii)		(19)	(16)
Operating profit based on longer-term investment returns		2,533	2,027
Short-term fluctuations in investment returns on shareholder-backed business note (viii)		204	(220)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes note (ix)		50	21
Gain on dilution of Group's holdings	I2	42	–
Amortisation of acquisition accounting adjustments arising on the purchase of REALIC	I1	(19)	–
Profit before tax attributable to shareholders		2,810	1,828

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

Notes

(i) Operating profit based on longer-term investment returns
The Group provides supplementary analysis of IFRS profit before tax attributable to shareholders so as to distinguish operating profit based on longer-term investment returns from other elements of total profit. Operating profit based on longer-term investment returns is the basis on which management regularly reviews the performance of Prudential's segments as defined by IFRS 8. Further discussion on the determination of operating profit based on longer-term investment returns is provided in note A3(2)(d).

(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(g), D3(g) and D4(g).

(iii) Jackson operating results based on longer-term investment returns
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.

	2012 £m	2011 £m
Debt securities:		
Amortisation of interest-related realised gains and losses	72	67
Risk margin reserve charge for longer-term credit-related losses (see note (iv) below)	(66)	(56)
Equity type investments:		
Longer-term returns	54	51

(iv) The risk margin reserve (RMR) charge for longer-term credit-related losses included in operating profit based on longer-term investment returns of Jackson for 2012 is based on an average annual RMR of 26 basis points (2011: 25 basis points) on average book values of US$47.6 billion (2011: US$44.4 billion) as shown below:

	2012				2011			
	Average book value	RMR	Annual expected loss		Average book value	RMR	Annual expected loss	
Moody's rating category (or equivalent under NAIC ratings of MBS)	US$m	%	US$m	£m	US$m	%	US$m	£m
A3 or higher	23,129	0.11	(26)	(16)	21,255	0.08	(17)	(11)
Baa1, 2 or 3	21,892	0.26	(56)	(36)	20,688	0.26	(54)	(34)
Ba1, 2 or 3	1,604	1.12	(18)	(11)	1,788	1.04	(19)	(11)
B1, 2 or 3	597	2.82	(17)	(11)	474	3.01	(14)	(9)
Below B3	342	2.44	(8)	(5)	211	3.88	(8)	(5)
Total	47,564	0.26	(125)	(79)	44,416	0.25	(112)	(70)
Related change to amortisation of deferred acquisition costs (see below)			21	13			22	14
Risk margin reserve charge to operating profit for longer-term credit-related losses			(104)	(66)			(90)	(56)

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

(vi) RPI to CPI inflation measure change
During 2011, the Group altered its inflation measure basis for future statutory increases to pension payments for certain tranches of its UK defined benefit pension schemes. This reflected the UK Government's decision to replace the basis of indexation from Retail Prices Index with Consumer Prices Index. This resulted in a credit to the operating profit before tax in 2011 of £42 million.

(vii) Restructuring costs are incurred in the UK and represent one-off expenses incurred in securing expense savings.

(viii) Short-term fluctuations in investment returns on shareholder-backed business.

	2012 £m	2011* £m
Insurance operations:		
Asia	76	(92)
US	(90)	(167)
UK	136	159
Other operations:		
Economic hedge value movement	(32)	–
Other	114	(120)
Total	204	(220)

General overview of defaults
The Group did not experience any defaults on its shareholder-backed debt securities portfolio in 2012 or 2011.

Asia insurance operations
The positive short-term fluctuations of £76 million in 2012 reflects unrealised gains on bond assets following a fall in yields in the period. These gains more than offset the impact of falling interest rates in Hong Kong and the transfer to operating profit of previously booked unrealised gains on the sale of the Group's stake in China Life of Taiwan. The realised gain on the sale of the Group's stake in China Life of Taiwan of £51 million is included in the Group's operating profit based on longer-term investment returns as disclosed above.

The fluctuations of £(92) million in 2011 in part reflected equity market falls in Taiwan and negative unrealised value movement on the Group's stake in China Life of Taiwan.

B: Summary of results continued

B1: Segment disclosure – profit before tax continued

US insurance operations

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

	2012 £m	2011* £m
Short-term fluctuations relating to debt securities:		
Charges in the year:		
Defaults	–	–
Losses on sales of impaired and deteriorating bonds	(23)	(32)
Bond write downs	(37)	(62)
Recoveries/reversals	13	42
Total charges in the year note (a)	(47)	(52)
Less: Risk margin charge included in operating profit based on longer-term investment returns note (iii)	79	70
	32	18
Interest-related realised gains:		
Arising in the year	94	158
Less: amortisation of gains and losses arising in current and prior years to operating profit based on longer-term investment returns	(91)	(84)
	3	74
Related change to amortisation of deferred acquisition costs	(3)	(3)
Total short-term fluctuations related to debt securities	32	89
Derivatives (other than equity-related): market value movements (net of related change to amortisation of deferred acquisition costs) note (b)	135	554
Net equity hedge results (principally guarantees and derivatives, net of related change to amortisation of deferred acquisition costs) note (c)	(302)	(788)
Equity-type investments: actual less longer-term return (net of related change to amortisation of deferred acquisition costs) A3(d)(i)	23	–
Other items (net of related change to amortisation of deferred acquisition costs)	22	(22)
Total	(90)	(167)

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

Notes

(a) The charges on the debt securities of Jackson comprise the following:

	2012 £m	2011 £m
Residential mortgage-backed securities:		
Prime (including agency)	(4)	(25)
Alt-A	(1)	(1)
Sub-prime	(3)	–
Total residential mortgage-backed securities	(8)	(26)
Corporate debt securities	(14)	(14)
Other	(25)	(12)
Total	(47)	(52)

(b) The gain of £135 million (2011: gain of £554 million) is principally for the value movement of non-equity free-standing derivatives held to manage interest rate exposures, and for the GMIB reinsurance asset that is considered to be a derivative under IAS 39.

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 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.

(c) The amount of £(302) million (2011: £(788) million) relates to the net equity hedge accounting effect of the equity-based derivatives and associated guarantee liabilities of Jackson's variable and fixed index annuity business. The details of the value movements excluded from operating profit based on longer-term investment returns are as described in note C. The principal movements are for (i) value for free-standing and GMWB 'not for life' embedded derivatives, (ii) accounting values for GMDB and GMWB 'for life' guarantees, (iii) fee assessments and claim payments in respect of guarantee liabilities and (iv) related changes to DAC amortisation. In 2012, the charge of (£302) million principally reflects fair value movements on free-standing futures contracts and short-dated options. The movements included within the net equity hedge result include the effect of lower interest rates for which the movement was particularly significant in 2011. The value movements on derivatives held to manage this and any other interest rate exposure are included in the £135 million (2011: £554 million) described above in note (b).

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 £862 million (2011: increase in net unrealised gains of £811 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 gain on short-term fluctuations in investment returns for UK insurance operations of £136 million (2011: £159 million) principally reflect net investment gains arising in the year on fixed income assets backing the capital of the shareholder-backed annuity business.

Economic hedge value movement
This item represents the costs on short-dated hedge contracts taken out in the first half of 2012 to provide downside protection against severe equity market falls through a period of particular uncertainty with respect to the Eurozone. The hedge contracts were terminated in the second half of 2012.

Other operations
Short-term fluctuations in investment returns for Other operations in 2012 of £114 million primarily represent unrealised fair value movements on Prudential Capital's bond portfolio. Short-term fluctuations in investment returns for Other operations in 2011 of £(120) million represent unrealised value movements on investments, including centrally held swaps to manage foreign exchange and certain macroeconomic exposures of the Group.

(ix) Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes

	2012 £m	**2011** £m
Actuarial gains and losses		
Actual less expected return on scheme assets	11	9
Experience gains on scheme liabilities	15	19
(Losses) gains on changes of assumptions for scheme liabilities	(40)	12
	(14)	40
Less: amount attributable to the PAC with-profits sub-fund	15	(18)
	1	22
Other gains and losses		
One-off uplift to recognise a portion of PSPS surplus	164	–
Movement in the provision for deficit funding of PSPS	–	(4)
Less: amount attributable to the PAC with-profits sub-fund	(115)	3
	49	(1)
Total	50	21

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

For the 2011 comparatives, the shareholders' share of actuarial and other gains and losses on defined benefit pension schemes comprises the aggregate effect of actual less expected returns on scheme assets, experience gains and losses, the effect of changes in assumptions and altered provisions for deficit funding, where relevant. For 2012, these items also apply. However, the shareholders' share of actuarial and other gains and losses on defined benefit pension schemes also includes £49 million for the effect of partial recognition of surplus of the main Prudential Staff Pension Scheme. This credit arose from an altered funding arrangement following the 5 April 2011 triennial valuation. Further details on the Group's defined benefit pension schemes are shown in note I3.

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 open ended investment companies (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 potentially dilutive 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.

		2012					
	Note	**Before tax** note B1 £m	**Tax** note 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		2,533	(582)	–	1,951	76.8p	76.7p
Short-term fluctuations in investment returns on shareholder-backed business	B1	204	(26)	–	178	7.0p	7.0p
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	B1	50	(12)	–	38	1.5p	1.5p
Gain on dilution of Group's holdings	I2	42	–	–	42	1.7p	1.7p
Amortisation of acquisition accounting adjustments arising on the purchase of REALIC	I1	(19)	7	–	(12)	(0.5)p	(0.5)p
Based on profit for the year		2,810	(613)	–	2,197	86.5p	86.4p

B: Summary of results continued

B2: Earnings per share continued

	Note	Before tax note B1 £m	Tax note F5 £m	Non-controlling interests £m	Net of tax and non-controlling interests £m	Basic earnings per share pence	Diluted earnings per share pence
		2011* £m					
Based on operating profit based on longer-term investment returns		2,027	(433)	(4)	1,590	62.8p	62.7p
Short-term fluctuations in investment returns on shareholder-backed business	B1	(220)	29	–	(191)	(7.6)p	(7.6)p
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	B1	21	(5)	–	16	0.6p	0.6p
Based on profit for the year		1,828	(409)	(4)	1,415	55.8p	55.7p

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

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:

	2012 millions	2011 millions
Weighted average shares for calculation of basic earnings per share	2,541	2,533
Shares under option at end of year	9	13
Number of shares that would have been issued at fair value on assumed option exercise	(6)	(8)
Weighted average shares for calculation of diluted earnings per share	2,544	2,538

B3: Dividends

	2012 £m	2011 £m
Dividends declared and paid in reporting year		
Parent company:		
Interim dividend (2012: 8.40p; 2011: 7.95p)	215	203
Final dividend for prior period (2012: 17.24p; 2011: 17.24p)	440	439
Total	655	642

Dividends paid in cash, as set in the consolidated statement of cash flows for 2012 were £655 million (2011: £642 million).

	2012 £m	2011 £m
Parent company dividends relating to reporting year:		
Interim dividend (2012: 8.40p; 2011: 7.95p)	215	203
Final dividend (2012: 20.79p; 2011: 17.24p)	532	439
Total	747	642

Dividend per share

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 final dividend for the year ended 31 December 2011 of 17.24 pence per ordinary share was paid to eligible shareholders on 24 May 2012 and the 2012 interim dividend of 8.4 pence per ordinary share was paid to eligible shareholders on 27 September 2012.

The Board has decided to rebase the full year dividend upwards by 4 pence, reflecting the strong progress made in both the earnings and free surplus generation of the business and in the delivery of our financial objectives. In line with this, the directors recommend a final dividend of 20.79 pence per share (2011: 17.24 pence), which brings the total dividend for the year to 29.19 pence (2011: 25.19 pence), representing an increase of 15.9 per cent over 2011.

The 2012 final dividend of 20.79 pence per ordinary share will be paid on 23 May 2013 in sterling to shareholders on the principal register and the Irish branch register at 6.00pm BST on Tuesday, 2 April 2013 (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 dividends in US dollars on or about 3 June 2013. The final dividend will be paid on or about 30 May 2013 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 using the exchange rate quoted by the WM Company at the close of business on 12 March 2013. The exchange rate at which the dividend payable to the SG Shareholders will be translated into SG$, will be determined by CDP. The dividend will distribute an estimated £532 million of shareholders' funds.

Shareholders on the principal register and Irish branch register will be able to participate in a Dividend Reinvestment Plan.

B4: Exchange translation

Exchange movement recognised in other comprehensive income

	2012 £m	2011* £m
Asia operations	(87)	(28)
US operations	(187)	35
Unallocated to a segment (central funds)	60	(44)
	(214)	(37)

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

The movements for Asia 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 2012	Average for 2012	Closing rate at 31 Dec 2011	Average for 2011
Hong Kong	12.60	12.29	12.07	12.48
Indonesia	15,665.76	14,842.01	14,091.80	14,049.41
Malaysia	4.97	4.89	4.93	4.90
Singapore	1.99	1.98	2.02	2.02
India	89.06	84.70	82.53	74.80
Vietnam	33,875.42	33,083.59	33,688.16	33,139.22
US	1.63	1.58	1.55	1.60

B: Summary of results continued

B5: Group statement of financial position

To explain more comprehensively the assets, liabilities and capital of the Group's businesses, it is appropriate to provide analyses 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 2012

	2012 £m							
	Insurance operations			Total insurance operations	Asset management operations	Unallocated to a segment (central operations)	Intra-group eliminations	31 Dec Group total
By operating segment	UK D2	US D3	Asia D4		E2			
Assets								
Intangible assets attributable to shareholders:								
Goodwill	–	–	239	239	1,230	–	–	1,469
Deferred acquisition costs and other intangible assets	105	3,222	908	4,235	14	18	–	4,267
Total	105	3,222	1,147	4,474	1,244	18	–	5,736
Intangible assets attributable to with-profits funds:								
In respect of acquired subsidiaries for venture fund and other investment purposes	178	–	–	178	–	–	–	178
Deferred acquisition costs and other intangible assets	6	–	72	78	–	–	–	78
Total[H1]	184	–	72	256	–	–	–	256
Total intangible assets	289	3,222	1,219	4,730	1,244	18	–	5,992
Deferred tax assets[H4]	183	1,889	83	2,155	107	52	–	2,314
Other non-investment and non-cash assets[H3,H6]	5,424	6,792	1,117	13,333	1,051	3,766	(6,113)	12,037
Investments of long-term business and other operations:								
Investment properties	10,852	24	4	10,880	–	–	–	10,880
Investments accounted for using the equity method	72	–	–	72	41	–	–	113
Financial investments:								
Loans	3,373	6,235	1,014	10,622	1,199	–	–	11,821
Equity securities and portfolio holdings in unit trusts	36,027	49,551	14,310	99,888	70	–	–	99,958
Debt securities[B5(c)]	83,862	32,993	21,402	138,257	1,846	–	–	140,103
Other investments	4,576	2,296	957	7,829	44	27	–	7,900
Deposits	11,131	211	1,227	12,569	84	–	–	12,653
Total investments[G1,H7,H8]	149,893	91,310	38,914	280,117	3,284	27	–	283,428
Properties held for sale[H9]	98	–	–	98	–	–	–	98
Cash and cash equivalents[H10]	2,638	513	1,668	4,819	1,083	482	–	6,384
Total assets	158,525	103,726	43,001	305,252	6,769	4,345	(6,113)	310,253

Note

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. The Group's total non-current assets at 31 December comprise:

	2012 £m	2011 £m
UK including insurance operations, M&G and central operations	1,927	1,906
US	152	144
Asia*	640	681
Total	2,719	2,731

* No individual country in Asia held non-current assets at the end of the year which exceeds 10 per cent of the Group total.

By operating segment	2012 £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 Group total
Equity and liabilities								
Equity								
Shareholders' equity H11	3,033	4,343	2,529	9,905	1,937	(1,483)	–	10,359
Non-controlling interests	1	–	4	5	–	–	–	5
Total equity	3,034	4,343	2,533	9,910	1,937	(1,483)	–	10,364
Liabilities								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Insurance contract liabilities H12	84,266	90,192	34,126	208,584	–	–	–	208,584
Investment contract liabilities with discretionary participation features G1	33,464	–	348	33,812	–	–	–	33,812
Investment contract liabilities without discretionary participation features G1	16,182	2,069	127	18,378	–	–	–	18,378
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds) D2,H12	10,526	–	63	10,589	–	–	–	10,589
Total policyholder liabilities and unallocated surplus of with-profits funds	144,438	92,261	34,664	271,363	–	–	–	271,363
Core structural borrowings of shareholder-financed operations: H13								
Subordinated debt	–	–	–	–	–	2,577	–	2,577
Other	–	153	–	153	275	549	–	977
Total	–	153	–	153	275	3,126	–	3,554
Operational borrowings attributable to shareholder-financed operations	127	26	7	160	1	2,084	–	2,245
Borrowings attributable to with-profits operations	1,033	–	–	1,033	–	–	–	1,033
Other non-insurance liabilities:								
Obligations under funding, securities lending and sale and repurchase agreements	1,461	920	55	2,436	–	–	–	2,436
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	2,307	25	1,851	4,183	162	–	–	4,345
Deferred tax liabilities	1,185	2,168	588	3,941	13	16	–	3,970
Current tax liabilities	237	–	49	286	8	151	–	445
Accruals and deferred income	429	–	110	539	266	28	–	833
Other creditors	2,766	611	1,601	4,978	3,771	145	(6,113)	2,781
Provisions	291	20	66	377	149	75	–	601
Derivative liabilities	1,007	645	837	2,489	150	190	–	2,829
Other liabilities	210	2,554	640	3,404	37	13	–	3,454
Total	9,893	6,943	5,797	22,633	4,556	618	(6,113)	21,694
Total liabilities	155,491	99,383	40,468	295,342	4,832	5,828	(6,113)	299,889
Total equity and liabilities	158,525	103,726	43,001	305,252	6,769	4,345	(6,113)	310,253

B: Summary of results continued

B5: Group statement of financial position continued

i Position at 31 December 2011

By operating segment	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 Group total
	2011* £m							
Assets								
Intangible assets attributable to shareholders:								
Goodwill	–	–	235	235	1,230	–	–	1,465
Deferred acquisition costs and other intangible assets	113	3,115	977	4,205	16	13	–	4,234
Total[H1]	113	3,115	1,212	4,440	1,246	13	–	5,699
Intangible assets attributable to with-profits funds:								
In respect of acquired subsidiaries for venture fund and other investment purposes	178	–	–	178	–	–	–	178
Deferred acquisition costs and other intangible assets	6	–	83	89	–	–	–	89
Total[H2]	184	–	83	267	–	–	–	267
Total intangible assets	297	3,115	1,295	4,707	1,246	13	–	5,966
Deferred tax assets	231	1,392	115	1,738	129	409	–	2,276
Other non-investment and non-cash assets[H3,H6]	4,771	1,542	1,024	7,337	1,000	4,532	(6,231)	6,638
Investments of long-term business and other operations:								
Investment properties	10,712	35	10	10,757	–	–	–	10,757
Investments accounted for using the equity method	70	–	–	70	–	–	–	70
Financial investments:								
Loans	3,115	4,110	1,233	8,458	1,256	–	–	9,714
Equity securities and portfolio holdings in unit trusts	36,722	38,036	11,997	86,755	594	–	–	87,349
Debt securities[B5(c)]	77,953	27,022	17,681	122,656	1,842	–	–	124,498
Other investments	4,568	2,376	470	7,414	78	17	–	7,509
Deposits	9,287	167	1,165	10,619	89	–	–	10,708
Total investments[G1,H7,H8]	142,427	71,746	32,556	246,729	3,859	17	–	250,605
Properties held for sale[H9]	–	3	–	3	–	–	–	3
Cash and cash equivalents[H10]	2,965	271	1,977	5,213	1,735	309	–	7,257
Total assets	150,691	78,069	36,967	265,727	7,969	5,280	(6,231)	272,745

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

By operating segment	2011* £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 Group total
Equity and liabilities								
Equity								
Shareholders' equity H11	2,581	3,761	2,306	8,648	1,783	(1,867)	–	8,564
Non-controlling interests	33	–	5	38	5	–	–	43
Total equity	2,614	3,761	2,311	8,686	1,788	(1,867)	–	8,607
Liabilities								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Insurance contract liabilities H12	82,732	67,278	30,353	180,363	–	–	–	180,363
Investment contract liabilities with discretionary participation features G1	29,348	–	397	29,745	–	–	–	29,745
Investment contract liabilities without discretionary participation features G1	14,944	1,911	112	16,967	–	–	–	16,967
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds) D2,H12	9,165	–	50	9,215	–	–	–	9,215
Total policyholder liabilities and unallocated surplus of with-profits funds	136,189	69,189	30,912	236,290	–	–	–	236,290
Core structural borrowings of shareholder-financed operations: G1,H13								
Subordinated debt	–	–	–	–	–	2,652	–	2,652
Other	–	160	–	160	250	549	–	959
Total	–	160	–	160	250	3,201	–	3,611
Operational borrowings attributable to shareholder-financed operations	103	127	141	371	13	2,956	–	3,340
Borrowings attributable to with-profits operations	972	–	–	972	–	–	–	972
Other non-insurance liabilities:								
Obligations under funding, securities lending and sale and repurchase agreements H4,H14,H15	1,945	1,169	–	3,114	–	–	–	3,114
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	2,043	18	1,101	3,162	678	–	–	3,840
Deferred tax liabilities	1,349	1,818	506	3,673	5	251	–	3,929
Current tax liabilities	553	–	116	669	106	155	–	930
Accruals and deferred income	321	–	103	424	290	22	–	736
Other creditors	2,829	548	660	4,037	4,493	245	(6,231)	2,544
Provisions	266	13	47	326	133	70	–	529
Derivative liabilities	1,298	887	480	2,665	182	207	–	3,054
Other liabilities	209	379	590	1,178	31	40	–	1,249
Total	10,813	4,832	3,603	19,248	5,918	990	(6,231)	19,925
Total liabilities	148,077	74,308	34,656	257,041	6,181	7,147	(6,231)	264,138
Total equity and liabilities	150,691	78,069	36,967	265,727	7,969	5,280	(6,231)	272,745

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

B: Summary of results continued

B5: Group statement of financial position continued

ii Group statement of financial position – additional analysis by business type

	2012 £m							2011* £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 eliminations	31 Dec Group total	31 Dec Group total
Assets								
Intangible assets attributable to shareholders:								
Goodwill	–	–	239	1,230	–	–	1,469	1,465
Deferred acquisition costs and other intangible assets	–	–	4,235	14	18	–	4,267	4,234
Total	–	–	4,474	1,244	18	–	5,736	5,699
Intangible assets attributable to with-profits funds:								
In respect of acquired subsidiaries for venture fund and other investment purposes	178	–	–	–	–	–	178	178
Deferred acquisition costs and other intangible assets	78	–	–	–	–	–	78	89
Total	256	–	–	–	–	–	256	267
Total intangible assets	256	–	4,474	1,244	18	–	5,992	5,966
Deferred tax assets	114	–	2,041	107	52	–	2,314	2,276
Other non-investment and non-cash assets	3,133	508	9,692	1,051	3,766	(6,113)	12,037	6,638
Investments of long-term business and other operations:								
Investment properties	8,659	622	1,599	–	–	–	10,880	10,757
Investments accounted for using the equity method	–	–	72	41	–	–	113	70
Financial investments:								
Loans	2,709	–	7,913	1,199	–	–	11,821	9,714
Equity securities and portfolio holdings in unit trusts	25,105	73,860	923	70	–	–	99,958	87,349
Debt securities	62,002	9,504	66,751	1,846	–	–	140,103	124,498
Other investments	4,745	57	3,027	44	27	–	7,900	7,509
Deposits	9,470	1,396	1,703	84	–	–	12,653	10,708
Total investments	112,690	85,439	81,988	3,284	27	–	283,428	250,605
Properties held for sale	98	–	–	–	–	–	98	3
Cash and cash equivalents	1,721	1,310	1,788	1,083	482	–	6,384	7,257
Total assets	118,012	87,257	99,983	6,769	4,345	(6,113)	310,253	272,745

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

	2012 £m							2011* £m
		Shareholder-backed business						
	Partici-pating funds	Unit-linked and variable annuity	Non-linked business	Asset manage-ment operations E2	Unallo-cated to a segment (central operations)	Intra-group elimina-tions	31 Dec Group total	31 Dec Group total
Equity and liabilities								
Equity								
Shareholders' equity	–	–	9,905	1,937	(1,483)	–	10,359	8,564
Non-controlling interests	1	–	4	–	–	–	5	43
Total equity	1	–	9,909	1,937	(1,483)	–	10,364	8,607
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)	97,795	85,523	77,456	–	–	–	260,774	227,075
Unallocated surplus of with-profits funds	10,589	–	–	–	–	–	10,589	9,215
Total policyholder liabilities and unallocated surplus of with-profits funds	108,384	85,523	77,456	–	–	–	271,363	236,290
Core structural borrowings of shareholder-financed operations:								
Subordinated debt	–	–	–	–	2,577	–	2,577	2,652
Other	–	–	153	275	549	–	977	959
Total	–	–	153	275	3,126	–	3,554	3,611
Operational borrowings attributable to shareholder-financed operations	–	1	159	1	2,084	–	2,245	3,340
Borrowings attributable to with-profits operations	1,033	–	–	–	–	–	1,033	972
Deferred tax liabilities	1,086	46	2,809	13	16	–	3,970	3,929
Other non-insurance liabilities	7,508	1,687	9,497	4,543	602	(6,113)	17,724	15,996
Total liabilities	118,011	87,257	90,074	4,832	5,828	(6,113)	299,889	264,138
Total equity and liabilities	118,012	87,257	99,983	6,769	4,345	(6,113)	310,253	272,745

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

B: Summary of results continued

B5: Group statement of financial position continued

b 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 £m			
	Note	UK	US	Asia	Total
At 1 January 2011		135,717	60,523	28,740	224,980
Comprising:					
Policyholder liabilities		125,530	60,523	28,674	214,727
Unallocated surplus of with-profits funds		10,187	–	66	10,253
Premiums		6,988	12,914	5,079	24,981
Surrenders		(4,255)	(4,270)	(2,237)	(10,762)
Maturities/deaths		(7,813)	(820)	(664)	(9,297)
Net flows		(5,080)	7,824	2,178	4,922
Shareholders' transfers post-tax		(216)	–	(30)	(246)
Investment-related items and other movements		5,862	136	365	6,363
Foreign exchange translation differences		(94)	706	(341)	271
As at 31 December 2011		136,189	69,189	30,912	236,290
Comprising:					
Policyholder liabilities		127,024	69,189	30,862	227,075
Unallocated surplus of with-profits funds		9,165	–	50	9,215
At 1 January 2012		136,189	69,189	30,912	236,290
Premiums		8,340	14,907	5,620	28,867
Surrenders		(4,785)	(4,356)	(2,541)	(11,682)
Maturities/deaths		(8,009)	(954)	(658)	(9,621)
Net flows		(4,454)	9,597	2,421	7,564
Shareholders' transfers post-tax		(205)	–	(31)	(236)
Investment-related items and other movements		13,006	4,241	2,178	19,425
Foreign exchange translation differences		(98)	(3,678)	(816)	(4,592)
Acquisition of REALIC	**I1**	–	12,912	–	12,912
At 31 December 2012		144,438	92,261	34,664	271,363
Comprising:					
Policyholder liabilities		133,912	92,261	34,601	260,774
Unallocated surplus of with-profits funds		10,526	–	63	10,589
Average policyholder liability balances*					
2012		130,468	77,497	32,732	240,697
2011		126,277	64,856	29,768	220,901

* Averages have been based on opening and closing balances and adjusted for acquisitions and disposals in the period and exclude 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. The policyholder liabilities shown include investment contracts without discretionary participation features (as defined in IFRS 4) and their full movement in the year. The items above are shown gross of reinsurance.

The analysis includes the impact of premiums, claims and investment movements on policyholders' liabilities. The impact does not represent premiums, claims and investment movements as reported in the income statement. For example, the premiums shown above will exclude any deductions for fees/charges and claims represent the policyholder liabilities provision released rather than the claim amount paid to the policyholder.

c Debt securities and loans

i Information on the credit risks of debt securities

	2012 £m						2011 £m
	Insurance operations			Total insurance operations	Asset management	Group total	Group total
	UK	US	Asia				
S&P – AAA	9,200	187	785	10,172	1,046	11,218	12,593
S&P – AA+ to AA-	9,623	6,343	5,523	21,489	106	21,595	17,038
S&P – A+ to A-	23,000	7,728	3,282	34,010	206	34,216	31,161
S&P – BBB+ to BBB-	17,720	10,230	1,906	29,856	235	30,091	25,860
S&P – Other	3,043	1,173	3,132	7,348	37	7,385	6,346
	62,586	25,661	14,628	102,875	1,630	104,505	92,998
Moody's – Aaa	8,446	55	1,389	9,890	135	10,025	9,615
Moody's – Aa1 to Aa3	1,420	18	271	1,709	36	1,745	806
Moody's – A1 to A3	927	21	169	1,117	–	1,117	1,352
Moody's – Baa1 to Baa3	1,385	56	375	1,816	12	1,828	1,228
Moody's – Other	307	13	112	432	–	432	318
	12,485	163	2,316	14,964	183	15,147	13,319
Implicit ratings of MBS based on NAIC valuations (see below)							
NAIC 1	–	2,934	–	2,934	–	2,934	2,577
NAIC 2	–	207	–	207	–	207	147
NAIC 3-6	–	321	–	321	–	321	368
	–	3,462	–	3,462	–	3,462	3,092
Fitch	527	184	533	1,244	21	1,265	1,039
Other	8,264	3,523	3,925	15,712	12	15,724	14,050
Total debt securities	83,862	32,993	21,402	138,257	1,846	140,103	124,498

In the table above, with the exception of some 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. For some mortgage-backed securities within Jackson, the table above includes these securities using the regulatory ratings detail issued by the National Association of Insurance Commissioners (NAIC). These regulatory ratings levels were established by external third parties (PIMCO for residential mortgage-backed securities and BlackRock Solutions for commercial mortgage-backed securities). Notes D2(c), D3(c), D4(c) and E2 provide further details on the credit risks of debt securities by segment.

B: Summary of results continued

B5: Group statement of financial position continued

ii Group's exposure to holdings in asset-backed securities

The Group's exposure to holdings in asset-backed securities (ABS), which comprise residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), collateralised debt obligations (CDO) funds and other asset-backed securities, at 31 December 2012 is as follows:

	2012 £m	2011 £m
Shareholder-backed operations:		
UK insurance operations (2012: 34% AAA, 17% AA) note (i)	1,408	1,358
US insurance operations D3	5,626	5,380
Asia insurance operations note (ii)	144	176
Asset management operations note (iii)	566	594
	7,744	7,508
With-profits operations:		
UK insurance operations (2012: 60% AAA, 9% AA) note (i)	5,850	5,351
Asia insurance operations note (ii)	241	454
	6,091	5,805
Total	13,835	13,313

Notes

(i) UK insurance operations
All of the exposure of the shareholder-backed business relates to the UK market and primarily relates to investments held by PRIL. Of the £5,850 million (2011: £5,351 million) relating to with-profits business, £1,697 million (2011: £1,314 million) relates to exposure to the US and with the remaining exposure being primarily to the UK market.

(ii) Asia insurance operations
The Asia insurance operations' exposure to asset-backed securities is primarily held by the with-profits operations. Of the £241 million, 63 per cent (2011: £454 million, 75 per cent) are investment grade.

(iii) Asset management operations
Asset management operations' exposure to asset-backed securities is held by Prudential Capital with no sub-prime exposure. Of the £566 million, 77 per cent (2011: £595 million, 77 per cent) are graded AAA.

iii Group sovereign debt exposure

The exposures held by the shareholder-backed business and with-profits funds in sovereign debts and bank debt securities at 31 December 2012 are given within the Risk and capital management section of the Business review under Credit risk.

iv 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.

C: Group risk management

C: Group risk management

Disclosures concerning the Group's risk framework and 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 have been included in the audited sections of the Risk and capital management disclosure in the Business review. Additional disclosures are shown in section D1.

D: Life assurance business

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 Modified Statutory Basis (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, 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
  – Guaranteed Investment Contracts (GICs) and funding agreements
  – minor amounts of 'annuity certain' contracts; and
- Prudential Corporation Asia
  – minor amounts for a number of small categories of business.

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's capital and profitability metrics involving IGD, Group economic capital, EEV and IFRS, to 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. At 31 December 2012 the reinsurers' share of insurance contract liabilities was £6,859 million (2011: £1,344 million). The increase arises from the acquisition of REALIC. Further details are shown in note D3(f) and I1. At 31 December 2012, 97 per cent (2011: 91 per cent) of the reinsurance recoverable insurance assets were ceded by the Group's UK and US operations, of which 92 per cent (2011: 94 per cent) of the balance were from reinsurers with Standard & Poor's rating A- and above.

c Guarantees

Notes D2(d), D3(d) and D4(d) 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 2012 as described in section D2(e)(ii). The UK business also has products with guaranteed annuity option features, mostly within Scottish Amicable Insurance Fund (SAIF), as described in section D2(d). 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(d). Jackson's derivative programme seeks to manage the exposures as described in section D3(h).

d Sensitivity of EEV shareholders' basis profit and equity to 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.

e Sensitivity of IFRS basis profit or loss and shareholders' 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 shareholders' 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.

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 the shareholder-backed business; and
- The main exposures of the Group's IFRS basis results to market risk for its life assurance operations on investments of the shareholder-backed business are for debt securities.

The most significant items for which the IFRS shareholders' profit or loss and shareholders' 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.

D: Life assurance business continued

D1: Group overview continued

Type of business	Market and credit risk			Insurance and lapse risk
	Investments/derivatives	Liabilities/unallocated surplus	Other exposure	
UK insurance operations (see also section D2(h))				
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 for assets covering liabilities and shareholder capital Interest rate risk for assets in excess of liabilities ie assets representing shareholder capital			Mortality experience and assumptions for longevity
US insurance operations (see also section D3(h))				
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 indexed annuity business	Derivative hedge programme to the extent not fully hedged against liability and fund performance	Incidence of equity participation features		
Fixed indexed annuities, Fixed annuities and GIC business	Credit risk Interest rate risk		Spread difference between earned rate and rate credited to policyholders	Lapse risk, but the effects of extreme events are mitigated by the application of market value adjustments and by the use of swaption contracts
	Profit and loss and shareholders' equity are volatile for these risks as they affect the values of derivatives and embedded derivatives and impairment losses. In addition, shareholders' equity is volatile for the incidence of these risks on unrealised appreciation of fixed income securities classified as available-for-sale under IAS 39			

Type of business	Market and credit risk			Insurance and lapse risk
	Investments/derivatives	**Liabilities/unallocated surplus**	**Other exposure**	
Asia insurance operations (see also section D4(h))				
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	
	Asset/liability mismatch risk			
Non-participating business	Credit risk Interest rate and price risk	Interest rates for those operations where the basis of insurance liabilities is sensitive to current market movements		.

ii IFRS shareholder results – Exposures for market and other risk

Key Group exposures

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

UK

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 UK shareholder-backed annuity business. At the total IFRS profit level, the result is particularly sensitive to temporary value movements on assets backing US and Asia policyholder liabilities (which in general are measured on a basis that is insensitive to current market movements) and shareholder equity.

US

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 and second order equity-based exposure in respect of variable annuity asset management fees. Further information is given below in note D3h(iv).

Jackson's derivative programme is used to manage interest rate risk associated with a broad range of products and equity market risk attaching to its equity-based products. Movements in equity markets, 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. Combined with the use of US GAAP measurement (as 'grandfathered' under IFRS 4) for the insurance contracts assets and liabilities which is largely insensitive to current period market movements, the Jackson total profit (ie including short-term fluctuations in investment returns) is very sensitive to market movements. In addition to these effects the Jackson shareholders' 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 shareholders' equity (ie outside the income statement). See D3(h) for details of the hedging.

D: Life assurance business continued

D1: Group overview continued

Asia

For Asia 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 risks.

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

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. Relevant correlation factors include:

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

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

The effect of Group diversification across the Group's life businesses 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(i), D3(i) and D4(i).

In the years 2008 to 2012, claims paid on the Group's life assurance contracts, including those classified as investment contracts under IFRS 4, ranged from £17 billion to £21 billion. Indicatively, it is to be expected that, of the Group's policyholder liabilities (excluding unallocated surplus) at 31 December 2012 of £260.8 billion, the amounts likely to be paid in 2013 will be of a similar magnitude.

D2: UK insurance operations

a Summary statement of financial position

In order to show the statement of financial position by reference to the differing degrees of policyholder and shareholder economic interest of the different types of fund and business, the analysis below is structured to show separately 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 long-term business.

£97 billion of the £150 billion of investments are held by SAIF and the PAC WPSF. Shareholders are exposed only indirectly to value movements on these assets.

	31 Dec 2012 £m						31 Dec 2011 £m
			Other funds and subsidiaries				
By operating segment	Scottish Amicable Insurance Fund note (iii)	PAC with-profits fund notes (i), (ii)	Unit-linked assets and liabilities	Annuity and other long-term business	Total	UK insurance operations Total	UK insurance operations Total
Assets							
Intangible assets attributable to shareholders:							
Deferred acquisition costs and other intangible assets	–	–	–	105	105	105	113
Total	–	–	–	105	105	105	113
Intangible assets attributable to with-profits funds:							
In respect of acquired subsidiaries for venture fund and other investment purposes	–	178	–	–	–	178	178
Deferred acquisition costs	–	6	–	–	–	6	6
Total	–	184	–	–	–	184	184
Total intangible assets	–	184	–	105	105	289	297
Deferred tax assets	1	113	–	69	69	183	231
Other non-investment and non-cash assets	369	2,440	385	2,230	2,615	5,424	4,771
Investments of long-term business and other operations:							
Investment properties[note (iv)]	500	8,159	622	1,571	2,193	10,852	10,712
Associate investments accounted for using the equity method	–	–	–	72	72	72	70
Financial investments:							
Loans[note (v)]	116	1,993	–	1,264	1,264	3,373	3,115
Equity securities and portfolio holdings in unit trusts	2,070	19,875	14,071	11	14,082	36,027	36,722
Debt securities	3,864	46,643	6,310	27,045	33,355	83,862	77,953
Other investments[note (vi)]	283	3,958	10	325	335	4,576	4,568
Deposits	910	8,395	822	1,004	1,826	11,131	9,287
Total investments	7,743	89,023	21,835	31,292	53,127	149,893	142,427
Properties held for sale	–	98	–	–	–	98	–
Cash and cash equivalents	120	1,077	889	552	1,441	2,638	2,965
Total assets	8,233	92,935	23,109	34,248	57,357	158,525	150,691

D: Life assurance business continued

D2: UK insurance operations continued

By operating segment	31 Dec 2012 £m Scottish Amicable Insurance Fund note (iii)	PAC with-profits fund notes (i),(ii)	Other funds and subsidiaries: Unit-linked assets and liabilities	Other funds and subsidiaries: Annuity and other long-term business	Other funds and subsidiaries: Total	UK insurance operations Total	31 Dec 2011 £m UK insurance operations Total
Equity and liabilities							
Equity							
Shareholders' equity	–	–	–	3,033	3,033	3,033	2,581
Non-controlling interests	–	1	–	–	–	1	33
Total equity	–	1	–	3,033	3,033	3,034	2,614
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)	7,878	76,529	22,197	27,308	49,505	133,912	127,024
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds)	–	10,526	–	–	–	10,526	9,165
Total	7,878	87,055	22,197	27,308	49,505	144,438	136,189
Operational borrowings attributable to shareholder-financed operations	–	–	1	126	127	127	103
Borrowings attributable to with-profits funds	17	1,016	–	–	–	1,033	972
Deferred tax liabilities	39	663	–	483	483	1,185	1,349
Other non-insurance liabilities	299	4,200	911	3,298	4,209	8,708	9,464
Total liabilities	8,233	92,934	23,109	31,215	54,324	155,491	148,077
Total equity and liabilities	8,233	92,935	23,109	34,248	57,357	158,525	150,691

Notes

(i) For the purposes of this table and subsequent explanation, references to the WPSF also include, for convenience, the amounts attaching to the Defined Charges Participating Sub-fund which comprises 3.3 per cent of the total assets of the 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. Included in the PAC with-profits fund is £13.3 billion (2011: £12.6 billion) of non-profits annuities liabilities.

(ii) Excluding policyholder liabilities of the Hong Kong branch of PAC.

(iii) SAIF is a separate sub-fund within the PAC long-term business fund.

(iv) Investment properties

At 31 December 2012, the Group's UK insurance operations had £10,852 million (2011: £10,712 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 A3.

	2012		2011	
	£m	%	£m	%
Office buildings	4,195	38.7	4,443	41.5
Shopping centres/commercial	4,389	40.4	4,315	40.3
Retail warehouses/industrial	1,624	15.0	1,406	13.1
Development	465	4.3	383	3.6
Other	179	1.6	165	1.5
Total	10,852	100.0	10,712	100.0

47.6 per cent (2011: 42.9 per cent) of the UK held investment property is located in London and Southeast England with 35.4 per cent (2011: 41.1 per cent) located throughout the rest of the UK and the remaining 17.0 per cent (2011: 16.0 per cent) located overseas.

(v) Loans

The loans of the Group's UK insurance operations comprise:

	2012 £m	2011 £m
SAIF and PAC WPSF:		
Mortgage loans*	1,311	1,036
Policy loans	16	20
Other loans†	782	917
Total SAIF and PAC WPSF loans	2,109	1,973
Shareholder-backed:		
Mortgage loans*	1,259	1,137
Other loans	5	5
Total shareholder-backed loans	1,264	1,142
Total UK insurance operations loans	3,373	3,115

* The mortgage loans are collateralised by properties. By carrying value, 86 per cent of the £1,259 million held for shareholder-backed business relates to lifetime (equity release) mortgage business which has an average loan to property value of 29 per cent.

† Other loans held by the PAC with-profits fund are all commercial loans and comprise mainly syndicated loans.

(vi) Other investments comprise:

	2012 £m	2011 £m
Derivative assets*	1,349	1,461
Partnerships in investment pools and other†	3,227	3,107
	4,576	4,568

* After including derivative liabilities of £1,007 million (2011: £1,298 million), which are also included in the statement of financial position, the overall derivative position was a net asset of £342 million (2011: £163 million).

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

D: Life assurance business continued

D2: UK insurance operations continued

b 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	Total £m
At 1 January 2011	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
Premiums	3,413	1,854	1,721	6,988
Surrenders	(2,285)	(1,851)	(119)	(4,255)
Maturities/Deaths	(5,551)	(655)	(1,607)	(7,813)
Net flows[note (a)]	(4,423)	(652)	(5)	(5,080)
Shareholders' transfers post tax	(216)	–	–	(216)
Switches	(237)	237	–	–
Investment-related items and other movements[note (b)]	3,338	25	2,499	5,862
Foreign exchange translation differences	(94)	–	–	(94)
At 31 December 2011/1 January 2012	90,141	21,281	24,767	136,189
Comprising:				
Policyholder liabilities	80,976	21,281	24,767	127,024
Unallocated surplus of with-profits funds	9,165	–	–	9,165
Premiums	4,539	1,775	2,026	8,340
Surrenders	(2,200)	(2,378)	(207)	(4,785)
Maturities/Deaths	(5,664)	(658)	(1,687)	(8,009)
Net flows[note (a)]	(3,325)	(1,261)	132	(4,454)
Shareholders' transfers post tax	(205)	–	–	(205)
Switches	(236)	236	–	–
Investment-related items and other movements[note (b)]	8,656	1,941	2,409	13,006
Foreign exchange translation differences	(98)	–	–	(98)
At 31 December 2012	94,933	22,197	27,308	144,438
Comprising:				
Policyholder liabilities	84,407	22,197	27,308	133,912
Unallocated surplus of with-profits funds	10,526	–	–	10,526
Average policyholder liability balances*				
2012	82,691	21,739	26,038	130,468
2011	81,281	21,476	23,520	126,277

* Averages have been based on opening and closing balances and exclude unallocated surplus of with-profits funds.

Notes

(a) Net outflows decreased from £5,080 million in 2011 to £4,454 million in 2012. An improvement in the net outflows of the with-profits business, following increased sales of with-profits bonds in the year, has been greater than the increase in outflows in the unit-linked business. The levels of inflows/outflows for unit-linked business is driven by the activity of corporate pension schemes with transfers in or out from only one or two schemes influencing the level of flows in the year. The net flows of negative £1,261 million in unit-linked business was a result of lower single premiums in and higher transfers out of this business in 2012.

(b) Investment-related items and other movements of £13,006 million across fund types reflected the continued strong performance of UK equity markets in 2012, as well as investment gains from debt securities following falling bond yields, and other asset classes.

c Information on credit risk of debt securities

The following table summarises by rating the securities held by UK insurance operations as at 31 December 2012 and 2011:

UK insurance operations

	31 Dec 2012 £m						31 Dec 2011 £m
			Other funds and subsidiaries				
	Scottish Amicable Insurance Fund	PAC with-profits fund	Unit-linked assets	PRIL	Other annuity and long-term business	Total	Total
S&P – AAA	441	4,716	582	3,023	438	9,200	9,928
S&P – AA+ to AA-	527	4,908	829	3,041	318	9,623	8,647
S&P – A+ to A-	1,031	12,345	1,805	6,934	885	23,000	21,474
S&P – BBB+ to BBB-	911	10,614	1,340	4,210	645	17,720	15,746
S&P – Other	224	2,358	115	307	39	3,043	3,175
	3,134	34,941	4,671	17,515	2,325	62,586	58,970
Moody's – Aaa	241	3,780	1,239	2,557	629	8,446	7,945
Moody's – Aa1 to Aa3	41	538	106	622	113	1,420	651
Moody's – A1 to A3	32	505	26	321	43	927	1,008
Moody's – Baa1 to Baa3	54	818	113	370	30	1,385	1,030
Moody's – Other	15	224	30	30	8	307	242
	383	5,865	1,514	3,900	823	12,485	10,876
Fitch	20	295	26	165	21	527	492
Other	327	5,542	99	2,157	139	8,264	7,615
Total debt securities	3,864	46,643	6,310	23,737	3,308	83,862	77,953

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. The £8,264 million total debt securities held at 31 December 2012 (2011: £7,615 million) which are not externally rated are either internally rated or unrated. These are analysed as follows:

	2012 £m	2011 £m
Internal ratings or unrated:		
AAA to A-	3,150	2,726
BBB to B-	3,752	3,773
Below B- or unrated	1,362	1,116
Total	8,264	7,615

The majority of unrated debt security investments were held in SAIF and the PAC with-profits sub-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 £2,296 million PRIL and other annuity and long-term business investments which are not externally rated, £6 million were internally rated AAA, £429 million AA, £737 million A, £895 million BBB, £115 million BB and £114 million were internally rated B+ and below or unrated.

During 2011 Standard & Poor's withdrew its ratings of debt securities issued by a number of sovereigns. Where these are no longer available Moody's ratings have been used. This primarily impacts the UK and Asia insurance operations.

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

D: Life assurance business continued

D2: UK insurance operations continued

d 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 (WPSF), SAIF, and the non-profit sub-fund;
- Prudential Annuities Limited (PAL), which is owned by the PAC with-profits sub-fund;
- Prudential Retirement Income Limited (PRIL), 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 2012, as shown in note D2(a), there are policyholder liabilities and unallocated surplus of £87.1 billion (2011: £81.6 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 £47 million at 31 December 2012 (2011: £90 million) to honour guarantees on a small amount of guaranteed annuity products. SAIF's exposure to guaranteed annuities is described below.

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 of directors (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. 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 as 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 for accumulating with-profits policies and is the surrender bases for conventional with-profits business; and
- For the SAIF and Scottish Amicable, 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 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; and
- 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.

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 (eg 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.

D: Life assurance business continued

D2: UK insurance operations continued

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.

	2012 £m	2011 £m
Net income of the fund:		
Investment return	8,350	4,094
Claims incurred	(6,857)	(6,411)
Movement in policyholder liabilities	(3,989)	(614)
Add back policyholder bonuses for the year (as shown below)	1,865	1,945
Claims incurred and movement in policyholder liabilities (including charge for provision for asset shares and excluding policyholder bonuses)	(8,981)	(5,080)
Earned premiums, net of reinsurance	4,558	3,404
Other income	39	17
Acquisition costs and other expenditure	(740)	(696)
Tax charge	(292)	(63)
Net income of the fund before movement in unallocated surplus	2,934	1,676
Movement in unallocated surplus	(863)	485
Surplus for distribution	2,071	2,161
Surplus for distribution allocated as follows:		
90% policyholders' bonus (as shown above)	1,865	1,945
10% shareholders' transfers	206	216
	2,071	2,161

ii Annuity business

Prudential's conventional annuities include level, fixed-increase and inflation-linked annuities, the link being to the Retail Prices Index (RPI) in the majority of cases. They are mainly written within the subsidiaries PAL, PRIL, the PAC non-profit sub-fund and the PAC with-profits sub-fund, but there are some annuity liabilities in Prudential Pensions Limited 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 2012, £41.7 billion (2011: £38.3 billion) of investments relate to non-profit annuity business of the PAC WPSF (including PAL) and the annuity business of PRIL. These investments are predominantly in debt securities (including retail price index-linked bonds to match retail price index-linked annuities), loans, deposits and property, 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 ie in excess of those based on asset share.

Provision is made for the risks attaching to some SAIF unitised with-profits policies that have (Market Value Reduction) MVR-free dates and for those SAIF products which have a guaranteed minimum benefit on death or maturity of premiums accumulated at 4 per cent per annum.

The Group's main exposure to guaranteed annuities in the UK is through SAIF and a provision of £371 million was held in SAIF at 31 December 2012 (2011: £370 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.

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.

e 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 (including the business recaptured by PAC WPSF in 2011) 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 requirement is explained further in note A3(2)(a) under the UK regulated with-profits section.

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

D: Life assurance business continued

D2: UK insurance operations continued

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 allowance for credit risk comprises (i) an amount for long-term best estimate defaults, and (ii) additional provisions for credit risk premium, downgrade resilience and short-term defaults.

The weighted components of the bond spread over swap rates for shareholder-backed fixed and linked annuity business for PRIL at 31 December 2012 and 31 December 2011, based on the asset mix at the relevant balance sheet date are shown below.

31 December 2012	Pillar 1 regulatory basis (bps)	Adjustment from regulatory to IFRS basis (bps)	IFRS (bps)
Bond spread over swap rates[note (i)]	161	–	161
Credit risk allowance			
Long-term expected defaults[note (ii)]	15	–	15
Additional provisions[note (iii)]	50	(23)	27
Total credit risk allowance	65	(23)	42
Liquidity premium	96	23	119

31 December 2011	Pillar 1 regulatory basis (bps)	Adjustment from regulatory to IFRS basis (bps)	IFRS (bps)
Bond spread over swap rates[note (i)]	201	–	201
Credit risk allowance			
Long-term expected defaults[note (ii)]	15	–	15
Additional provisions[note (iii)]	51	(24)	27
Total credit risk allowance	66	(24)	42
Liquidity premium	135	24	159

Notes

(i) Bond spread over swap rates reflect market observed data.
(ii) Long-term expected defaults are derived by applying Moody's data from 1970 to 2009 and the definition of the credit rating used is the second highest credit rating published by Moody's, Standard & Poor's and Fitch.
(iii) Additional provisions comprise credit risk premium, which is derived from Moody's data from 1970 to 2009, an allowance for a one-notch downgrade of the portfolio subject to credit risk and an additional allowance for short-term defaults.

The prudent Pillar 1 regulatory basis reflects the overriding objective of maintaining 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'.

Movement in the credit risk allowance for PRIL for the year ended 31 December 2012

The movement during 2012 of the average basis points allowance for PRIL on Pillar 1 regulatory and IFRS bases are as follows:

	Pillar 1 regulatory basis (bps)	IFRS (bps)
	Total	**Total**
Total allowance for credit risk at 31 December 2011	66	42
Credit rating changes	3	2
Asset trading	1	1
New business and other	(5)	(3)
Total allowance for credit risk at 31 December 2012	65	42

For periods prior to full year 2011, favourable credit experience was retained in short-term allowances for credit risk on both the Pillar 1 and IFRS bases. From full year 2011 onwards, the methodology applied is to continue to retain such surplus experience in the IFRS credit provisions but not for Pillar 1.

Overall the movement has led to the credit allowance for Pillar 1 purposes to be 40 per cent (2011: 33 per cent) of the bond spread over swap rates. For IFRS purposes it represents 26 per cent (2011: 20 per cent) of the bond spread over swap rates.

The reserves for credit risk allowance at 31 December 2012 for the UK shareholder annuity fund were as follows:

	Pillar 1 regulatory basis £bn	IFRS £bn
	Total	**Total**
PRIL	1.9	1.2
PAC non-profit sub-fund	0.2	0.1
Total – 31 December 2012	2.1	1.3
Total – 31 December 2011	2.0	1.3

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. Since 2009, new mortality projection models have been released annually by the CMI. The CMI 2009 model was used to produce the 2010 and 2011 results, with calibration to reflect an appropriate view of future mortality improvements. The CMI 2011 model was used to produce the 2012 results, again with calibration to reflect an appropriate view of future mortality improvements.

D: Life assurance business continued

D2: UK insurance operations continued

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

	Non-profit annuities within the WPSF (including PAL)		PRIL	
2012	**Males**	**Females**	**Males**	**Females**
In payment	93% – 99% PCMA00 with future improvements in line with Prudential's own calibration of the CMI 2011 mortality model, with a long-term improvement rate of 2.25%.	89% – 101% PCFA00 with future improvements in line with Prudential's own calibration of the CMI 2011 mortality model, with a long-term improvement rate of 1.50%.	92% – 96% PCMA00 with future improvements in line with Prudential's own calibration of the CMI 2011 mortality model, with a long-term improvement rate of 2.25%.	84% – 97% PCFA00 with future improvements in line with Prudential's own calibration of the CMI 2011 mortality model, with a long-term improvement rate of 1.50%.
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

	Non-profit annuities within the WPSF (including PAL)		PRIL	
2011	**Males**	**Females**	**Males**	**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%.	93% – 94% 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% – 96% 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

	Non-profit annuities within the WPSF (including PAL)		PRIL	
2010	**Males**	**Females**	**Males**	**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

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.

f Reinsurance

The Group's UK insurance business cedes only minor amounts of business outside the Group. During 2012, reinsurance premiums for externally ceded business were £135 million (2011: £132 million) and reinsurance recoverable assets were £608 million (2011: £589 million) in aggregate. The gains and losses recognised in profit and loss for the 2012 and 2011 contracts were immaterial.

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

Credit risk

There has been no change of approach in the setting of assumption levels.

However, changes in the portfolio have given rise to altered levels of credit risk allowance as set out in note D2 (e)(iii).

2012

Other operating assumption changes

In 2012, for the shareholder-backed business, the net effect of assumption changes, other than the allowance for credit risk described above was a charge to shareholder results of £17 million. This comprises the aggregate effect of strengthening of mortality assumptions for the annuity business, offsetting releases of margins and altered expenses and other assumptions.

For the with-profits sub-fund, the aggregate effect of assumption changes in 2012 was a net charge to unallocated surplus of £90 million, relating to changes in mortality and offsetting releases of margins, expense, persistency and economic assumptions.

2011

Other operating assumption changes

In 2011, for the shareholder-backed business, the aggregate effect of assumption changes other than the allowance for credit risk described above, was a net charge to the shareholder results of £9 million, comprising a number of individually small assumption changes.

For the with-profits sub-fund, the aggregate effect of assumption changes in 2011 was a net charge to unallocated surplus of £59 million, relating to changes in mortality, expense, persistency and economic assumptions.

h Exposure and sensitivity of IFRS basis profit or loss and shareholders' equity to market and other risks

i With-profits business

SAIF

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

With-profits sub-fund business

Shareholder UK results of UK with-profits business (including non-participating annuity business of the WPSF and of Prudential Annuities Limited (PAL), which is owned by the WPSF) are only sensitive to market risk through the indirect effect of investment performance on declared policyholder bonuses.

The investment assets of PAC with-profits funds are subject to market risk. 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. Therefore, the level of unallocated surplus is particularly sensitive to the level of investment returns on the portion of the assets that represents surplus. The effects for 2012 and 2011 are demonstrated in note D5. However, as unallocated surplus is accounted for as a liability under IFRS, movements in its value do not affect shareholders' profit and equity.

D: Life assurance business continued

D2: UK insurance operations continued

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 which is currently one-ninth of the cost of bonuses declared. Investment performance is a key driver of bonuses, and hence the shareholders' share of the cost of bonuses. Due to the 'smoothed' basis of bonus declaration, the sensitivity to investment performance in a single year is low relative to movements in the period to period performance. However, over multiple periods, it is important.

Mortality and other insurance risk are relatively minor factors in the determination of the bonus rates. Adverse persistency experience can affect the level of profitability from with-profits but in any given one year, the shareholders' share of cost of bonus may only be marginally affected. However, altered persistency trends may affect future expected shareholder transfers.

ii Shareholder-backed annuity business

The principal items affecting the IFRS results of the UK shareholder-backed annuity business are mortality experience and assumptions, and credit risk. The assets covering the 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.

Asset/liability duration matching is reviewed regularly. Except to the extent of any asset/liability duration mismatch and exposure to credit risk, the sensitivity of the Group's results to market risk for movements in the carrying value of the liabilities and covering assets is broadly neutral on a net basis.

The main market risk sensitivity for the UK shareholder-backed annuity business arises from interest rate risk on the debt securities which substantially represent shareholders' equity. This shareholders' 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.

In summary, 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;
- 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 changes to the assumed rate of improvements in mortality give rise to changes in the measurement of liabilities; and
- Changes in renewal expense levels.

A decrease in assumed mortality rates of 1 per cent would decrease gross profits by approximately £74 million (2011: £64 million). A decrease in credit default assumptions of five basis points would increase gross profits by £157 million (2011: £137 million). A decrease in renewal expenses (excluding asset management expenses) of 5 per cent would increase gross profits by £25 million (2011: £25 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.

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 liabilities of other business and are also broadly insensitive to market risk. 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, the policyholder liabilities of the UK insurance operations are, except for pension annuity business, not generally exposed to interest rate risk. At 31 December 2012, pension annuity liabilities accounted for 98 per cent (2011: 98 per cent) of UK shareholder-backed business liabilities. For pension annuity business, liabilities are exposed to interest rate risk. However, the net exposure to the PAC WPSF (for PAL) and shareholders (for annuity 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 and credit 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:

	2012 £m				2011 £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	9,006	3,993	(3,265)	(5,983)	7,676	3,426	(2,820)	(5,178)
Policyholder liabilities	(7,878)	(3,513)	2,867	5,235	(6,842)	(3,060)	2,510	4,593
Related deferred tax effects	(259)	(110)	91	172	(208)	(91)	77	146
Net sensitivity of profit after tax and shareholders' equity	869	370	(307)	(576)	626	275	(233)	(439)

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.

	2012 £m		2011 £m	
	A decrease of 20%	A decrease of 10%	A decrease of 20%	A decrease of 10%
Pre-tax profit	(316)	(158)	(319)	(160)
Related deferred tax effects	73	36	80	40
Net sensitivity of profit after tax and shareholders' equity	(243)	(122)	(239)	(120)

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 shown 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 business continued

D2: UK insurance operations continued

i 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(e) 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 above show the carrying value of the policyholder liabilities. The tables in the accompanying notes below show the maturity profile of the cash flows for insurance contracts, as defined by IFRS, ie those containing significant insurance risk, and investment contracts, which do not.

	2012 £m									
	With-profits business			Annuity business (insurance contracts)			Other			
	Insurance contracts	Investment contracts	Total	Non-profit annuities within WPSF (including PAL)	PRIL	Total	Insurance contracts	Investment contracts	Total	TOTAL
Policyholders liabilities	37,698	33,486	71,184	13,223	20,114	33,337	13,231	16,160	29,391	133,912
	2012 %									
Expected maturity:										
0 to 5 years	45	39	42	30	26	27	35	28	31	36
5 to 10 years	24	25	24	24	22	22	25	23	24	24
10 to 15 years	13	17	15	18	17	18	17	17	17	16
15 to 20 years	8	11	10	12	13	13	10	12	11	11
20 to 25 years	5	6	5	8	9	9	6	9	8	7
over 25 years	5	2	4	8	13	11	7	11	9	6

	2011 £m									
	With-profits business			Annuity business (insurance contracts)			Other			
	Insurance contracts	Investment contracts	Total	Non-profit annuities within WPSF (including PAL)	PRIL	Total	Insurance contracts	Investment contracts	Total	TOTAL
Policyholder liabilities	38,974	29,365	68,339	12,637	18,236	30,873	12,885	14,927	27,812	127,024
	2011 %									
Expected maturity:										
0 to 5 years	47	32	41	29	25	27	34	28	31	35
5 to 10 years	24	26	25	24	22	22	25	22	24	24
10 to 15 years	13	19	16	18	18	18	18	18	18	17
15 to 20 years	8	14	10	12	13	13	11	12	11	11
20 to 25 years	5	7	6	8	10	9	7	9	7	7
over 25 years	3	2	2	9	12	11	5	11	9	6

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 future 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 Bonds, 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.

D3: US insurance operations

a Summary results and statement of financial position

i Results and movements in shareholders' equity

	2012 £m	2011* £m
Operating profit based on longer-term investment returns	964	651
Short-term fluctuations in investment returns	(90)	(167)
Amortisation of acquisition accounting adjustments arising on the purchase of REALIC[n]	(19)	–
Profit before shareholder tax	855	484
Tax	(234)	(127)
Profit for the year	621	357

	2012 £m	2011* £m
Profit for the year (as above)	621	357
Items recognised in other comprehensive income:		
Exchange movements	(181)	35
Unrealised valuation movements on securities classified as available-for-sale:		
Unrealised holding gains arising during the year	930	912
Deduct net gains included in the income statement	(68)	(101)
Total unrealised valuation movements	862	811
Related change in amortisation of deferred acquisition costs	(270)	(275)
Related tax	(205)	(187)
Total other comprehensive income	206	384
Total comprehensive income for the year	827	741
Dividends, interest payments to central companies and other movements	(245)	(330)
Net increase in equity	582	411
Shareholders' equity at beginning of year:		
As previously reported	4,271	3,815
Effect of change in accounting policy for deferred acquisition costs*	(510)	(465)
After effect of change	3,761	3,350
Shareholders' equity at end of year	4,343	3,761

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

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 £862 million (2011: £811 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 2012, Jackson recorded £37 million (2011: £62 million) of impairment losses arising from:

	2012 £m	2011 £m
Residential mortgage-backed securities	8	21
Public fixed income	2	–
Other	27	41
	37	62

D: Life assurance business continued

D3: US insurance operations continued

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 2012, 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 £2,057 million to a net unrealised gain of £2,807 million. The gross unrealised gain in the statement of financial position increased from £2,303 million at 31 December 2011 to £2,985 million at 31 December 2012, while the gross unrealised loss decreased from £246 million at 31 December 2011 to £178 million at 31 December 2012.

Available for sale securities

	2012 £m			2011 £m
		Changes in unrealised appreciation†	Foreign exchange translation	
		Reflected as part of movement in consolidated statement of comprehensive income		
Assets fair valued at below book value				
Book value*	4,551			2,455
Unrealised (loss) gain	(178)	59	9	(246)
Fair value (as included in statement of financial position)	4,373			2,209
Assets fair valued at or above book value				
Book value*	25,467			22,504
Unrealised gain (loss)	2,985	803	(121)	2,303
Fair value (as included in statement of financial position)	28,452			24,807
Total				
Book value*	30,018			24,959
Net unrealised gain (loss)	2,807	862	(112)	2,057
Fair value (as included in statement of financial position)‡	32,825			27,016

* Book value represents cost/amortised cost of the debt securities.
† Translated at the average rate of US$1.5849: £1.00
‡ Debt securities for US operations included in the statement of financial position at 31 December 2012 comprise:

	2012 £m	2011 £m
Available-for-sale	32,825	27,016
Fair value through profit and loss:		
Securities of consolidated investment funds	–	6
Securities held to back liabilities for funds withheld under reinsurance arrangement	168	–
	32,993	27,022

Included within the movement in gross unrealised losses for the debt securities of Jackson of £59 million (2011: £122 million) as shown above was a net decrease in value of £33 million (2011: £12 million increase) relating to the sub-prime and Alt-A securities as referred to in section B5.

ii Statement of financial position

	31 Dec 2012 £m			31 Dec 2011* £m
	Variable annuity separate account assets and liabilities note (i)	Fixed annuity, GIC and other business note (i)	Total†	Total
Assets				
Intangible assets attributable to shareholders:				
Deferred acquisition costs and other intangibles	–	3,222	3,222	3,115
Total	–	3,222	3,222	3,115
Deferred tax assets	–	1,889	1,889	1,392
Other non-investment and non-cash assets note (vi)	–	6,792	6,792	1,542
Investments of long-term business and other operations:				
Investment properties	–	24	24	35
Financial investments:				
Loans note (ii)	–	6,235	6,235	4,110
Equity securities and portfolio holdings in unit trusts note (v)	49,298	253	49,551	38,036
Debt securities	–	32,993	32,993	27,022
Other investments note (iii)	–	2,296	2,296	2,376
Deposits	–	211	211	167
Total investments	49,298	42,012	91,310	71,746
Properties held for sale	–	–	–	3
Cash and cash equivalents	–	513	513	271
Total assets	49,298	54,428	103,726	78,069
Equity and liabilities				
Equity				
Shareholders' equity note (iii)	–	4,343	4,343	3,761
Total equity	–	4,343	4,343	3,761
Liabilities				
Policyholder:				
Contract liabilities (including amounts in respect of contracts classified as investment contracts under IFRS 4) note (iv)	49,298	42,963	92,261	69,189
Total	49,298	42,963	92,261	69,189
Core structural borrowings of shareholder-financed operations	–	153	153	160
Operational borrowings attributable to shareholder-financed operations	–	26	26	127
Deferred tax liabilities	–	2,168	2,168	1,818
Other non-insurance liabilities note (vi)	–	4,775	4,775	3,014
Total liabilities	49,298	50,085	99,383	74,308
Total equity and liabilities	49,298	54,428	103,726	78,069

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

† The statement of financial position at 31 December 2012 includes the assets and liabilities of the acquired REALIC business. Details of the acquisition are described in note I1.

D: Life assurance business continued

D3: US insurance operations continued

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 comprise:

	2012 £m	2011 £m
Mortgage loans*	3,543	3,559
Policy loans†	2,692	551
Total US insurance operations loans	6,235	4,110

* All of the mortgage loans are commercial mortgage loans which are collateralised by properties. The property types are industrial, multi-family residential, suburban office, retail and hotel. The breakdown by property type is as follows:

	2012 %	2011 %
Industrial	29	28
Multi-family residential	25	23
Office	19	19
Retail	17	19
Hotels	10	11
	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 £6.3 million (2011: £6.6 million). The portfolio has a current estimated average loan to value of 65 per cent (2011: 68 per cent) which provides significant cushion to withstand substantial declines in value.

At 31 December 2012, Jackson had mortgage loans with a carrying value of £78 million where the contractual terms of the agreements had been restructured. In addition to the regular impairment review afforded all loans in the portfolio, restructured loans are also reviewed for impairment. An impairment will be recorded if the expected cash flows under the newly restructured terms discounted at the original yield (the pre-structured interest rate) are below the carrying value of the loan.

† The policy loans are fully secured by individual life insurance policies or annuity policies. The increase in 2012 reflects the purchase of REALIC as explained in note I1. The policy loans from the purchase of REALIC amounted to £1,842 million at 31 December 2012, and are accounted for at fair value through profit and loss as described above. All other policy loans are accounted for at amortised cost, less any impairment.

(iii) Other investments comprise:

	2012 £m	2011 £m
Derivative assets*G3	1,546	1,677
Partnerships in investment pools and other†	750	699
	2,296	2,376

* 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 liabilities of £645 million (2011: £887 million), which are also included in Other non-insurance liabilities, the derivative position for US operations is a net asset of £901 million (2011: £790 million).

† Partnerships in investment pools and other comprise primarily investments in limited partnerships. These include interests in the PPM America Private Equity Fund and diversified investments in 167 (2011: 167) 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 2012

The policyholder liabilities, net of reinsurers' share of £6,076 million (2011: £907 million), reflect balances in respect of the following:

	2012 £m	2011 £m
Policy reserves and liabilities on non-linked business:		
Reserves for future policyholder benefits and claims payable	7,663	518
Deposits on investment contracts (as defined under IFRS 'grandfathered' US GAAP)	27,425	28,314
Guaranteed investment contracts	1,799	1,617
Unit-linked (variable annuity) business	49,298	37,833
	86,185	68,282

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 £825 million (2011: £1,070 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 includes investments in mutual funds, the majority of which are equity based.

(vi) Reinsurance balances relating to REALIC

Included within Other non-investment and non-cash assets of £6,792 million (2011: £1,542 million) were balances of £6,076 million (2011: £907 million) for reinsurers' share of insurance contract liabilities. Of the £6,076 million as at 31 December 2012, £5,234 million related to the reinsurance ceded by the newly acquired REALIC business. REALIC holds collateral for certain of these reinsurance arrangements with a corresponding funds withheld liability. As of 31 December 2012, the funds withheld liability of £2,021 million was recorded within Other non-insurance liabilities.

b 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:

US insurance operations

	Variable annuity separate account liabilities £m	Fixed annuity, GIC and other business £m	Total £m
At 1 January 2011	31,203	29,320	60,523
Premiums	9,176	3,738	12,914
Surrenders	(1,898)	(2,372)	(4,270)
Maturities/Deaths	(300)	(520)	(820)
Net flows[note (b)]	6,978	846	7,824
Transfers from general to separate account	957	(957)	–
Investment-related items and other movements	(1,735)	1,871	136
Foreign exchange translation differences[note (a)]	430	276	706
At 31 December 2011/1 January 2012	37,833	31,356	69,189
Premiums	10,361	4,546	14,907
Surrenders	(2,149)	(2,207)	(4,356)
Maturities/Deaths	(404)	(550)	(954)
Net flows[note (b)]	7,808	1,789	9,597
Transfers from general to separate account	1,577	(1,577)	–
Investment-related items and other movements[note (c)]	4,014	227	4,241
Foreign exchange translation differences[note (a)]	(1,998)	(1,680)	(3,678)
Acquisition of REALIC[notes (d), I1]	64	12,848	12,912
At 31 December 2012	49,298	42,963	92,261
Average policyholder liability balances*			
2012	43,549	33,948	77,497
2011	34,518	30,338	64,856

* Averages have been based on opening and closing balances, and adjusted for acquisitions and disposals in the period.

Notes

(a) Movements in the year have been translated at an average rate of US$1.58/£1.00 (2011: US$1.60/£1.00). The closing balances have been translated at closing rate of US$1.63/£1.00 (2011: US$1.55/£1.00). Differences upon retranslation are included in foreign exchange translation differences.

(b) Net flows for the year were £9,597 million compared with £7,824 million in 2011 driven largely by increased new business volumes.

(c) Positive investment-related items and other movements in variable annuity separate account liabilities of £4,014 million for 2012 reflects the increase in the US equity market during the year with the S&P index increasing by 13.4 per cent. Fixed annuity, GIC and other business investment and other movements primarily reflects the interest credited to policyholder account in the year, net of falls in the technical provisions held for the guarantees issued with variable annuity business.

(d) The acquisition of REALIC reflects the liabilities, before reduction for reinsurances ceded, acquired at the date of acquisition.

D: Life assurance business continued

D3: US insurance operations continued

c Information on credit risks of debt securities

Summary	2012 £m	2011 £m
Corporate and government security and commercial loans:		
Government	4,126	2,163
Publicly traded and SEC Rule 144A* securities	19,699	16,281
Non-SEC Rule 144A* securities	3,542	3,198
Total	27,367	21,642
Residential mortgage-backed securities	2,400	2,591
Commercial mortgage-backed securities	2,639	2,169
Other debt securities	587	620
Total US debt securities	32,993	27,022

* A 1990 SEC rule that facilitates the resale of privately placed securities that are without SEC registration to qualified institutional investors. The rule was designed to develop a more liquid and efficient institutional resale market for unregistered securities.

i Credit quality

The following table summarises by rating the debt securities, as at 31 December 2012 and 2011 using Standard & Poor's (S&P), Moody's, Fitch and implicit ratings of mortgage-backed securities (MBS) based on NAIC* valuations.

	2012 £m	2011 £m
S&P – AAA	187	133
S&P – AA+ to AA-	6,343	4,476
S&P – A+ to A-	7,728	6,382
S&P – BBB+ to BBB-	10,230	8,446
S&P – Other	1,173	999
	25,661	20,436
Moody's – Aaa	55	62
Moody's – Aa1 to Aa3	18	15
Moody's – A1 to A3	21	29
Moody's – Baa1 to Baa3	56	67
Moody's – Other	13	17
	163	190
Implicit ratings of MBS based on NAIC* valuations (see below)		
NAIC 1	2,934	2,577
NAIC 2	207	147
NAIC 3-6	321	368
	3,462	3,092
Fitch	184	184
Other†	3,523	3,120
Total debt securities	32,993	27,022

* The Securities Valuation Office of the National Association of Insurance Commissioners (NAIC) classifies debt securities into six quality categories ranging from Class 1 (the highest) to Class 6 (the lowest). Performing securities are designated as Classes 1 to 5 and securities in or near default are designated Class 6.
† The amounts within Other which are not rated by S&P, Moody's nor Fitch, nor are MBS securities using the revised regulatory ratings, have the following NAIC classifications:

	2012 £m	2011 £m
NAIC 1	1,453	1,258
NAIC 2	2,022	1,792
NAIC 3-6	48	70
	3,523	3,120

For some mortgage-backed securities within Jackson, the table above includes these securities using the regulatory ratings detail issued by the NAIC. These regulatory ratings levels were established by external third parties (PIMCO for residential mortgage-backed securities and BlackRock Solutions for commercial mortgage-backed securities) based on Jackson's carrying value.

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 where markets for the securities are no longer active as a result of market conditions, IAS 39 requires that valuation techniques be applied. IFRS 7 requires classification of the fair values applied by the Group into a three level hierarchy. 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 2012, 0.1 per cent of Jackson's debt securities were classified as level 3 (31 December 2011: 0.1 per cent) comprising of 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 2012, are exposures to asset-backed securities as follows:

	2012 £m	2011 £m
RMBS:		
Sub-prime (2012: 15% AAA, 6% AA)	261	207
Alt-A (2012: 4% AAA, 1% AA)	323	310
Prime including agency (2012: 0% AAA, 75% AA)	1,816	2,074
CMBS (2012: 40% AAA, 24% AA)	2,639	2,169
CDO funds (2012: 0% AAA, 27% AA)*, including £nil exposure to sub-prime	44	44
Other ABS (2012: 24% AAA, 15% AA), including £nil exposure to sub-prime	543	576
Total	5,626	5,380

* Including Group's economic interest in Piedmont and other consolidated CDO funds.

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 table shows the fair value of those securities that are in a gross unrealised loss position for various percentages of book value at 31 December:

	2012 £m		2011 £m	
	Fair value	Unrealised loss	Fair value	Unrealised loss
Between 90% and 100%	4,214	(112)	1,829	(60)
Between 80% and 90%	85	(13)	172	(28)
Below 80%*	74	(53)	208	(158)
Total	4,373	(178)	2,209	(246)

* The unrealised losses as at 31 December 2012 include £77 million (2011: £183 million) relating to mortgage-backed and other debt securities. The unrealised losses in the portfolio by reference to the length of time of three years or more as at 31 December 2012 are £36 million (2011: £105 million) in the investment grade and £31 million (2011: £61 million) in non-investment grade.

D: Life assurance business continued

D3: US insurance operations continued

d 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 2012, interest-sensitive fixed annuities accounted for 13 per cent (2011: 16 per cent) of policy and contract liabilities of Jackson. Interest-sensitive fixed annuities are primarily deferred annuity products that are used for asset accumulation in 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. At 31 December 2012, Jackson had fixed interest rate annuities totalling £11.7 billion (US$19.0 billion) (2011: £11.5 billion (US$17.8 billion)) in account value with minimum guaranteed rates ranging from 1.0 per cent to 5.5 per cent and a 3.09 per cent average guaranteed rate (2011: 1.0 per cent to 5.5 per cent and a 3.08 per cent average guaranteed rate).

Approximately 50 per cent (2011: 48 per cent) of the interest-sensitive fixed annuities Jackson wrote in 2012 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 (FIA) accounted for 8 per cent (2011: 9 per cent) of Jackson's policy and contract liabilities at 31 December 2012. 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 between 1.0 per cent and 3.0 per cent. Jackson had fixed indexed annuities allocated to indexed funds totalling £5.6 billion (US$9.2 billion) (2011: £5.0 billion (US$7.8 billion)) in account value with minimum guaranteed rates on indexed accounts ranging from 1.0 per cent to 3.0 per cent and a 1.82 per cent average guaranteed rate (2011: 1.0 per cent to 3.0 per cent and a 1.76 per cent average guarantee rate). Jackson also offers fixed interest accounts on some fixed indexed annuity products. Fixed interest accounts of fixed indexed annuities totalled £1.5 billion (US$2.3 billion) (2011: £1.4 billion (US$2.1 billion)) in account value with minimum guaranteed rates ranging from 1.0 per cent to 3.0 per cent and a 2.53 per cent average guaranteed rate (2011: 1.0 per cent to 3.0 per cent and a 2.50 per cent average guarantee rate).

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 2012, immediate annuities accounted for 1 per cent (2011: 1 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 2012, VAs accounted for 60 per cent (2011: 63 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 a selection of variable accounts. 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 2012, approximately 8 per cent (2011: approximately 10 per cent) of VA funds were in fixed accounts. Jackson had fixed interest rate accounts in variable annuities totalling £4.3 billion (US$7.0 billion) (2011: £4.3 billion (US$6.7 billion)) in account value with minimum guaranteed rates ranging from 1.0 per cent to 3.0 per cent and a 1.89 per cent average guaranteed rate (2011: 1.0 per cent to 3.0 per cent and a 1.99 per cent average guarantee rate).

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(h). The GMAB was eliminated from Jackson's product offerings in 2011. The GMIB is no longer offered, with existing coverage being reinsured.

In March 2012, Jackson launched a new variable annuity product, Elite Access, which has no guaranteed benefits and provides tax efficient access to alternative investments. Single premium sales in the period since launch were £849 million.

iii Aggregate distribution of account values

The table below shows the distribution of account values for fixed annuities (interest sensitive and fixed indexed) and variable annuities within the range of minimum guaranteed interest rates as described in notes i and ii above as at 31 December 2012 and 2011:

Minimum guaranteed interest rate	Account value 2012 £m	Account value 2011 £m
1.0%	2,534	1,988
> 1.0% – 2.0%	8,374	8,321
> 2.0% – 3.0%	9,174	9,352
> 3.0% – 4.0%	1,236	841
> 4.0% – 5.0%	1,518	1,425
> 5.0%	209	167
Total	23,045	22,094

iv Life insurance

Jackson's life insurance products accounted for 15 per cent (2011: 7 per cent) of Jackson's policy and contract liabilities at 31 December 2012. The increase from 2011 was a result of the acquisition of REALIC. Jackson discontinued new sales of life insurance products effective 1 August 2012. The life products included term life, universal life and variable universal life. Term life provides protection for a defined period and a benefit that is payable to a designated beneficiary upon death of the insured. Universal life provides permanent individual life insurance for the life of the insured and includes a savings element. Variable universal life is a type of life insurance policy that combines death benefit protection with the ability for the policyholder account to be invested in separate account funds.

At 31 December 2012, Jackson (including the newly acquired REALIC) had interest sensitive life business in force with total account value of £6.0 billion (US$9.7 billion) (2011: £3.3 billion (US$5.1 billion)), with minimum guaranteed interest rates ranging from 2.5 per cent to 6.0 per cent with a 4.67 per cent average guaranteed rate (2011: 3.0 per cent to 6.0 per cent with a 4.88 per cent average guaranteed rate). The table below shows the distribution of the interest-sensitive life business' account values within this range of minimum guaranteed interest rates as at 31 December 2012 and 2011:

Minimum guaranteed interest rate	Account value 2012 £m	Account value 2011 £m
1.0%	–	–
> 1.0% – 2.0%	–	–
> 2.0% – 3.0%	183	130
> 3.0% – 4.0%	2,141	1,145
> 4.0% – 5.0%	2,097	686
> 5.0%	1,550	1,317
Total	5,971	3,278

D: Life assurance business continued

D3: US insurance operations continued

v 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 2012, institutional products accounted for 3 per cent of policy and contract liabilities (2011: 4 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. In 2012 and 2011, there were no funding agreements terminable by the policyholder with less than 90 days' notice.

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.

e 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 A3, 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 (ie deferred income);
- Any amounts previously assessed against policyholders that are refundable on termination of the contract; and
- Any probable future loss on the contract (ie 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 the 'for life' portion of 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 2012, these liabilities were valued using a series of deterministic investment performance scenarios, a mean investment return of 8.4 per cent (2011: 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.

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.

The assumptions used for calculating the direct GMIB liability at 31 December 2012 and 2011, 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, GMIB and GMWB 'for life' liability balances, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised.

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 (ie 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.

Change of accounting policy

As explained in note A5, the Company has adopted the US Financial Accounting Standards Board requirements in the Emerging Issues Task Force (EITF) Update No. 2010-26 on 'Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts' from 1 January 2012 into Prudential's Group IFRS reporting for the results of Jackson and those Asia operations whose IFRS insurance assets and liabilities are measured principally by reference to US GAAP principles. Under the Update, insurers are required to capitalise only those incremental costs directly relating to successfully acquiring a contract from 1 January 2012. For Group IFRS reporting, the Company has chosen to apply this new basis retrospectively for the results of these operations.

On application of the new policy for Jackson, the deferred costs balance for business in force at 31 December 2011, was retrospectively reduced from £3,880 million to £3,095 million.

D: Life assurance business continued

D3: US insurance operations continued

Mean reversion technique

For variable annuity products, under US GAAP (as 'grandfathered' under IFRS 4) the projected gross profits, against which acquisition costs are amortised, 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 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 realised on average over the entire eight year period. Projected returns after the mean reversion period revert back to the 8.4 per cent assumption.

However, to ensure that the methodology does not over anticipate a reversion to trend following adverse markets, the mean reversion technique has a cap and floor feature whereby the projected returns in each of the next five years can be no more than 15 per cent per annum and no less than 0 per cent per annum (both gross of asset management fees) in each year. The capping feature was relevant in late 2008, 2009 and 2010 due to the very sharp market falls in 2008. Notwithstanding this capping feature, the mean reversion technique gave rise to a benefit in 2008 of £110 million. This benefit was effectively 'paid back' under the mean reversion technique through charges for accelerated amortisation in 2011, as discussed below.

At 31 December 2012, the projected rate of return for the next five years is materially the same as the long-term assumption of 8.4 per cent, and so the mean reversion technique had little effect at that date.

Sensitivity of amortisation charge

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 comprises:

(i) A core amount that reflects a relatively stable proportion of underlying profit; and
(ii) An element of acceleration or deceleration arising from market movements differing from expectations.

In periods where the cap and floor feature of the mean reversion technique are not relevant, the technique operates to dampen the second element above. Nevertheless, extreme market movements can cause material acceleration or deceleration of amortisation in spite of this dampening effect.

Furthermore, in those periods where the cap or floor is relevant, the mean reversion technique provides no further dampening and additional volatility may result.

2011

In 2011, the DAC amortisation charge to operating profit included £190 million of accelerated amortisation. This amount reflected the combined effect of:

(a) The separate account performance in the year of negative 4 per cent, net of all fees as it compared with the assumed level for the year; and
(b) The reduction in the previously assumed future rates of return for the upcoming five years from 15 per cent, to a level nearer the middle of the corridor (of 0 per cent and 15 per cent), so that, in combination with the historical returns, the eight-year average in the mean reversion calculation was the 8.4 per cent assumption.

The reduction in assumed future rates reflected, in large part, the elimination from the calculation in 2011 of the 2008 negative returns. Setting aside other complications and the growth in the book, the 2011 accelerated amortisation can be broadly equated as 'paying back' the benefit experienced in 2008.

2012

In 2012, the DAC amortisation charge to operating profit of £356 million was determined after taking credit for decelerated amortisation of £56 million. This amount primarily reflects the separate account performance of 11 per cent, net of all fees, over the assumed level for the year.

2013

The application of the mean reversion formula has the effect of dampening the impact of equity market movements on DAC amortisation while the mean reversion assumption lies within the corridor. It would take a very significant movement in equity markets in 2013 (outside the range of negative 20 per cent to positive 50 per cent) for the mean reversion assumption to move outside the corridor.

Statement of changes in equity – 'shadow DAC adjustments'

Consequent upon the positive unrealised valuation movement in 2012 of £862 million (2011: positive £811 million), there is a debit of £270 million (2011: £275 million debit) for altered 'shadow' DAC 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 2012, the cumulative 'shadow DAC balance' was negative £952 million (2011: negative £720 million).

f Reinsurance

The reinsurance asset for business ceded outside the Group was £6,076 million (2011: £907 million). The increase from 2011 is due to the acquisition of REALIC as described in note I1, whereby certain former REALIC business was retained by Swiss Re through 100 per cent reinsurance agreements. Apart from the reinsurance acquired through the purchase of REALIC, 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 2012, the premiums for such ceded business amounted to £193 million (2011: £72 million). Net commissions received on ceded business and claims incurred ceded to external reinsurers totalled £24 million and £123 million respectively during 2012 (2011: £9 million and £84 million respectively). There were no deferred gains or losses on reinsurance contracts in either 2012 or 2011.

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

In 2012 and 2011, there were no changes of assumptions that had a material impact on the results of US insurance operations.

h Exposure and sensitivity of IFRS basis profit and shareholders' equity to market and other risks

Jackson's main exposures are to market risk through its exposure to interest rate risk and equity risk. Approximately 94 per cent (2011: 92 per cent) of its general account investments support interest-sensitive and fixed indexed annuities, life business and surplus and 6 per cent (2011: 8 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.

Jackson 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.

Jackson 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.

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.

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, 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; 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 default event occurs in exchange for periodic payments made by Jackson for the life of the agreement. Jackson does not write default protection using credit derivatives.

The estimated sensitivity of Jackson's profit and shareholders' equity to equity and interest rate risks provided below is net of the related changes in amortisation of DAC. The effect on the related changes in amortisation of DAC provided is based on the current 'grandfathered' US GAAP DAC basis but does not include any effect from an acceleration or deceleration of amortisation of DAC. Note A5 provides explanation of the new US GAAP DAC basis adopted by the Company from 1 January 2012. Note D3(e) above provides an explanation of the dynamics that affect the amortisation charge.

D: Life assurance business continued

D3: US insurance operations continued

i Sensitivity to equity risk

Variable annuity contract related

At 31 December 2012 and 2011, 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 2012	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%	40,964	1,839	64.4 years	
GMWB – Premium only	0%	2,213	91		
GMWB*	0-5%	3,359	88*		
GMAB – Premium only	0%	53	–		
Highest specified anniversary account value minus withdrawals post-anniversary					
GMDB		4,554	324	64.0 years	
GMWB – Highest anniversary only		1,880	245		
GMWB*		697	137*		
Combination net deposits plus minimum return, highest specified anniversary account value minus withdrawals post-anniversary					
GMDB	0-6%	2,705	348	66.4 years	
GMIB‡	0-6%	1,588	469		3.3 years
GMWB*	0-8%†	31,167	1,918*		

31 December 2011	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%	31,571	2,914	64.2 years	
GMWB – Premium only	0%	2,325	195		
GMWB*	0-5%	2,582	582*		
GMAB – Premium only	0%	54	2		
Highest specified anniversary account value minus withdrawals post-anniversary					
GMDB		4,002	678	63.7 years	
GMWB – Highest anniversary only		1,855	423		
GMWB*		735	217*		
Combination net deposits plus minimum return, highest specified anniversary account value minus withdrawals post-anniversary					
GMDB	0-6%	2,098	479	66.1 years	
GMIB‡	0-6%	1,661	575		4.2 years
GMWB*	0-8%†	21,902	2,263*		

* Amounts shown for GMWB comprise sums for the 'not for life' portion (where the guaranteed withdrawal base less the account value equals to the net amount at risk (NAR)), and a 'for life' portion (where the NAR has been estimated as the present value of future expected benefit payment remaining after the amount of the 'not for life' guaranteed benefits is zero).

† Ranges shown based on simple interest. The upper limits of 5 per cent, or 8 per cent simple interest are approximately equal to 4.1 per cent and 6 per cent respectively, on a compound interest basis over a typical ten year bonus period. For example 1 + 10 x 0.05 is similar to 1.041 growing at a compound rate of 4.01 per cent for a further nine years.

‡ The GMIB reinsurance guarantees are fully reinsured.

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

	2012 £m	2011 £m
Mutual fund type:		
Equity	38,092	28,902
Bond	5,673	4,251
Balanced	4,601	3,846
Money market	766	677
Total	49,132	37,676

As noted above, 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. This risk is managed using an 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, the net effect on 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 in the financial reporting the immediate impact of equity market movements as the free-standing derivatives reset immediately, while the hedged liabilities reset more slowly and fees are recognised prospectively. The opposite impact would be observed if the equity markets were to decrease.

At 31 December 2012, the estimated sensitivity of Jackson's profit for VA business, and shareholders' equity to immediate increases and decreases in equity markets is shown below. The sensitivities are shown net of related changes in DAC amortisation.

	2012 £m				2011* £m			
	Decrease of 20%	Decrease of 10%	Increase of 10%	Increase of 20%	Decrease of 20%	Decrease of 10%	Increase of 10%	Increase of 20%
Pre-tax profit, net of related changes in amortisation of DAC (excluding impact on future separate account fees)	326	120	(86)	(215)	373	196	(242)	(539)
Related deferred tax effects	(114)	(42)	30	75	(130)	(69)	85	189
Net sensitivity of profit after tax and shareholders' equity	212	78	(56)	(140)	243	127	(157)	(350)

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

The above table provides sensitivity movements as at a point in time, while 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.

The directional movements in the sensitivities reflect the hedging programme in place at 31 December 2012.

Other sensitivity to equity risk

In addition to the exposure explained 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 2012 and 2011. The table below shows the sensitivity to a 10 per cent 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.

	2012 £m		2011* £m	
	Decrease of 20%	Decrease of 10%	Decrease of 20%	Decrease of 10%
Pre-tax profit, net of related changes in amortisation of DAC	(143)	(72)	(129)	(64)
Related deferred tax effects	50	25	45	23
Net sensitivity of profit after tax and shareholders' equity	(93)	(47)	(84)	(41)

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

D: Life assurance business continued

D3: US insurance operations continued

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 shown 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.

ii Sensitivity to interest rate risk

Notwithstanding the market risk exposure previously described, 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. The GMWB features attaching to variable annuity business (other than 'for-life') are accounted for as 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, again 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 1 per cent and 2 per cent decrease (subject to a floor of zero) and increase in interest rates at 31 December 2012 and 2011 is as follows:

	2012 £m				2011* £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	1,525	778	(625)	(1,142)	1,549	736	(592)	(1,078)
Policyholder liabilities	(2,021)	(871)	610	970	(925)	(446)	395	753
Related effect on amortisation of DAC	309	93	(39)	(14)	(132)	(61)	33	46
Pre-tax profit effect	(187)	–	(54)	(186)	492	229	(164)	(279)
Related effect on charge for deferred tax	65	–	19	65	(172)	(80)	57	98
Net profit effect	(122)	–	(35)	(121)	320	149	(107)	(181)
Other comprehensive income								
Direct effect on carrying value of debt securities	3,873	2,175	(2,175)	(3,873)	2,679	1,513	(1,513)	(2,679)
Related effect on amortisation of DAC	(1,332)	(748)	748	1,332	(954)	(539)	539	954
Related effect on movement in deferred tax	(889)	(499)	499	889	(604)	(341)	341	604
Net effect	1,652	928	(928)	(1,652)	1,121	633	(633)	(1,121)
Total net effect on shareholders' equity	1,530	928	(963)	(1,773)	1,441	782	(740)	(1,302)

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

These sensitivities are shown only for interest rates in isolation and do not include other movements in credit risk that may affect credit spreads and valuations of debt securities.

iii Currency translation risk

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 2012, the rates were US$1.58 (2011: US$1.60) and US$1.63 (2011: US$1.55) to £1.00 sterling, respectively. A 10 per cent increase or decrease in these rates would reduce or increase profit before tax attributable to shareholders, profit for the year and shareholders' equity attributable to US insurance operations respectively as follows:

	A 10% increase in US$:£ exchange rates		A 10% decrease in US$:£ exchange rates	
	2012 £m	2011* £m	2012 £m	2011* £m
Profit before tax attributable to shareholders[note]	(78)	(44)	95	53
Profit for the year	(56)	(32)	69	39
Shareholders' equity attributable to US insurance operations	(395)	(342)	483	418

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

Note
Sensitivity on profit before tax ie aggregate of the operating profit based on longer-term investment returns and short-term fluctuations in investment returns.

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.

iv Other sensitivities

As noted in section D1, total profit is very sensitive to market risk on the assets covering liabilities other than variable annuity business segregated in the separate accounts.

As with other shareholder-backed business the profit or loss for Jackson is presented 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. 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 and interest sensitive life 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 expense, mortality and persistency studies.

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.

Jackson is sensitive to lapse risk. However, Jackson uses 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.

For variable annuity business, the key assumption is the expected long-term level of separate account returns, which for 2012 and 2011 was 8.4 per cent. The impact of using this return is reflected in two principal ways, namely:

- Through the projected expected gross profits which are used to determine the amortisation of deferred acquisition costs. This is applied through the use of a mean reversion technique which is described in more detail in note D3(e) above; and
- The required level of provision for guaranteed minimum death benefit claims.

D: Life assurance business continued

D3: US insurance operations continued

i Duration of liabilities

The table below shows the carrying value of policyholder liabilities. The table below also shows the maturity profile of the cash flows for 2012 and 2011:

	2012 £m			2011 £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	42,963	49,298	92,261	31,356	37,833	69,189
	2012 %			2011 %		
Expected maturity:						
0 to 5 years	45	46	46	47	47	47
5 to 10 years	27	31	29	27	30	29
10 to 15 years	12	13	13	11	13	12
15 to 20 years	7	6	6	6	6	6
20 to 25 years	5	2	3	5	2	3
Over 25 years	4	2	3	4	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.

D4: Asia insurance operations

a Summary statement of financial position

31 December	2012 £m With-profits business note (i)	2012 £m Unit-linked assets and liabilities	2012 £m Other business	2012 £m Total	2011* £m Total
Assets					
Intangible assets attributable to shareholders:					
Goodwill	–	–	239	239	235
Deferred acquisition costs and other intangible assets	–	–	908	908	977
Total	–	–	1,147	1,147	1,212
Intangible assets attributable to with-profits funds:					
Deferred acquisition costs and other intangible assets	72	–	–	72	83
Deferred tax assets	–	–	83	83	115
Other non-investment and non-cash assets	324	123	670	1,117	1,024
Investments of long-term business and other operations:					
Investment properties	–	–	4	4	10
Financial investments:					
Loans note (iii)	600	–	414	1,014	1,233
Equity securities and portfolio holdings in unit trusts	3,160	10,491	659	14,310	11,997
Debt securities	11,495	3,194	6,713	21,402	17,681
Other investments	504	47	406	957	470
Deposits	165	574	488	1,227	1,165
Total investments	15,924	14,306	8,684	38,914	32,556
Cash and cash equivalents	524	421	723	1,668	1,977
Total assets	16,844	14,850	11,307	43,001	36,967
Equity and liabilities					
Equity					
Shareholders' equity	–	–	2,529	2,529	2,306
Non-controlling interests	–	–	4	4	5
Total equity	–	–	2,533	2,533	2,311
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)	13,388	14,028	7,185	34,601	30,862
Unallocated surplus of with-profits funds note (ii)	63	–	–	63	50
Total	13,451	14,028	7,185	34,664	30,912
Operational borrowings attributable to shareholder-financed operations	–	–	7	7	141
Deferred tax liabilities	384	46	158	588	506
Other non-insurance liabilities	3,009	776	1,424	5,209	3,097
Total liabilities	16,844	14,850	8,774	40,468	34,656
Total equity and liabilities	16,844	14,850	11,307	43,001	36,967

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

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) For the purposes of the presentation of unallocated surplus of with-profits within the statement of financial position, the Hong Kong branch balance is reported within the unallocated surplus of the PAC with-profits sub-fund of the UK insurance operations.

D: Life assurance business continued

D4: Asia insurance operations continued

(iii) Asia insurance operations
The loans of the Group's Asia insurance operations comprise:

	2012 £m	2011 £m
Mortgage loans*	43	31
Policy loans*	610	572
Other loans†	361	630
Total Asia insurance operations loans	1,014	1,233

* 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 Malaysia operation and which are all investment graded by two local rating agencies.

Summary policyholder liabilities (net of reinsurance) and unallocated surplus
At 31 December 2012, the policyholder liabilities net of reinsurance of £175 million (2011: £151 million) and unallocated surplus for Asia operations of £34.5 billion (2011: £30.8 billion) comprised the following:

	2012 £m	2011 £m
Singapore	10,731	9,323
Hong Kong	8,610	8,279
Malaysia	3,336	2,829
Indonesia	2,110	1,809
Korea	2,131	1,852
Taiwan	1,931	1,429
Other countries	5,640	5,240
Total Asia operations	34,489	30,761

b 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 Asia insurance operations from the beginning of the year to the end of the year is as follows:

	With-profits business £m	Unit-linked liabilities £m	Other business £m	Total £m
At 1 January 2011	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
Premiums:				
New business	162	1,136	723	2,021
In-force	1,110	1,163	785	3,058
	1,272	2,299	1,508	5,079
Surrenders[note (c)]	(502)	(1,490)	(245)	(2,237)
Maturities/Deaths	(431)	(39)	(194)	(664)
Net flows[note (b)]	339	770	1,069	2,178
Shareholders' transfers post tax	(30)	–	–	(30)
Investment-related items and other movements	1,274	(1,154)	245	365
Foreign exchange translation differences[note (a)]	36	(325)	(52)	(341)
At 31 December 2011/1 January 2012	12,643	12,015	6,254	30,912
Comprising:				
Policyholder liabilities	12,593	12,015	6,254	30,862
Unallocated surplus of with-profits funds	50	–	–	50
Premiums:				
New business	216	1,336	636	2,188
In-force	1,263	1,292	877	3,432
	1,479	2,628	1,513	5,620
Surrenders[note (c)]	(608)	(1,675)	(258)	(2,541)
Maturities/Deaths	(432)	(30)	(196)	(658)
Net flows[note (b)]	439	923	1,059	2,421
Shareholders' transfers post tax	(31)	–	–	(31)
Investment-related items and other movements[note (d)]	639	1,451	88	2,178
Foreign exchange translation differences[note (a)]	(239)	(361)	(216)	(816)
At 31 December 2012	13,451	14,028	7,185	34,664
Comprising:				
Policyholder liabilities	13,388	14,028	7,185	34,601
Unallocated surplus of with-profits funds	63	–	–	63
Average policyholder liability balances*				
2012	12,990	13,022	6,720	32,732
2011	11,775	12,370	5,623	29,768

* Averages have been based on opening and closing balances and exclude unallocated surplus of with-profits funds.

Notes

(a) Movements in the year have been translated at the average exchange rates for the year ended 31 December 2012. The closing balance has been translated at the closing spot rates as at 31 December 2012. Differences upon retranslation are included in foreign exchange translation differences.

(b) Net flows have increased by £243 million to £2,421 million in 2012, compared with £2,178 million in 2011, reflecting increased flows from new business and growth in the in-force books.

(c) In 2012 the rate of surrenders for shareholder-backed business (expressed as a percentage of opening liabilities) was 10.6 per cent (2011: 9.8 per cent). Excluding India where the market has been going through a significant period of change following regulatory changes in 2010, the surrender rate in 2012 was at 9.7 per cent (2011: 9.6 per cent). For with-profits business, surrenders have increased from £502 million in 2011 to £608 million in 2012, primarily as a result of certain products in Hong Kong reaching their five year anniversary, the point at which some product features trigger.

(d) Positive investment-related items and other movements of £2,178 million in 2012 primarily reflects improvements in the Asia equity market.

D: Life assurance business continued

D4: Asia insurance operations continued

c Information on credit risks of debt securities

The following table summarises the credit quality of the debt securities of the Asia insurance operations as at 31 December 2012 by rating agency ratings:

	2012 £m				2011 £m
	With-profits business	Unit-linked assets	Other business	Total	Total
S&P – AAA	675	19	91	785	1,423
S&P – AA+ to AA-	2,960	466	2,097	5,523	3,843
S&P – A+ to A-	2,059	279	944	3,282	3,055
S&P – BBB+ to BBB-	1,377	112	417	1,906	1,451
S&P – Other	1,443	815	874	3,132	2,137
	8,514	1,691	4,423	14,628	11,909
Moody's – Aaa	700	215	474	1,389	1,489
Moody's – Aa1 to Aa3	139	34	98	271	128
Moody's – A1 to A3	93	14	62	169	304
Moody's – Baa1 to Baa3	196	122	57	375	131
Moody's – Other	98	12	2	112	59
	1,226	397	693	2,316	2,111
Fitch	322	93	118	533	351
Other	1,433	1,013	1,479	3,925	3,310
Total Asia debt securities	11,495	3,194	6,713	21,402	17,681

The following table analyses debt securities of 'Other business' which are not externally rated:

	2012 £m	2011 £m
Government bonds	287	244
Corporate bonds rated as investment grade by local external ratings agencies	1,069	776
Other	123	45
	1,479	1,065

d Products and guarantees

The life insurance products offered by the Group's Asia operations include a range of with-profits and non-participating term, whole life, endowment and unit-linked policies. The Asia 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 Asia operations and, in particular, the products' options and guarantees, vary from territory to territory depending upon local market circumstances.

In general terms, the Asia 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 Asia 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.

Subject to local market circumstances and regulatory requirements, the guarantee features described in note D2(d) 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 Group is contractually obliged to provide guarantees on all benefits. Unit-linked products have the lowest level of guarantee.

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; and
- 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, though this is not of a significant extent 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 2012 of £505 million and £1,628 million respectively (2011: £447 million and £1,407 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 Asia 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.

e Process for setting assumptions and determining liabilities

The future policyholder benefit provisions for Asia 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 some countries in Asia 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 India, Japan, Taiwan and until 2012, Vietnam. Under this basis, 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. In Vietnam, the Company improved its estimation basis for liabilities in 2012 from one determined substantially by reference to US GAAP requirements. After making this change, the estimation basis for Vietnam is aligned substantially with that used in Singapore, Malaysia and some other Asia operations.

f Reinsurance

The Asia businesses cede only minor amounts of business outside the Group with immaterial effects on reported profit. During 2012, reinsurance premiums for externally ceded business were £178 million (2011: £226 million) and the reinsurance assets were £175 million (2011: £151 million) in aggregate.

g Effect of changes in bases, estimates and assumptions used to measure insurance assets and liabilities

In 2012, the IFRS operating profit based on longer-term investment returns for Asia insurance operations included a net £48 million credit (2011: £38 million) representing a small number of non-recurring items that are not anticipated to re-occur in subsequent periods.

Separately, the IFRS policyholder liabilities of the shareholder-backed non-linked business of the Group's Hong Kong operation are measured on a prospective net premium valuation approach with zero allowance for lapses. In 2012, the basis of determining the valuation rate of interest has been altered to align with a permitted practice of the Hong Kong authorities for regulatory reporting. The main change is to apply a valuation rate of interest that incorporates a reinvestment yield that is weighted by reference to current and the historical three year average, rather than the year end rate. The change reduced the carrying value of policyholder liabilities at 31 December 2012 by £95 million. This benefit is included within the short-term fluctuations in investment returns in the Group's supplementary analysis of profit.

D: Life assurance business continued

D4: Asia insurance operations continued

h Exposure and sensitivity of IFRS basis profit and shareholders' equity to market and other risks

The Asia 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. Non-participating business is largely backed by debt securities or deposits. The exposure to market risk of the Group arising from its Asia operations is therefore at modest levels. This arises from the fact that the Asia operations have a balanced portfolio of with-profits, unit-linked and other types of business.

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 regular 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, eg surrender charges.

(i) Sensitivity of profit and shareholders' equity to risks other than currency translation risk

With-profits business

Similar principles to those explained for UK with-profits business apply to profit emergence for the Asia 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.

Unit-linked business

As for the UK insurance operations, for unit-linked business, the main factor affecting the profit and shareholders' equity of the Asia operations is investment performance through asset management fees. The sensitivity of profits and shareholders' equity to changes in insurance risk, interest rate risk and credit risk are not material.

Other business

Interest rate risk

Asia operations offer a range of insurance and investment products, predominantly with-profits and non-participating term, whole life endowment and unit-linked. Excluding with-profit and unit-linked business, the results of the Asia business are sensitive to the vagaries of routine movements in interest rates.

For the purposes of analysing sensitivity to variations in interest rates, reference has been made to the movements in the 10-year government bond rates of the territories. At 31 December 2012, 10-year government bond rates vary from territory to territory and range from 0.60 per cent to 9.50 per cent (2011: 0.99 per cent to 12.88 per cent).

For the sensitivity analysis as at 31 December 2011, as shown in the table below, for the majority of the territories, a movement of 1 per cent in the 10-year government bond rate has been used. Exceptions to this approach are for Japan and Taiwan, where a movement of 0.5 per cent has been used. Following falls in interest rates in many of the territories during 2012, the approach was altered such that the reasonably possible interest rate movement used is 1 per cent for all territories but subject to a floor of zero where the bond rates are currently below 1 per cent. This revised approach was applied in estimating the sensitivity at 31 December 2012.

The estimated sensitivity to the decrease and increase in interest rates at 31 December 2012 and 2011 is as follows:

	2012 £m		2011 £m	
	Decrease of 1%	Increase of 1%	Decrease of 1%*	Increase of 1%*
Pre-tax profit	216	(269)	73	(159)
Related deferred tax (where applicable)	(56)	53	(22)	34
Net effect on profit and shareholders' equity	160	(216)	51	(125)

* Except for Japan and Taiwan using 0.5 per cent sensitivity.

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.

The degree of sensitivity of the results of the non-linked shareholder-backed business of the Asia operations to movements in interest rates depends upon the degree to which the liabilities under the 'grandfathered' IFRS 4 measurement basis reflects market interest rates from period to period. For example, for those countries, such as those applying US GAAP, the results can be more sensitive as the effect of interest rate movements on the backing investments may not be offset by liability movements.

Equity price risk

The non-linked shareholder business has limited exposure to equity and property investment (£663 million at 31 December 2012). Generally, changes in equity and property investment values are not directly offset by movements in policyholder liabilities.

The estimated sensitivity to a 10 per cent and 20 per cent change in equity and property prices for shareholder-backed Asia 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 2012 and 2011 would be as follows:

	2012 £m		2011 £m	
	Decrease of 20%	Decrease of 10%	Decrease of 20%	Decrease of 10%
Pre-tax profit	(134)	(67)	(120)	(60)
Related deferred tax (where applicable)	31	15	24	12
Net effect on profit and shareholders' equity	(103)	(52)	(96)	(48)

A 10 per cent 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 shown 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.

Insurance risk

Many of the territories in Asia are exposed to mortality/morbidity risk and provision is made within policyholder liabilities on a prudent regulatory basis to cover the potential exposure. If these prudent assumptions were strengthened by 5 per cent then it is estimated that post tax profit would be decreased by approximately £30 million (2011: £27 million). Mortality and morbidity has a symmetrical effect on the portfolio and any weakening of these assumptions would have a similar equal and opposite impact.

(ii) Sensitivity of IFRS basis profit and shareholders' equity to currency translation risk

Consistent with the Group's accounting policies, the profits of the Asia insurance operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2012, 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 Asia operations respectively as follows:

	A 10% increase in local currency to £ exchange rates		A 10% decrease in local currency to £ exchange rates	
	2012 £m	2011 £m	2012 £m	2011 £m
Profit before tax attributable to shareholders[note]	(90)	(57)	110	70
Profit for the year	(75)	(46)	92	56
Shareholders' equity, excluding goodwill, attributable to Asia operations	(243)	(228)	297	278

Note

Sensitivity on profit (loss) before tax ie aggregate of the operating profit based on longer-term investment returns and short-term fluctuations in investment returns.

i Duration of liabilities

The table below shows the carrying value of policyholder liabilities. The table below also shows the maturity profile of the cash flows, taking account of expected future premiums and investment returns for 2012 and 2011:

	2012 £m	2011 £m
Policyholder liabilities	34,601	30,862
	%	%
Expected maturity:		
0 to 5 years	23	22
5 to 10 years	19	19
10 to 15 years	17	15
15 to 20 years	13	13
20 to 25 years	9	10
Over 25 years	19	21

D: Life assurance business continued

D5: Capital position statement for life assurance businesses

The primary purpose of this section is to meet the disclosure requirements of FRS 27, the UK GAAP Standard on Life Assurance. Prudential, together with other major UK life assurers, undertook to the UK Accounting Standards Board in 2004 to adopt this standard for Group IFRS reporting. Under the disclosure requirements of FRS 27 the capital position statement and related footnotes are prepared by reference to local regulation.

a Summary statement

The Group's estimated capital position for life assurance businesses with reconciliations to shareholders' equity is shown below. As noted above, available capital for each fund or group of companies has been determined by reference to local regulation at 31 December 2012 and 2011.

	2012 £m									
	SAIF	WPSF note (i)	Total PAC with-profits fund	Other UK life assurance subsidiaries and funds note (ii)	Jackson	Asia 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	–	–	–	920	4,343	2,290	7,553	393	(1,143)	6,803
Goodwill	–	–	–	–	–	239	239	1,153	77	1,469
Total	–	–	–	920	4,343	2,529	7,792	1,546	(1,066)	8,272
Held in long-term funds note (iii)	–	–	–	2,087	–	–	2,087	–	–	2,087
Total Group shareholders' equity	–	–	–	3,007	4,343	2,529	9,879	1,546	(1,066)	10,359
Adjustments to regulatory basis										
Unallocated surplus of with-profits funds note (v)	–	10,526	10,526	–	–	63	10,589			
Shareholders' share of realistic liabilities	–	(2,469)	(2,469)	–	–	–	(2,469)			
Deferred acquisition costs of non-participating business not recognised for regulatory reporting purposes and goodwill	–	(6)	(6)	(103)	(3,199)	(893)	(4,201)			
Jackson surplus notes note (iv)	–	–	–	–	153	–	153			
Investment and policyholder liabilities valuation differences between IFRS and regulatory basis for Jackson note (vii)	–	–	–	–	696	–	696			
Adjustment from IAS 19 basis pension deficit attributable to WPSF to pension liability for regulatory purposes	–	(107)	(107)	–	–	–	(107)			
Valuation difference on PAL between IFRS basis and regulatory basis	–	(215)	(215)	–	–	–	(215)			
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) note (v)	–	(729)	(729)	(534)	906	(78)	(435)			
Total adjustments	–	7,000	7,000	(637)	(1,444)	(908)	4,011			
Total available capital resources of life assurance businesses on local regulatory bases	–	7,000	7,000	2,370	2,899	1,621	13,890			

	2012 £m						
	SAIF	WPSF note (i)	Total PAC with-profits fund	Other UK life assurance subsidiaries and funds note (ii)	Jackson	Asia life assurance subsidiaries	Total life assurance operations
Policyholder liabilities							
With-profits liabilities of UK regulated with-profits funds:							
Insurance contracts	7,217	29,353	36,570	–	–	6,696	43,266
Investment contracts (with discretionary participation features)	352	33,112	33,464	–	–	95	33,559
Total	7,569	62,465	70,034	–	–	6,791	76,825
Other liabilities:							
Insurance contracts:							
With-profits liabilities of non-UK regulated funds	–	–	–	–	–	6,597	6,597
Unit-linked, including variable annuity	–	29	29	6,086	49,298	14,028	69,441
Other life assurance business	309	14,013	14,322	27,259	40,894	7,058	89,533
Investment contracts without discretionary participation features (principally unit-linked and similar contracts in the UK and GIC liabilities of Jackson)note (vi)	–	22	22	16,160	2,069	127	18,378
Total	309	14,064	14,373	49,505	92,261	27,810	183,949
Total policyholder liabilities shown in the consolidated statement of financial position	7,878	76,529	84,407	49,505	92,261	34,601	260,774

D: Life assurance business continued

D5: Capital position statement for life assurance businesses continued

	2011* £m									
	SAIF	WPSF note (i)	Total PAC with-profits fund	Other UK life assurance subsidiaries and funds note (ii)	Jackson	Asia 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	–	–	–	930	3,761	2,071	6,762	229	(1,514)	5,477
Goodwill	–	–	–	–	–	235	235	1,153	77	1,465
Total	–	–	–	930	3,761	2,306	6,997	1,382	(1,437)	6,942
Held in long-term funds note (iii)	–	–	–	1,622	–	–	1,622	–	–	1,622
Total Group shareholders' equity	–	–	–	2,552	3,761	2,306	8,619	1,382	(1,437)	8,564
Adjustments to regulatory basis										
Unallocated surplus of with-profits funds note (v)	–	9,165	9,165	–	–	50	9,215			
Shareholders' share of realistic liabilities	–	(2,394)	(2,394)	–	–	–	(2,394)			
Deferred acquisition costs of non-participating business not recognised for regulatory reporting purposes and goodwill	–	(6)	(6)	(111)	(3,095)	(929)	(4,141)			
Jackson surplus notes note (iv)	–	–	–	–	160	–	160			
Investment and policyholder liabilities valuation differences between IFRS and regulatory basis for Jackson note (vii)	–	–	–	–	1,002	–	1,002			
Adjustment from IAS 19 basis pension deficit attributable to WPSF to pension liability for regulatory purposes	–	16	16	–	–	–	16			
Valuation difference on PAL between IFRS basis and regulatory basis	–	(640)	(640)	–	–	–	(640)			
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) note (v)	–	(2)	(2)	(504)	699	66	259			
Total adjustments	–	6,139	6,139	(615)	(1,234)	(813)	3,477			
Total available capital resources of life assurance businesses on local regulatory bases	–	6,139	6,139	1,937	2,527	1,493	12,096			

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

	2011 £m						
	SAIF	**WPSF** note (i)	**Total PAC with-profits fund**	**Other UK life assurance subsidiaries and funds** note (ii)	**Jackson**	**Asia life assurance subsidiaries**	**Total life assurance operations**
Policyholder liabilities							
With-profits liabilities of UK regulated with-profits funds:							
Insurance contracts note (viii)	7,934	30,077	38,011	–	–	6,777	44,788
Investment contracts (with discretionary participation features)	412	28,936	29,348	–	–	397	29,745
Total	8,346	59,013	67,359	–	–	7,174	74,533
Other liabilities:							
Insurance contracts:							
With-profits liabilities of non-UK regulated funds	–	–	–	–	–	5,419	5,419
Unit-linked, including variable annuity note (viii)		26	26	6,387	37,833	12,015	56,261
Other life assurance business	209	13,365	13,574	24,734	29,445	6,142	73,895
Investment contracts without discretionary participation features (principally unit-linked and similar contracts in the UK and GIC liabilities of Jackson) note (vi)	–	17	17	14,927	1,911	112	16,967
Total	209	13,408	13,617	46,048	69,189	23,688	152,542
Total policyholder liabilities shown in the consolidated statement of financial position	8,555	72,421	80,976	46,048	69,189	30,862	227,075

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 Asia 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, ring-fenced 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 basis, as shown in the table above, and other methodology differences.
(vi) Insurance business accounted for as financial instruments under IAS 39.
(vii) 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.
(viii) The allocation between the with-profits liabilities and unit-linked liabilities within the WPSF column have been adjusted for those previously published to align with the basis of presentation applied in 2012.

D: Life assurance business 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 by 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 £7.0 billion (2011: £6.1 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 2012 (2011: £2.0 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.

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.

Other UK life assurance subsidiaries and funds

The available capital of £2,370 million (2011: £1,937 million) reflects the excess of regulatory basis assets over liabilities of the subsidiaries and funds, before deduction of the capital resources requirement of £1,376 million (2011: £1,194 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 policyholder's 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 using 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 £2,899 million (2011: £2,527 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 2012, 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 net of tax was to decrease statutory surplus by £357 million at 31 December 2012.

Michigan insurance law specifically allows value of business acquired (VOBA) as an admitted asset as long as certain criteria are met. US NAIC standards limit the admitted amount of goodwill/VOBA generally to 10 per cent of capital and surplus. At 31 December 2012, Jackson reported £289 million of statutory basis VOBA as a result of the REALIC acquisition, which is fully admissible under Michigan insurance law.

iii Asia operations

The available capital shown above of £1,621 million (2011: £1,493 million) represents the excess of local regulatory basis assets over liabilities before deduction of required capital of £661 million (2011: £608 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

A risk-based regulatory framework applies in Singapore.

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

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 continued until 1 January 2012, when it was withdrawn. The withdrawal of this temporary relief did not have a significant impact on the Group's Indonesia business;

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.

Solvency capital is determined using a risk-based capital approach. The adjusted solvency capital assets of the Company must exceed 200 per cent of the risk related capital requirement value at risk. A number of changes to the risk-based capital rules in Japan were effective in April 2012, but the changes did not have a significant impact on the Group's Japan business;

D: Life assurance business continued

D5: Capital position statement for life assurance businesses continued

Malaysia

A risk-based capital framework applies in Malaysia.

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 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 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.

Participating fund surplus is not allowed to be used to support deficit (if any) and capital requirement of the non-participating business. The capital requirement is calculated based on a prescribed series of risk charges. The local regulator has set a Supervisory Target Capital Level of 130 per cent below which supervisory actions of increasing intensity will be taken. Each insurer is also required to set its own Individual Target Capital Level to reflect its own risk profile and this is expected to be higher than the Supervisory Target Capital Level;

Vietnam

Mathematical reserves are calculated using a modified net premium approach, set using assumptions agreed with the regulator.

The capital requirement is determined as 4 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; and

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.

A risk-based capital framework applies in Korea. Under this risk-based 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 2012, together with market risk sensitivity disclosure provided to key management, is provided in the business review section of the Group's 2012 Annual Report.

c Movements in total available capital

Total available capital for the Group's life assurance operations has changed as follows:

	2012 £m				
	WPSF note (i)	**Other UK life assurance subsidiaries and funds** note (iii)	**Jackson** note (ii)	**Asia life assurance subsidiaries** note (iv)	**Group Total**
Available capital at 31 December 2011	6,139	1,937	2,527	1,493	12,096
Changes in assumptions	(136)	(145)	–	30	(251)
Changes in management policy	500	–	–	(24)	476
Changes in regulatory requirements	–	–	–	27	27
New business and other factors note (v)	497	578	372	95	1,542
Available capital at 31 December 2012	7,000	2,370	2,899	1,621	13,890

	2011 £m				
	WPSF note (i)	Other UK life assurance subsidiaries and funds note (iii)	Jackson note (ii)	Asia life assurance subsidiaries note (iv)	Group Total
Available capital at 31 December 2010	6,800	1,707	2,907	1,378	12,792
Changes in assumptions	(60)	38	–	(32)	(54)
Changes in management policy	(15)	–	–	–	(15)
Changes in regulatory requirements	–	–	–	17	17
New business and other factors[note (v)]	(586)	192	(380)	130	(644)
Available capital at 31 December 2011	6,139	1,937	2,527	1,493	12,096

Notes

(i) WPSF

The increase in 2012 of £861 million reflects primarily the positive impact of investment returns earned on the opening available capital.

The decrease in 2011 of £661 million reflects primarily the negative effect of the lower interest rate used to value projected policyholder benefit payments, partially offset by the positive impact of investment returns earned on the opening available capital.

(ii) Jackson

The increase of £372 million in 2012 reflects an underlying increase of £483 million (applying the 2012 year end exchange rate of US$1.63:£1.00) and £111 million of exchange translation loss.

The decrease of £380 million in 2011 reflects an underlying decrease of £402 million (applying the 2011 year end exchange rate of US$1.55:£1.00) and £22 million of exchange translation gains.

(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) Asia life assurance subsidiaries

The increase of £128 million in 2012 reflects an underlying increase of £177 million (applying the relevant 2012 year end exchange rates) and £49 million of exchange translation loss.

The increase of £115 million in 2011 reflected an underlying increase of £134 million (applying the relevant 2011 year end exchange rates) and £19 million of exchange translation loss.

(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.

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.

D: Life assurance business continued

D5: Capital position statement for life assurance businesses continued

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. 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.

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.

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 Intragroup arrangements in respect of SAIF

Should the assets of SAIF be inadequate to meet the guaranteed benefit obligations of the policyholders of SAIF, the PAC long-term fund would be liable to cover any such deficiency in the first instance. 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.

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 and Europe is undertaken through M&G which is made up of three distinct businesses being Retail, Institutional and Finance. M&G's investment expertise covers all key asset classes, equities, fixed interest and commercial real estate, and includes a number of specialist fixed income and real estate strategies. M&G manages its own retail fund operations, funds for pensions, insurance companies and third-party entities.

Asset management in the US is undertaken through PPM America which manages assets for the Group's UK, Asia and US affiliates plus also provides investment services to other affiliated and unaffiliated institutional clients including collateralised debt obligations (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.

Eastspring Investments 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.

Other operations cover 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:

	2012 £m				**2011** £m
	M&G	**US**	**Eastspring Investments** note (iii)	**Total**	**Total**
Revenue (excluding revenue of consolidated investment funds and NPH broker-dealer fees)	1,234	296	282	1,812	1,583
Revenue of consolidated investment funds note (i)	(11)	–	–	(11)	9
NPH broker-dealer fees note (i)	–	435	–	435	405
Gross revenue*	1,223	731	282	2,236	1,997
Charges (excluding charges of consolidated investment funds and NPH broker-dealer fees)	(713)	(257)	(207)	(1,177)	(1,147)
Charges of consolidated investment funds note (i)	11	–	–	11	(9)
NPH broker-dealer fees note (i)	–	(435)	–	(435)	(405)
Gross charges	(702)	(692)	(207)	(1,601)	(1,561)
Profit before tax	521	39	75	635	436
Comprising:					
Operating profit based on longer-term investment returns	371	39	75	485	461
Short-term fluctuations in investment returns note (ii)	93	–	–	93	(29)
Shareholder's share of actuarial gains and losses on defined benefit pension schemes	15	–	–	15	4
Gain on dilution of Group's holdings	42	–	–	42	–
Profit before tax	521	39	75	635	436

* For 2012, gross revenue includes the Group's share of results from the associate PPM South Africa. In prior years, PPM South Africa was treated as a subsidiary and accounted for accordingly.

Notes

(i) Under IFRS, disclosure details of segment revenue are required. The segment revenue of the Group's asset management operations are required to include two items that are for amounts which, reflecting their commercial nature, are also wholly reflected as charges within the income statement. After allowing for these charges, there is no effect on profit from these two items which are:
  (a) Investment funds which are managed on behalf of third parties and are consolidated under IFRS in recognition of the control arrangements for the funds. The gains and losses of these funds are non-recourse to M&G and the Group; and
  (b) NPH broker-dealer fees which represent commissions received, that are then paid on to the writing brokers on sales of investment products.
  The presentation in the table above shows the amounts attributable to these two items so that the underlying revenue and charges can be seen.

(ii) Short-term fluctuations in investment returns for M&G are primarily in respect of unrealised fair value movements on Prudential Capital's bond portfolio.

(iii) Included within Eastspring Investments revenue and charges are £42 million of commissions (2011: £44 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:

	2012 £m	2011* £m
Asset management fee income	728	662
Other income	6	4
Staff costs	(289)	(270)
Other costs	(147)	(134)
Underlying profit before performance-related fees	298	262
Share of associate results	13	26
Performance-related fees	9	13
Operating profit from asset management operations	320	301
Operating profit from Prudential Capital	51	56
Total M&G operating profit based on longer-term investment returns	371	357

* Following the divestment in the first half of 2012 of M&G's holding in PPM South Africa from 75 per cent to 49.99 per cent and its treatment from 2012 as an associate, M&G's operating income and expense no longer include any element from PPM South Africa, with the share of associates' results being presented in a separate line. The table above reflects the retrospective application of this basis of presentation for the 2011 results. Total profit remains the same.

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 the total revenue of Prudential Capital (including short-term fluctuations) of £218 million (2011: £96 million) and commissions which have been netted off in arriving at the fee income of £728 million (2011: £662 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' equity included in the Group consolidated statement of financial position in respect of asset management operations are as follows:

	2012 £m				2011 £m
	M&G note (iii)	US	Eastspring Investments	Total	Total
Assets					
Intangible assets:					
Goodwill	1,153	16	61	1,230	1,230
Deferred acquisition costs and other intangibles assets	10	2	2	14	16
Total	1,163	18	63	1,244	1,246
Other non-investment and non-cash assets	901	174	83	1,158	1,129
Associate investments accounted for using the equity method	41	–	–	41	–
Financial investments:					
Loans note (i)	1,199	–	–	1,199	1,256
Equity securities and portfolio holdings in unit trusts	50	–	20	70	594
Debt securities note (ii)	1,839	–	7	1,846	1,842
Other investments	38	6	–	44	78
Deposits	3	33	48	84	89
Total investments	3,170	39	75	3,284	3,859
Cash and cash equivalents	909	48	126	1,083	1,735
Total assets	6,143	279	347	6,769	7,969
Equity and liabilities					
Equity					
Shareholders' equity	1,545	124	268	1,937	1,783
Non-controlling interests	–	–	–	–	5
Total equity	1,545	124	268	1,937	1,788
Liabilities					
Core structural borrowing of shareholder-financed operations	275	–	–	275	250
Intra-group debt represented by operational borrowings at Group level note (iv)	2,084	–	–	2,084	2,956
Net asset value attributable to external holders of consolidated unit trusts and similar funds	162	–	–	162	678
Other non-insurance liabilities note (v)	2,077	155	79	2,311	2,297
Total liabilities	4,598	155	79	4,832	6,181
Total equity and liabilities	6,143	279	347	6,769	7,969

Notes

(i) Loans

The M&G loans relate to loans and receivables managed by Prudential Capital. These assets are generally secured but most have no external credit ratings. Internal ratings prepared by the Group's asset management operations as part of the risk management process are:

	2012 £m	2011 £m
Loans and receivables internal ratings:		
A+ to A-	–	129
BBB+ to BBB-	836	1,000
BB+ to BB-	339	89
B+ to B-	24	38
Total M&G loans	1,199	1,256

E: Asset management (including US broker-dealer) and other operations continued

E2: Statement of financial position for asset management operations continued

(ii) Debt securities

Of the £1,846 million total debt securities at 31 December 2012 (2011: £1,842 million) for asset management operations, the following amounts were held by M&G.

	2012 £m	2011 £m
M&G:		
AAA to A- by Standard & Poor's or Aaa rated by Moody's	1,493	1,547
Other	346	287
Total M&G debt securities	1,839	1,834

(iii) The M&G statement of financial position includes the 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:

	2012 £m	2011 £m
Commercial paper	1,535	2,706
Medium-Term Notes	549	250
Total intra-group debt represented by operational borrowings at Group level	2,084	2,956

(v) Other non-insurance liabilities consists primarily of intra-group balances, derivative liabilities and other creditors.

E3: Regulatory and other surplus for asset management operations

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				
	2012 £m				2011 £m
	M&G	US	Eastspring Investments	Total	Total
Regulatory and other surplus					
Beginning of year	156	129	127	412	432
Gains during the year	356	8	52	416	326
Movement in capital requirement	(3)	–	6	3	(14)
Capital injection	–	–	9	9	8
Distributions made	(254)	(8)	(56)	(318)	(342)
Exchange movement	–	(5)	(4)	(9)	2
End of year	255	124	134	513	412

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 shareholders' equity to market and other financial risk

i Currency translation

Consistent with the Group's accounting policies, the profits of Eastspring Investments and US asset management operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. The rates for the functional currencies of most significant operations are shown in note B4.

A 10 per cent increase in the relevant exchange rates would have reduced reported profit before tax attributable to shareholders and shareholders' equity, excluding goodwill attributable to Eastspring Investments and US asset management operations, by £10 million (2011: £9 million) and £29 million (2011: £30 million) respectively.

ii 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 2012 by asset management operations were £1,846 million (2011: £1,842 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 shareholders' equity. The Group's 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 expenditure for the year of £498 million (2011: £483 million) as detailed in note B1. An analysis of the assets and liabilities of other operations is shown in note B5.

The Group holds certain derivatives that are used to manage foreign currency movements and macroeconomic exposures. The fair value of these derivatives is sensitive to the combined effect of movements in exchange rates, interest rates and inflation rates. The possible permutations cover a wide range of scenarios. For indicative purposes, a reasonably possible range of fair value movements could be plus or minus £17 million.

F: Income statement notes

F1: Segmental information

	Year ended 31 December 2012 £m								
	Insurance operations			Asset management E1					
	UK	US	Asia	M&G	US	Eastspring Investments	Total segment	Unallocated corporate	Group total
Gross premiums earned	7,020	14,660	8,230	–	–	–	29,910		29,910
Outward reinsurance premiums	(135)	(193)	(178)	–	–	–	(506)		(506)
Earned premiums, net of reinsurance	6,885	14,467	8,052	–	–	–	29,404	–	29,404
Investment return note (ii)	14,495	6,193	3,112	251	6	8	24,065	(14)	24,051
Other income	213	(2)	153	972	725	274	2,335	(314)	2,021
Total revenue, net of reinsurance	21,593	20,658	11,317	1,223	731	282	55,804	(328)	55,476
Benefits and claims	(18,253)	(18,703)	(7,875)	–	–	–	(44,831)	–	(44,831)
Outward reinsurers' share of benefits and claims note (iv)	159	(8)	108	–	–	–	259	–	259
Movement in unallocated surplus of with-profits funds note (iii)	(863)	–	(518)	–	–	–	(1,381)	–	(1,381)
Benefits and claims and movements in unallocated surplus of with-profits funds, net of reinsurance	(18,957)	(18,711)	(8,285)	–	–	–	(45,953)	–	(45,953)
Acquisition costs and other operating expenditure F3	(1,478)	(1,079)	(1,965)	(686)	(692)	(207)	(6,107)	52	(6,055)
Finance costs: interest on core structural borrowings of shareholder-financed operations	–	(13)	–	(16)	–	–	(29)	(251)	(280)
Total charges, net of reinsurance	(20,435)	(19,803)	(10,250)	(702)	(692)	(207)	(52,089)	(199)	(52,288)
Profit (loss) before tax *(being tax attributable to shareholders' and policyholders' returns)* note (i)	1,158	855	1,067	521	39	75	3,715	(527)	3,188
Tax charge attributable to policyholders' returns	(300)	–	(78)	–	–	–	(378)	–	(378)
Profit (loss) from continuing operations before tax attributable to shareholders	858	855	989	521	39	75	3,337	(527)	2,810

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 2012 £m								
	Insurance operations			Asset management					
	UK	US	Asia	M&G	US	Eastspring Investments	Total segment	Unallocated corporate	Group total
Operating profit based on longer-term investment returns	736	964	913	371	39	75	3,098	(565)	2,533
Short-term fluctuations in investment returns on shareholder-backed business	136	(90)	76	93	–	–	215	(11)	204
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	(14)	–	–	15	–	–	1	49	50
Gain on dilution of Group holdings	–	–	–	42	–	–	42	–	42
Amortisation of acquisition accounting adjustments arising on purchase of REALIC	–	(19)	–	–	–	–	(19)	–	(19)
Profit (loss) from continuing operations before tax attributable to shareholders	858	855	989	521	39	75	3,337	(527)	2,810

	Year ended 31 December 2011* £m								
	Insurance operations			Asset management E1					
	UK	US	Asia	M&G	US	Eastspring Invest-ments	Total segment	Unallo-cated corporate	Group total
Gross premiums earned	5,678	12,650	7,378	–	–	–	25,706	–	25,706
Outward reinsurance premiums	(131)	(72)	(226)	–	–	–	(429)		(429)
Earned premiums, net of reinsurance	5,547	12,578	7,152	–	–	–	25,277	–	25,277
Investment return note (ii)	7,604	1,447	283	128	1	2	9,465	(105)	9,360
Other income	193	(62)	155	923	653	290	2,152	(283)	1,869
Total revenue, net of reinsurance	13,344	13,963	7,590	1,051	654	292	36,894	(388)	36,506
Benefits and claims	(12,048)	(12,931)	(6,081)	–	–	–	(31,060)	–	(31,060)
Outward reinsurers' share of benefits and claims note (iv)	290	280	176	–	–	–	746	–	746
Movement in unallocated surplus of with-profits funds note (iii)	485	–	540	–	–	–	1,025	–	1,025
Benefits and claims and movements in unallocated surplus of with-profits funds, net of reinsurance	(11,273)	(12,651)	(5,365)	–	–	–	(29,289)	–	(29,289)
Acquisition costs and other operating expenditure F3	(1,239)	(815)	(1,562)	(704)	(630)	(212)	(5,162)	42	(5,120)
Finance costs: interest on core structural borrowings of shareholder-financed operations	–	(13)	–	(15)	–	–	(28)	(258)	(286)
Total charges, net of reinsurance	(12,512)	(13,479)	(6,927)	(719)	(630)	(212)	(34,479)	(216)	(34,695)
Profit (loss) before tax *(being tax attributable to shareholders' and policyholders' returns)* note (i)	832	484	663	332	24	80	2,415	(604)	1,811
Tax charge attributable to policyholders' returns	68	–	(51)	–	–	–	17	–	17
Profit (loss) from continuing operations before tax attributable to shareholders	900	484	612	332	24	80	2,432	(604)	1,828

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 2011* £m								
	Insurance operations			Asset management					
	UK	US	Asia	M&G	US	Eastspring Invest-ments	Total segment	Unallo-cated corporate	Group total
Operating profit based on longer-term investment returns	723	651	704	357	24	80	2,539	(512)	2,027
Short-term fluctuations in investment returns on shareholder-backed business	159	(167)	(92)	(29)	–	–	(129)	(91)	(220)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	18	–	–	4	–	–	22	(1)	21
Profit (loss) from continuing operations before tax attributable to shareholders	900	484	612	332	24	80	2,432	(604)	1,828

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

F: Income statement notes continued

F1: Segmental information continued

Notes

(i) This 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 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.

(iv) The increase in the credit for outwards reinsurers' share of benefits and claims for Jackson from 2010 to 2011 arises from the fair value movements on the GMIB reinsurance in 2011. As the GMIB reinsurance is net settled it is considered to be a derivative under IAS 39. The movement was particularly high in 2011 due to the reduction in US interest rates in 2011.

F2: Revenue

	2012 £m	2011 £m
Long-term business premiums		
Insurance contract premiums	27,447	23,705
Investment contracts with discretionary participation feature premiums	2,243	1,861
Inwards reinsurance premiums	220	140
Less: reinsurance premiums ceded	(506)	(429)
Earned premiums, net of reinsurance note (iv)	29,404	25,277
Investment return		
Realised and unrealised gains and losses on securities at fair value through profit and loss	15,338	866
Realised and unrealised losses and gains on derivatives at fair value through profit and loss	75	86
Realised losses on available-for-sale securities, previously recognised in other comprehensive income	68	101
Realised losses on loans	(51)	(43)
Interest notes (i),(ii)	6,600	6,440
Dividends	1,462	1,304
Other investment return	559	606
Investment return	24,051	9,360
Fee income from investment contract business and asset management notes (iii),(iv)	2,021	1,869
Total revenue	55,476	36,506

Notes

(i) The segmental analysis of interest income is as follows:

	2012 £m	2011 £m
Insurance operations:		
UK	4,310	4,286
US	1,778	1,717
Asia	403	339
Asset management operations:		
M&G	114	110
US	1	1
Eastspring Investments	3	3
Total segment	6,609	6,456
Unallocated corporate	(9)	(16)
Total	6,600	6,440

(ii) Interest income includes £13 million (2011: £8 million) accrued in respect of impaired securities.

(iii) Fee income includes £35 million (2011: £13 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:

	2012 £m				
	Asia	US	UK	Intragroup	Total
Revenue from external customers:					
Insurance operations	8,205	14,465	7,098	–	29,768
Asset management	274	725	972	(333)	1,638
Unallocated corporate	–	–	19	–	19
Intragroup revenue eliminated on consolidation	(84)	(77)	(172)	333	–
Total revenue from external customers	8,395	15,113	7,917	–	31,425

	2011 £m				
	Asia	US	UK	Intragroup	Total
Revenue from external customers:					
Insurance operations	7,307	12,516	5,740	–	25,563
Asset management	290	653	923	(323)	1,543
Unallocated corporate	–	–	40	–	40
Intragroup revenue eliminated on consolidation	(93)	(68)	(162)	323	–
Total revenue from external customers	7,504	13,101	6,541	–	27,146

Revenue from external customers is made up of the following:

	2012 £m	2011 £m
Earned premiums, net of reinsurance	29,404	25,277
Fee income from investment contract business and asset management (presented as 'Other income')	2,021	1,869
Total revenue from external customers	31,425	27,146

In their capacity as fund managers to fellow Prudential Group subsidiaries, M&G, Eastspring Investments and US asset management businesses generate fees for investment management and related services. These services are charged at appropriate arm's length prices, typically priced as a percentage of funds under management. Intragroup fees included within asset management revenue were earned by the following asset management segment:

	2012 £m	2011 £m
Intragroup revenue generated by:		
M&G	172	162
Eastspring Investments	84	93
US broker-dealer and asset management (including Curian)	77	68
Total intragroup fees included within asset management segment	333	323

Revenue from external customers of Asia, US and UK insurance operations shown above are net of outwards reinsurance premiums of £178 million, £193 million, and £135 million respectively (2011: £226 million, £72 million and £131 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 £1,745 million (2011: Singapore £1,383 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

	2012 £m	2011* £m
Acquisition costs incurred for insurance policies	(2,649)	(2,264)
Acquisition costs deferred less amortisation of acquisition costs for insurance policies	480	520
Administration costs and other expenditure	(3,728)	(3,524)
Movements in amounts attributable to external unit holders	(158)	148
Total acquisition costs and other expenditure	(6,055)	(5,120)

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

Notes

(i) Acquisition costs in 2012 comprise amounts related to insurance contracts of £(1,949) million (2011: £(1,679) million), and investment contracts and asset management contracts of £(220) million (2011: £(65) million).

(ii) There were no fee expenses relating to financial liabilities held at amortised cost included in acquisition costs in 2012 and 2011.

(iii) The total depreciation and amortisation expense of £(731) million (2011: £(584) million) relates to amortisation of deferred acquisition costs of insurance contracts and asset management contracts.
The segmental analysis of total depreciation and amortisation expense is as follows:

	2012 £m	2011* £m
Insurance operations:		
UK	(65)	(55)
US	(302)	(237)
Asia	(332)	(270)
Asset management operations:		
M&G	(6)	(7)
US	(1)	(1)
Eastspring Investments	(4)	(4)
Total segment	(710)	(574)
Unallocated corporate	(21)	(10)
Total	(731)	(584)

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

(iv) Interest expense, excluding interest on core structural borrowings of shareholder-financed operations, amounted to £(140) million (2011: £(123) 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:

	2012 £m	2011 £m
Insurance operations:		
UK	(62)	(49)
US	(28)	(31)
Asia	(7)	(10)
Asset management operations:		
M&G	(18)	(11)
Total segment	(115)	(101)
Unallocated corporate	(25)	(22)
Total	(140)	(123)

(v) Movements in amounts attributable to external unit holders are in respect of those OEIC and unit trusts which are required to be consolidated and comprises a charge of £(195) million (2011: a credit of £28 million) for UK insurance operations and a credit of £37 million (2011: £120 million) for Asia 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:

	2012 £m	**2011** £m
Group Head Office	(168)	(168)
Asia Regional Head Office:		
Gross costs	(99)	(86)
Recharges to Asia operations	36	35
	(63)	(51)
Total	(231)	(219)

F4: Finance costs – Interest on core structural borrowings of shareholder-financed operations

Finance costs of £280 million (2011: £286 million) comprise £251 million (2011: £258 million) interest on core debt of the parent company, £13 million (2011: £13 million) on US insurance operations' surplus notes and £16 million (2011: £15 million) on PruCap's bank loan.

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:

	2012 £m	**2011*** £m
Current tax expense:		
Corporation tax	(950)	(775)
Adjustments in respect of prior years	143	33
Total current tax	(807)	(742)
Deferred tax arising from:		
Origination and reversal of temporary differences	(178)	293
(Expense) credit in respect of a previously unrecognised tax loss, tax credit or temporary difference from a prior period	(6)	57
Total deferred tax (charge) credit	(184)	350
Total tax charge	(991)	(392)

The total tax expense arises as follows:

	2012 £m	**2011*** £m
Current tax expense:		
UK	(393)	(475)
Foreign	(414)	(267)
	(807)	(742)
Deferred tax (charge) credit:		
UK	(45)	455
Foreign	(139)	(105)
	(184)	350
Total	(991)	(392)

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in the accounting policy described in note A5.

F: Income statement notes continued

F5: Tax continued

The current tax charge of £807 million includes £18 million (2011: charge of £16 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) 5 per cent of the net insurance premium or (ii) the estimated assessable profits, depending on the nature of the business written.

In the UK, life insurance companies are taxed on both their shareholders' profits and on their policyholders' investment returns on certain insurance and investment products. Tax on shareholders' profits is calculated at the standard corporation tax rate, and tax on policyholders' investment returns is calculated at the basic rate of income tax. Although both types of tax are included in the total tax charge in the Group's consolidated income statement, they are presented separately in the income statement to provide the most relevant information about tax that the Group pays on its profits.

Until the end of 2012 for the Group's UK life insurance companies, shareholders' profits were calculated using regulatory surplus as a starting point, with appropriate deferred tax adjustments for IFRS. Beginning in 2013, under new UK life tax rules, shareholders' profits will be calculated using accounting profit or loss as a starting point.

The total tax charge comprises tax attributable to policyholders and unallocated surplus of with-profits funds, unit-linked policies and shareholders as shown below.

	2012 £m			**2011*** £m
Tax charge	**Current tax**	**Deferred tax**	**Total**	**Total**
Tax (charge) credit to policyholders' returns	(488)	110	(378)	17
Tax charge attributable to shareholders	(319)	(294)	(613)	(409)
Total tax charge	(807)	(184)	(991)	(392)

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

The principal reason for the increase in the tax charge attributable to policyholders' returns is an increase in deferred tax on unrealised gains and losses on investments.

The total deferred tax (charge)/credit arises as follows:

	2012 £m	**2011*** £m
Unrealised gains and losses on investments	(91)	129
Balances relating to investment and insurance contracts	467	148
Short-term timing differences	(226)	66
Capital allowances	–	2
Unused tax losses	(334)	5
Deferred tax (charge)/credit	(184)	350

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

In 2012, a deferred tax charge of £198 million (2011: charge of £187 million) has been taken through other comprehensive income. Other movements in deferred tax totalling a £378 million credit mainly arises as a result of bringing a deferred tax asset in respect of the acquired REALIC business on to the balance sheet. When these amounts are taken with the deferred tax charge shown above there is no significant change in the Group's net deferred tax liability (2011: decrease of £0.1 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:

	2012 £m	2011* £m
Profit before tax	3,188	1,811
Tax (charge) credit attributable to policyholders' returns	(378)	17
Profit before tax attributable to shareholders	2,810	1,828
Tax attributable to shareholders' profits:		
Tax charge	(991)	(392)
Less: tax attributable to policyholders' returns	378	(17)
Tax charge attributable to shareholders' returns	(613)	(409)
Profit for the year	2,197	1,419

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

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:

	2012 £m			2011* £m		
	Attributable to shareholders	Attributable to policyholders†	Total	Attributable to shareholders	Attributable to policyholders†	Total
Profit (loss) before tax	2,810	378	3,188	1,828	(17)	1,811
Taxation charge:						
Expected tax rate	27%	100%	36%	28%	100%	28%
Expected tax (charge) credit	(763)	(378)	(1,141)	(519)	17	(502)
Variance from expected tax charge note v(ii)	150	–	150	110	–	110
Actual tax (charge) credit	(613)	(378)	(991)	(409)	17	(392)
Average effective tax rate	22%	100%	31%	22%	100%	22%

* The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

† For the column entitled 'Attributable to policyholders', the profit (loss) before tax represents income, before tax attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies. This income has been determined after deduction of charges for policyholder benefits and movements on unallocated surplus which are determined net of tax. Hence, the pre-tax results attributable to policyholders is the inverse of the tax charge attributable to policyholders.

F: Income statement notes continued

F5: Tax continued

iii Reconciliation of effective tax rate

The total tax charge is attributable to shareholders and policyholders as summarised in the income statement.

Reconciliation of tax charge on profit attributable to shareholders for continuing operations:

	2012 £m (except for tax rates)				
2012	**Asia insurance operations**	**US insurance operations**	**UK insurance operations**	**Other operations**	**Total**
Operating profit (loss) based on longer-term investment returns	913	964	736	(80)	2,533
Non-operating profit (loss)	76	(109)	122	188	277
Profit before tax attributable to shareholders	989	855	858	108	2,810
Expected tax rate:*	23%	35%	25%	25%	27%
Tax at the expected tax rate	227	300	210	26	763
Effects of:					
Adjustment to tax charge in relation to prior years	(11)	10	(26)	(10)	(37)
Movements in provisions for open tax matters	–	(3)	–	32	29
Income not taxable or taxable at concessionary rates	(87)	–	–	(2)	(89)
Deductions not allowable for tax purposes	30	–	–	3	33
Different local basis of tax on overseas profits	–	(68)	–	–	(68)
Impact of changes in local statutory tax rates	–	–	(39)	9	(30)
Deferred tax adjustments	(6)	–	8	(1)	1
Irrecoverable withholding taxes	–	–	–	14	14
Other	5	(5)	8	(11)	(3)
Total actual tax charge	158	234	161	60	613
Analysed into:					
Tax on operating profit based on longer-term investment returns	142	272	126	42	582
Tax on non-operating profit	16	(38)	35	18	31
Actual tax rate:					
Operating profit based on longer-term investment returns	16%	28%	17%	(53)%	23%
Total profit	16%	27%	19%	56%	22%

* The expected tax rates shown in the table above (rounded to the nearest whole percentage) reflect the corporation tax rates generally applied to taxable profits of the relevant country jurisdictions. For Asia 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 non-insurance operations, which are taxed at a variety of rates. The rates will fluctuate from year to year dependent on the mix of profits.

	2011† £m (except for tax rates)				
	Asia insurance operations	US insurance operations	UK insurance operations	Other operations	Total
Operating profit (loss) based on longer-term investment returns	704	651	723	(51)	2,027
Non-operating profit	(92)	(167)	177	(117)	(199)
Profit (loss) before tax attributable to shareholders	612	484	900	(168)	1,828
Expected tax rate:*	25%	35%	27%	27%	28%
Tax at the expected tax rate	151	170	243	(45)	519
Effects of:					
Adjustment to tax charge in relation to prior years	(7)	–	33	(19)	7
Movements in provisions for open tax matters	–	–	–	(44)	(44)
Income not taxable or taxable at concessionary rates	(36)	–	(1)	–	(37)
Deductions not allowable for tax purposes	12	–	–	4	16
Different local basis of tax on overseas profits	–	(37)	–	–	(37)
Impact of changes in local statutory tax rates	–	–	(32)	1	(31)
Deferred tax adjustments	7	–	–	–	7
Irrecoverable withholding taxes	–	–	–	13	13
Other	(3)	(6)	(14)	19	(4)
Total actual tax charge (credit)	124	127	229	(71)	409
Analysed into:					
Tax on operating profit based on longer-term investment returns	122	185	190	(64)	433
Tax on non-operating profit	2	(58)	39	(7)	(24)
Actual tax rate:					
Operating profit based on longer-term investment returns	17%	28%	26%	125%	21%
Total profit	20%	26%	25%	42%	22%

* The expected tax rates shown in the table above (rounded to the nearest whole percentage) reflect the corporation tax rates generally applied to taxable profits of the relevant country jurisdictions. For Asia 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 non-insurance operations, which are taxed at a variety of rates. The rates will fluctuate from year to year dependent on the mix of profits.

† The 2011 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

c Taxes paid

In 2012 Prudential remitted £2.2 billion (2011: £1.6 billion) of tax to Revenue authorities, this includes £925 million (2011: £561 million) of corporation tax, £184 million of other taxes and £1,078 million collected on behalf of employees, customers and third parties.

The geographical split of taxes remitted by Prudential is as follows:

	2012 £m				2011 £m			
	Corporation taxes*	Other taxes†	Taxes collected‡	Total	Corporation taxes*	Other taxes†	Taxes collected‡	Total
Asia	221	37	152	410	170	32	64	266
US	181	25	264	470	131	20	221	372
UK	522	121	662	1,305	260	112	595	967
Other	1	1	–	2	–	1	–	1
Total tax paid	925	184	1,078	2,187	561	165	880	1,606

* In certain countries such as the UK, the corporation tax payments for the Group's life insurance businesses are based on taxable profits which include policyholder investment returns on certain life insurance products.

† Other taxes paid includes property taxes, withholding taxes, customs duties, stamp duties, employer payroll taxes and irrecoverable indirect taxes.

‡ Taxes collected are other taxes that Prudential remits to tax authorities which it is obliged to collect from employees, customers and third parties which includes sales/VAT/GST taxes, employee and annuitant payroll taxes.

G: Financial assets and liabilities

G1: Financial instruments – Designation and fair values

The Group designates all financial assets as at fair value, either through profit and loss or on an available-for-sale, or as loans and receivables on an amortised cost basis, net of impairment basis. 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 A3.

	2012 £m				
	Fair value through profit and loss	Available-for-sale	Loans and receivables at amortised cost	Total carrying value	Fair value
Financial assets					
Cash and cash equivalents	–	–	6,384	6,384	6,384
Deposits	–	–	12,653	12,653	12,653
Equity securities and portfolio holdings in unit trusts	99,958	–	–	99,958	99,958
Debt securities note (i)	107,278	32,825	–	140,103	140,103
Loans note (ii)	2,068	–	9,753	11,821	12,333
Other investments note (iii)	7,900	–	–	7,900	7,900
Accrued investment income	–	–	2,798	2,798	2,798
Other debtors	–	–	1,361	1,361	1,361
	217,204	32,825	32,949	282,978	

	2012 £m				
	Fair value through profit and loss note (v)	Amortised cost	IFRS 4 basis value	Total carrying value	Fair value
Financial liabilities					
Core structural borrowings of shareholder-financed operations notes (i), H13	–	3,554	–	3,554	4,133
Operational borrowings attributable to shareholder-financed operations H13	–	2,245	–	2,245	2,245
Borrowings attributable to with-profits funds H13	40	993	–	1,033	1,042
Obligations under funding, securities lending and sale and repurchase agreements	–	2,436	–	2,436	2,455
Net asset value attributable to unit holders of consolidated unit trust and similar funds	4,345	–	–	4,345	4,345
Investment contracts with discretionary participation features note (iv)	–	–	33,812	33,812	–
Investment contracts without discretionary participation features	16,309	2,069	–	18,378	18,419
Other creditors	259	2,522	–	2,781	2,781
Derivative liabilities	2,829	–	–	2,829	2,829
Other liabilities	2,021	1,433	–	3,454	3,453
	25,803	15,252	33,812	74,867	

	2011 £m				
	Fair value through profit and loss	Available-for-sale	Loans and receivables at amortised cost	Total carrying value	Fair value
Financial assets					
Cash and cash equivalents	–	–	7,257	7,257	7,257
Deposits	–	–	10,708	10,708	10,708
Equity securities and portfolio holdings in unit trusts	87,349	–	–	87,349	87,349
Debt securities note (i)	97,482	27,016	–	124,498	124,498
Loans note (ii)	279	–	9,435	9,714	9,828
Other investments note (iii)	7,509	–	–	7,509	7,509
Accrued investment income	–	–	2,710	2,710	2,710
Other debtors	–	–	987	987	987
	192,619	27,016	31,097	250,732	

	2011 £m				
	Fair value through profit and loss note (v)	Amortised cost	IFRS 4 basis value	Total carrying value	Fair value
Financial liabilities					
Core structural borrowings of shareholder-financed operations notes (i), H13	–	3,611	–	3,611	3,815
Operational borrowings attributable to shareholder-financed operations H13	–	3,340	–	3,340	3,340
Borrowings attributable to with-profits funds H13	39	933	–	972	978
Obligations under funding, securities lending and sale and repurchase agreements	–	3,114	–	3,114	3,144
Net asset value attributable to unit holders of consolidated unit trust and similar funds	3,840	–	–	3,840	3,840
Investment contracts with discretionary participation features note (iv)	–	–	29,745	29,745	–
Investment contracts without discretionary participation features	15,056	1,911	–	16,967	17,008
Other creditors	281	2,263	–	2,544	2,544
Derivative liabilities	3,054	–	–	3,054	3,054
Other liabilities	–	1,249	–	1,249	1,249
	22,270	16,421	29,745	68,436	

Notes

(i) As at 31 December 2012 £525 million (2011: £523 million) of convertible bonds were included in debt securities and £673 million (2011: £702 million) were included in borrowings.

(ii) Loans and receivables are reported net of allowance for loan losses of £83 million (2011: £89 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, the impact on profit from movements in credit risk during 2012 and 2011 was negligible.

G: Financial assets and liabilities continued

G1: Financial instruments – Designation and fair values continued

Determination of fair value

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 eg 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

The table below includes financial instruments carried at fair value analysed by level of the IFRS 7 'Financial Instruments: Disclosures' defined fair value hierarchy. This hierarchy is based on the inputs to the fair value measurement and reflects the lowest level input that is significant to that measurement.

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

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

Level 1 includes financial instruments where there is clear evidence that the valuation is based on a quoted publicly traded price in an active market (eg exchange listed equities, mutual funds with quoted prices and exchange traded derivatives).

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

Level 2 includes investments where a direct link to an actively traded price is not readily apparent, but which are valued using inputs which are largely observable either directly (ie as prices) or indirectly (ie derived from prices). A significant proportion of the Group's Level 2 assets are corporate bonds, structured securities and other non-national government debt securities. These assets, in line with market practice, are generally valued using independent pricing services or third-party broker quotes. 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 and 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.

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 (eg 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.

Of the total Level 2 debt securities of £105,839 million at 31 December 2012 (31 December 2011: £94,378 million), £8,248 million are valued internally (31 December 2011: £6,847 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 in 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 includes investments which are internally valued or subject to a significant number of unobservable assumptions (eg private equity funds and certain derivatives which are bespoke or long-dated).

At 31 December 2012, the Group held £6,660 million (2011: £4,565 million), 3 per cent of the fair valued financial investments, net of derivative liabilities (2011: 2 per cent), within Level 3.

Of these amounts, £3,916 million (2011: £3,732 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. At 31 December 2012, the £3,916 million (2011: £3,732 million) represented 4.3 per cent (2011: 4.3 per cent) of the total fair valued financial instruments, net of derivative liabilities of the participating funds.

Included within the £2,703 million Level 3 fair valued financial investments, net of derivative liabilities at 31 December 2012 (2011: £800 million) held to support non-linked shareholder-backed business were loans of £1,842 million, attaching to the purchase of REALIC in 2012 held to back the liabilities for funds withheld under reinsurance arrangement. The funds withheld liability, which was also accounted for on a fair value basis and classified as Level 3, amounted to £2,021 million at 31 December 2012. This liability is included within Other financial liabilities held at fair value in the table below.

Excluding the financial investments of £1,842 million held to back the funds withheld liability under REALIC's reinsurance arrangement, the Level 3 fair valued financial investments, net of derivative liabilities, supporting non-linked shareholder-backed business at 31 December 2012 were £861 million (2011: £800 million) (representing 1.2 per cent of the total fair valued financial investments net of derivative liabilities backing this business (2011: 1.3 per cent)). Of this amount, £837 million of net assets are externally valued and £24 million of net liabilities are internally valued (2011: net assets of £757 million and £43 million respectively). Internal valuations, which represent 0.03 per cent of the total fair valued financial investments net of derivative liabilities supporting non-linked shareholder-backed business at 31 December 2012 (2011: 0.1 per cent), are inherently more subjective than external valuations.

If the value of all Level 3 investments backing non-linked shareholder-backed business valued internally was varied downwards by 10 per cent, the change in valuation would be £2 million (2011: £4 million), which would reduce shareholders' equity by this amount before tax. Of this amount, a £1 million increase (2011: £1 million decrease) would pass through the income statement substantially as part of short-term fluctuations in investment returns outside of operating profit and a £3 million decrease (2011: £3 million decrease) would be included as part of other comprehensive income, being unrealised movements on assets classified as available-for-sale.

G: Financial assets and liabilities continued

G1: Financial instruments – Designation and fair values continued

	31 December 2012 £m			
	Level 1	Level 2	Level 3	Total
Analysis of financial investments, net of derivative liabilities by business type				
With-profits				
Equity securities and portfolio holdings in unit trusts	22,129	2,496	480	25,105
Debt securities	15,910	45,550	542	62,002
Other investments (including derivative assets)	108	1,743	2,894	4,745
Derivative liabilities	(61)	(1,072)	–	(1,133)
Total financial investments, net of derivative liabilities	38,086	48,717	3,916	90,719
Percentage of total	42%	54%	4%	100%
Unit-linked and variable annuity separate account				
Equity securities and portfolio holdings in unit trusts	73,632	189	39	73,860
Debt securities	3,843	5,659	2	9,504
Other investments (including derivative assets)	47	10	–	57
Derivative liabilities	–	(1)	–	(1)
Total financial investments, net of derivative liabilities	77,522	5,857	41	83,420
Percentage of total	93%	7%	0%	100%
Non-linked shareholder-backed				
Loans	–	226	1,842*	2,068
Equity securities and portfolio holdings in unit trusts	937	7	49	993
Debt securities	13,721	54,630	246	68,597
Other investments (including derivative assets)	31	2,306	761	3,098
Derivative liabilities	(16)	(1,484)	(195)	(1,695)
Total financial investments, net of derivative liabilities	14,673	55,685	2,703	73,061
Percentage of total	20%	76%	4%	100%
Group total analysis, including other financial liabilities held at fair value				
Group total				
Loans	–	226	1,842*	2,068
Equity securities and portfolio holdings in unit trusts	96,698	2,692	568	99,958
Debt securities	33,474	105,839	790	140,103
Other investments (including derivative assets)	186	4,059	3,655	7,900
Derivative liabilities	(77)	(2,557)	(195)	(2,829)
Total financial investments, net of derivative liabilities	130,281	110,259	6,660	247,200
Borrowings attributable to the with-profits fund held at fair value	–	(40)	–	(40)
Investment contracts liabilities without discretionary participation features held at fair value	–	(16,309)	–	(16,309)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(3,309)	(430)	(606)	(4,345)
Other financial liabilities held at fair value	–	(259)	(2,021)*	(2,280)
Total financial instruments at fair value	126,972	93,221	4,033	224,226
Percentage of total	57%	41%	2%	100%

* The Level 3 loans and other financial liabilities held by the non-linked shareholder-backed business include amounts of £1,842 million and £(2,021) million, respectively relating to the reinsurance arrangements attaching to the purchase of REALIC as described in note I1.

	31 December 2011 £m			
	Level 1	Level 2	Level 3	Total
Analysis of financial investments, net of derivative liabilities by business type				
With-profits				
Equity securities and portfolio holdings in unit trusts	24,001	1,762	284	26,047
Debt securities	13,298	43,279	655	57,232
Other investments (including derivative assets)	252	1,378	2,793	4,423
Derivative liabilities	(214)	(1,127)	–	(1,341)
Total financial investments, net of derivative liabilities	37,337	45,292	3,732	86,361
Percentage of total	43%	53%	4%	100%
Unit-linked and variable annuity separate account				
Equity securities and portfolio holdings in unit trusts	59,662	198	30	59,890
Debt securities	4,160	4,698	3	8,861
Other investments (including derivative assets)	18	95	–	113
Derivative liabilities	(2)	(7)	–	(9)
Total financial investments, net of derivative liabilities	63,838	4,984	33	68,855
Percentage of total	93%	7%	0%	100%
Non-linked shareholder-backed				
Loans	–	279	–	279
Equity securities and portfolio holdings in unit trusts	1,175	176	61	1,412
Debt securities	11,753	46,401	251	58,405
Other investments (including derivative assets)	30	2,237	706	2,973
Derivative liabilities	(78)	(1,408)	(218)	(1,704)
Total financial investments, net of derivative liabilities	12,880	47,685	800	61,365
Percentage of total	21%	78%	1%	100%
Group total analysis, including other financial liabilities held at fair value				
Group total				
Loans	–	279	–	279
Equity securities and portfolio holdings in unit trusts	84,838	2,136	375	87,349
Debt securities	29,211	94,378	909	124,498
Other investments (including derivative assets)	300	3,710	3,499	7,509
Derivative liabilities	(294)	(2,542)	(218)	(3,054)
Total financial investments, net of derivative liabilities	114,055	97,961	4,565	216,581
Borrowings attributable to the with-profits fund held at fair value	–	(39)	–	(39)
Investment contracts liabilities without discretionary participation features held at fair value	–	(15,056)	–	(15,056)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(2,586)	(805)	(449)	(3,840)
Other financial liabilities held at fair value	–	(281)	–	(281)
Total financial instruments at fair value	111,469	81,780	4,116	197,365
Percentage of total	57%	41%	2%	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 2012 to that presented at 31 December 2012 and at 1 January 2011 to that presented at 31 December 2011.

Total investment return recorded in the income statement represents interest and dividend income, realised gains and losses, 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.

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.

G: Financial assets and liabilities continued

G1: Financial instruments – Designation and fair values continued

The transfers in and out of Level 3 during 2012 represent sundry individual financial investments, none of which are materially significant as highlighted in the table below:

	£m										
	At 1 Jan	Total gains/ losses in income statement	Total gains/ losses recorded in other comprehensive income	Acquisition of REALIC	Purchases	Sales	Settled	Issued	Transfers into level 3	Transfers out of level 3	At 31 Dec
2012											
Loans	–	(46)	(42)	1,858	–	–	(12)	84	–	–	1,842
Equity securities and portfolio holdings in unit trusts	375	49	44	–	255	(98)	–	–	6	(63)	568
Debt securities	909	65	(3)	–	260	(217)	(73)	–	18	(169)	790
Other investments (including derivative assets)	3,499	250	(61)	–	482	(515)	–	–	–	–	3,655
Derivative liabilities	(218)	13	–	–	–	–	–	–	–	10	(195)
Total financial investments, net of derivative liabilities	4,565	331	(62)	1,858	997	(830)	(85)	84	24	(222)	6,660
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(449)	(20)	(47)	–	2	1	–	(93)	–	–	(606)
Other financial investments	–	41	46	(2,075)	–	–	73	(106)	–	–	(2,021)
Total	4,116	352	(63)	(217)	999	(829)	(12)	(115)	24	(222)	4,033
2011											
Equity securities and portfolio holdings in unit trusts	576	50	(1)	–	62	(278)	–	–	–	(34)	375
Debt securities	1,117	46	5	–	274	(490)	(21)	–	51	(73)	909
Other investments (including derivative assets)	3,106	224	(50)	–	691	(417)	–	–	–	(55)	3,499
Derivative liabilities	(226)	(17)	–	–	–	–	–	–	–	25	(218)
Total financial investments, net of derivative liabilities	4,573	303	(46)	–	1,027	(1,185)	(21)	–	51	(137)	4,565
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	(379)	(78)	–	–	(10)	18	–	–	–	–	(449)
Total	4,194	225	(46)	–	1,017	(1,167)	(21)	–	51	(137)	4,116

Of the total gains and losses in the income statement of £357 million (2011: £225 million), £126 million (2011: £99 million) relates to financial instruments still held at the end of the year, which can be analysed as follows:

	2012 £m	**2011** £m
Equity securities	27	49
Debt securities	51	20
Other investments	48	176
Derivative liabilities	–	(68)
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	–	(78)
Total	126	99

Transfers between Level 1 and Level 2

During 2012, the transfers between levels within the Group's portfolio were primarily transfers from Level 1 to Level 2 of £600 million (2011: £335 million) and transfers from Level 2 to Level 1 of £227 million (2011: nil). These transfers which relate to equity securities and debt securities arose to reflect the change in the observability of the inputs used in valuing these securities.

Interest income and expense

The interest income on financial assets not at fair value through profit and loss for the year ended 31 December 2012 from continuing operations was £1,886 million (2011: £1,814 million).

The interest expense on financial liabilities not at fair value through profit and loss for the year ended 31 December 2012 from continuing operations was £420 million (2011: £456 million).

G2: Market risk

Interest rate risk

The following table shows an analysis of the classes of financial assets and liabilities except for cash and cash equivalents 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:

	2012 £m			
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
Financial assets				
Deposits	1,021	11,445	187	12,653
Debt securities	131,732	7,851	520	140,103
Loans	8,992	2,809	20	11,821
Other investments (including derivatives)	1,896	1,126	4,878	7,900
	143,641	23,231	5,605	172,477
Financial liabilities				
Core structural borrowings of shareholder-financed operations	3,279	275	–	3,554
Operational borrowings attributable to shareholder-financed operations	574	1,670	1	2,245
Borrowings attributable to with-profits funds	379	562	92	1,033
Obligations under funding, securities lending and sale and repurchase agreements	403	2,033	–	2,436
Investment contracts without discretionary participation features	1,179	894	16,305	18,378
Derivative liabilities	974	576	1,279	2,829
Other liabilities	165	116	3,173	3,454
	6,953	6,126	20,850	33,929

	2011 £m			
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
Financial assets				
Deposits	790	9,439	479	10,708
Debt securities	117,988	5,788	722	124,498
Loans	6,424	3,091	199	9,714
Other investments (including derivatives)	1,912	1,077	4,520	7,509
	127,114	19,395	5,920	152,429
Financial liabilities				
Core structural borrowings of shareholder-financed operations	3,362	249	–	3,611
Operational borrowings attributable to shareholder-financed operations	3,114	213	13	3,340
Borrowings attributable to with-profits funds	120	743	109	972
Obligations under funding, securities lending and sale and repurchase agreements	580	2,534	–	3,114
Investment contracts without discretionary participation features	1,011	903	15,053	16,967
Derivative liabilities	1,426	615	1,013	3,054
Other liabilities	158	142	949	1,249
	9,771	5,399	17,137	32,307

G: Financial assets and liabilities continued

G2: Market risk continued

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.

	2012 £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]	3,554	140	791	603	958	1,038	691	1,753	5,974
Operational borrowings attributable to shareholder-financed operations[H13]	2,245	1,708	558	–	–	–	–	–	2,266
Borrowings attributable to with-profits funds[H13]	1,033	115	542	199	71	12	73	194	1,206
Obligations under funding, securities lending and sale and repurchase agreements	2,436	2,436	–	–	–	–	–	–	2,436
Other liabilities	3,453	945	45	5	–	–	–	2,458	3,453
Net asset value attributable to unit holders of consolidated unit-trusts and similar funds	4,345	4,345	–	–	–	–	–	–	4,345
Other creditors	2,781	2,515	23	36	73	70	406	–	3,123
	19,847	12,204	1,959	843	1,102	1,120	1,170	4,405	22,803

	2011 £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]	3,611	245	624	606	840	1,243	737	1,834	6,129
Operational borrowings attributable to shareholder-financed operations[H13]	3,340	2,971	394	–	–	–	–	–	3,365
Borrowings attributable to with-profits funds[H13]	972	199	418	158	100	5	97	139	1,116
Obligations under funding, securities lending and sale and repurchase agreements	3,114	3,114	–	–	–	–	–	–	3,114
Other liabilities	1,249	842	106	5	–	–	–	296	1,249
Net asset value attributable to unit holders of consolidated unit-trusts and similar funds	3,840	3,840	–	–	–	–	–	–	3,840
Other creditors	2,544	2,268	20	27	36	45	148	–	2,544
	18,670	13,479	1,562	796	976	1,293	982	2,269	21,357

ii Maturity analysis of derivatives

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

	2012 £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	1,033	1,025	(22)	(14)	(50)	939

	2011 £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	601	731	(18)	(11)	(31)	671

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

	2012 £m	2011 £m
Derivative assets	3,862	3,655
Derivative liabilities	(2,829)	(3,054)
Net derivative position	1,033	601

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 (ie 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.

	2012 £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	Total carrying value
Life assurance investment contracts	4	16	15	11	8	10	64	52

	2011 £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	Total carrying value
Life assurance investment contracts	3	12	13	11	9	10	58	47

G: Financial assets and liabilities continued

G2: Market risk continued

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 £12 billion (2011: £11 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.

Market and other financial risks

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 D2a(iv), D3a(ii)(ii) and D4a(iii), 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, £25 million (2011: £39 million) are past their due date but have not been impaired. Of the total past due but not impaired, £18 million is less than one year past their due date (2011: £3 million). The Group expects full recovery of these loans and receivables.

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 £86 million (2011: £90 million).

In addition, during the year the Group took possession of £16 million (2011: £13 million) of other collateral held as security, which mainly consists of assets that could be readily convertible into cash.

Further details of collateral and pledges are provided in note G4.

Currency risk

As at 31 December 2012, the Group held 19 per cent (2011: 21 per cent) and 7 per cent (2011: 9 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.

Financial assets, of which 56 per cent (2011: 55 per cent) are held by the PAC with-profits fund, allow the PAC with-profits fund to obtain exposure to foreign equity markets.

Financial liabilities, of which 28 per cent (2011: 28 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).

The amount of exchange loss recognised in the income statement in 2012, except for those arising on financial instruments measured at fair value through profit and loss, is £213 million (2011: £1 million gain). This constitutes £1 million loss (2011: £11 million loss) on Medium Term Notes (MTN) liabilities and £212 million of net loss (2011: £12 million net gain), 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, with the exception of some Asia 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 2012 were as follows:

	2012 £m					
	UK insurance operations	US insurance operations	Asia insurance operations	Asset management	Unallocated to a segment	Group total
Derivative assets	1,349	1,546	927	38	2	3,862
Derivative liabilities	(1,007)	(645)	(837)	(150)	(190)	(2,829)
	342	901	90	(112)	(188)	1,033

	2011 £m					
	UK insurance operations	US insurance operations	Asia insurance operations	Asset management	Unallocated to a segment	Group total
Derivative assets	1,461	1,677	444	71	2	3,655
Derivative liabilities	(1,298)	(887)	(480)	(182)	(207)	(3,054)
	163	790	(36)	(111)	(205)	601

The above derivative assets are included in 'other investments' in the primary statements.

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 with-profits funds use derivatives for the purposes of efficient portfolio management or reduction in investment risks. For UK annuity business derivatives are used to assist with asset and liability cash flow matching.

Some of the Group's products, especially those sold in the US, have certain guarantee features linked to equity indexes. A mismatch between guaranteed 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 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 2012, was an asset of less than £1 million (2011: asset of £3 million). Movements in the fair value of the hedging instruments of a net loss of £3 million (2011: net loss of £2 million) and the hedged items of a net gain of £3 million (2011: net gain of £2 million) are recorded in the income statement in respect of the fair value hedges above.

Net investment hedges

The Group has designated perpetual subordinated capital securities totalling US$2.85 billion (2011: US$2.85 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 £1,746 million as at 31 December 2012 (2011: £1,823 million). The foreign exchange loss of £81 million (2011: loss of £18 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.

Cash flow hedges

The Group has no cash flow hedges in place.

G: Financial assets and liabilities continued

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 2012, the Group had lent £3,015 million (2011: £7,843 million) of securities of which £2,047 million (2011: £5,820 million) was lent by the PAC with-profits fund and held collateral under such agreements of £3,137 million (2011: £8,160 million) of which £2,138 million (2011: £6,108 million) was held by the PAC with-profits fund.

At 31 December 2012, 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 £943 million (2011: £1,607 million), together with accrued interest.

Collateral and pledges under derivative transactions

At 31 December 2012, the Group had pledged £754 million (2011: £840 million) for liabilities and held collateral of £1,964 million (2011: £1,953 million) in respect of over-the-counter derivative transactions.

These transactions are conducted under terms that are usual and customary to collateralised transactions including, where relevant, standard securities lending and repurchase agreement.

G5: Impairment of financial assets

In accordance with the Group's accounting policy set out in note A3, 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 2012, impairment losses of £50 million (2011: £126 million) were recognised for available-for-sale securities and loans and receivables analysed as shown in the attached table.

	2012 £m	2011 £m
Available-for-sale securities held by Jackson	37	62
Loans and receivables*	13	64
	50	126

* 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 £37 million (2011: £62 million). Of this amount, 22 per cent (2011: 34 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 74 per cent (2011: 75 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 2012, the Group realised gross losses on sales of available-for-sale securities of £44 million (2011: £43 million) with 64 per cent (2011: 64 per cent) of these losses related to the disposal of fixed maturity securities of 10 (2011: 10) individual issuers, which were disposed of as part of risk reduction programmes intended to limit future credit loss exposure. Of the £44 million (2011: £43 million), £23 million (2011: £32 million) relates to losses on sales of impaired and deteriorating securities.

The effect of those reasonably likely changes in the key assumptions that underpin the assessment of whether impairment has taken place depends on the factors described in note A4. 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 2012, the amount of gross unrealised losses for fixed maturity securities classified as available-for-sale under IFRS in an unrealised loss position was £178 million (2011: £246 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

	2012 £m	2011 £m
Cost		
At beginning of year	1,585	1,586
Additional consideration paid on previously acquired business	2	–
Exchange differences	2	(1)
At end of year	1,589	1,585
Aggregate impairment	(120)	(120)
Net book amount at end of year	1,469	1,465
Goodwill attributable to shareholders comprises:		
M&G	1,153	1,153
Other	316	312
	1,469	1,465

'Other' represents goodwill amounts across cash generating units (CGUs) in Asia and US operations. Other goodwill amounts are not individually material.

Impairment testing
Goodwill does not generate cash flows independently of other groups of assets and thus is assigned to 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.

Assessment of whether goodwill may be impaired
Goodwill is tested for impairment by comparing the CGUs' 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.

H: Other information on statement of financial position items continued

H1: Intangible assets attributable to shareholders continued

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, eg 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 (2011: 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 (2011: 12 per cent) has been applied to post-tax cash flows. The pre-tax risk discount rate was 15 per cent (2011: 15 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 5 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; and

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 2012 and 2011 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 (DAC) and other intangible assets in the Group consolidated statement of financial position attributable to shareholders comprise:

	2012 £m	2011* £m	2010* £m
Deferred acquisition costs related to insurance contracts as classified under IFRS 4	3,866	3,805	3,550
Deferred acquisition costs related to investment management contracts, including life assurance contracts classified as financial instruments and investment management contracts under IFRS 4	100	107	110
	3,966	3,912	3,660
Present value of acquired in-force policies for insurance contracts as classified under IFRS 4 (PVIF)	64	64	70
Other intangibles	237	258	171
	301	322	241
Total of deferred acquisition costs and other intangible assets	4,267	4,234	3,901

* The 2011 and 2010 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

	2012 £m						2011 £m	2010 £m
	Deferred acquisition costs				PVIF and other intan-gibles	Total	Total	Total
	UK	US note (i)	Asia	Asset manage-ment				
Balance at 1 January								
As previously reported	111	3,880	744	12	322	5,069	4,667	4,097
Effect of change in accounting policy[A5]	–	(785)	(50)	–	–	(835)	(766)	(651)
After effect of change	111	3,095	694	12	322	4,234	3,901	3,446
Additions	12	798	249	3	31	1,093	1,117	968
Acquisition of REALIC in 2012 and UOB Life Assurance Ltd in 2010	–	–	–	–	5	5	–	12
Amortisation to the income statement:								
Operating profit	(20)	(356)	(277)	(5)	(51)	(709)	(792)	(515)
Amortisation related to short-term fluctuations in investment returns	–	76	–	–	–	76	287	283
	(20)	(280)	(277)	(5)	(51)	(633)	(505)	(232)
Exchange differences	–	(144)	(12)	–	(6)	(162)	(2)	129
Change in shadow DAC related to movement in unrealised appreciation of Jackson's securities classified as available-for-sale†	–	(270)	–	–	–	(270)	(275)	(410)
Disposals	–	–	–	–	–	–	(2)	(5)
Dilution of Group's holdings	–	–	–	–	–	–	–	(7)
Balance at 31 December	103	3,199	654	10	301	4,267	4,234	3,901

* The 2011 and 2010 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.
† (See note D3(g) for explanation).

US operations DAC
Summary balances
The DAC amount in respect of US insurance operations comprises amounts in respect of:

	2012 £m	2011* £m	2010* £m
Variable annuity business	3,330	2,960	2,283
Other business	821	855	980
Cumulative shadow DAC (for unrealised gains/losses booked in other comprehensive income)	(952)	(720)	(434)
Total DAC for US operations	3,199	3,095	2,829

* The 2011 and 2010 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

H: Other information on statement of financial position items continued

H1: Intangible assets attributable to shareholders continued

Deferred acquisition costs related to insurance and investment contracts attributable to shareholders

The movement in deferred acquisition costs relating to insurance and investments contracts attributable to shareholders are as follows:

	2012 £m		2011* £m		2010* £m	
	Insurance contracts	Investment management note	Insurance contracts	Investment management note	Insurance contracts	Investment management note
DAC at 1 January	3,805	105	3,550	110	3,172	107
Additions	1,048	12	982	17	710	21
Amortisation	(563)	(17)	(450)	(20)	(19)	(18)
Exchange differences	(154)	–	–	–	104	–
Change in shadow DAC related to movement in unrealised appreciation of Jackson's securities classified as available-for-sale	(270)	–	(275)	–	(410)	–
Dilution of holding in PruHealth	–	–	–	–	(7)	–
DAC at 31 December	3,866	100	3,807	107	3,550	110

* The 2011 and 2010 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

Note

All of the additions are through internal development. The carrying amount of the balance comprises the following gross and accumulated amortisation amounts:

	31 December		
	2012 £m	2011 £m	2010 £m
Gross amount	210	200	183
Accumulated amortisation	(110)	(93)	(73)
Net book amount	100	107	110

Present value of acquired in-force (PVIF) and other intangibles attributable to shareholders

	2012 £m				2011 £m			
		Other intangibles note (ii)				Other intangibles note (ii)		
	PVIF note (i)	Distribution rights	Software	Total	PVIF note (i)	Distribution rights	Software	Total
At 1 January								
Cost	212	235	163	610	203	136	144	483
Accumulated amortisation	(148)	(36)	(104)	(288)	(133)	(23)	(86)	(242)
	64	199	59	322	70	113	58	241
Additions (including amounts arising on acquisition of subsidiaries)	5	–	31	36	–	96	24	120
Amortisation charge	(5)	(17)	(29)	(51)	(5)	(9)	(21)	(35)
Disposals	–	–	–	–	–	–	(2)	(2)
Exchange differences	–	(5)	(1)	(6)	(1)	(1)	–	(2)
At 31 December	64	177	60	301	64	199	59	322
Comprising:								
Cost	217	230	193	640	200	235	163	598
Accumulated amortisation	(153)	(53)	(133)	(339)	(136)	(36)	(104)	(276)
	64	177	60	301	64	199	59	322

Notes

(i) All of the PVIF balances relate to insurance contracts and is accounted for under UK GAAP as permitted by IFRS 4. Investment contracts have been fully amortised. 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.

(ii) Other intangibles comprise distribution and software rights. 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. Software is amortised over its useful economic life, which generally represents the licence period of the software acquired. Amortisation is charged to the 'acquisition costs and other expenditure' line in the income statement.

H2: Intangible assets attributable to with-profits funds

a Goodwill in respect of acquired investment subsidiaries for venture fund and other investment purposes

	2012 £m	2011 £m
At 1 January	178	166
Additions in the year	–	12
At 31 December	178	178

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 of 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 2016 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 per cent to 14 per cent derived by reference to risk-free rates and an equity premium risk. In 2012, no goodwill was deemed to be impaired following the impairment testing carried out.

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:

	2012 £m	2011 £m
Deferred acquisition costs related to insurance contracts attributable to the PAC with-profits fund	6	6
Distribution rights attributable to with-profits funds of the Asia insurance operations	70	83
Computer software attributable to with-profits funds of the Asia insurance operations	2	–
	78	89

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:

	2012 £m	2011 £m
At 1 January	6	13
Amortisation charge	–	(7)
At 31 December	6	6

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.

H: Other information on statement of financial position items continued

H2: Intangible assets attributable to with-profits funds continued

Distribution rights attributable to with-profit funds of the Asia 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.

	2012 £m	2011 £m
At 1 January		
Gross amount	96	108
Accumulated amortisation	(13)	(11)
	83	97
Amortisation charge	(9)	(5)
Exchange differences	(4)	1
Reclassification	–	(10)
At 31 December	70	83
Comprising:		
Gross amount	92	96
Accumulated amortisation	(22)	(13)
	70	83

H3: Reinsurers' share of insurance contract liabilities

	2012 £m	2011 £m
Insurance contract liabilities	6,079	1,486
Claims outstanding	780	161
	6,859	1,647
Comprising amounts in respect of:		
UK insurance operations[D2(f)]	608	589
US insurance operations[D3(f)]	6,076	907
Asia insurance operations[D4(f)]	175	151
	6,859	1,647

The movement on reinsurers' share of insurance contract liabilities is as follows:

	2012 £m	2011 £m
At 1 January	1,486	1,167
Acquisition of REALIC	4,810	–
Other movements in the year	(55)	303
Foreign exchange translation differences	(162)	16
At 31 December	6,079	1,486

H4: Tax assets and liabilities

Assets

Of the £254 million (2011: £546 million) current tax recoverable, the majority is expected to be recovered in one year or less.

Deferred tax asset

	2012 £m	2011 £m
Unrealised losses on investments	102	297
Balances relating to investment and insurance contracts	1	13
Short-term timing differences	2,097	1,513
Capital allowances	15	15
Unused deferred tax losses	99	438
Total	2,314	2,276

The deferred tax asset at 31 December 2012 and 2011 arises in the following parts of the Group:

	2012 £m	2011 £m
UK insurance operations:		
SAIF	1	1
PAC with-profits fund (including PAL)	113	78
Other	69	153
US insurance operations	1,889	1,392
Asia insurance operations	83	114
Other operations	159	538
Total	2,314	2,276

The increase in the deferred tax asset primarily relates to additional short-term timing differences on US insurance reserves following the REALIC acquisition partially offset by the utilisation of tax losses across the Group.

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 often 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 2012 results and financial position at 31 December 2012 the possible tax benefit of approximately £158 million (31 December 2011: £158 million), which may arise from capital losses valued at approximately £0.8 billion (31 December 2011: £0.7 billion), is sufficiently uncertain that it has not been recognised. In addition, a potential deferred tax asset of £122 million (31 December 2011: £147 million), which may arise from trading tax losses and other potential temporary differences totalling £0.5 billion (31 December 2011: £0.6 billion) is sufficiently uncertain that it has not been recognised. Of these, losses of £105 million will expire within the next seven years. The remaining losses have no expiry date. Until the end of 2012, for the Group's UK life insurance companies, shareholders' profits were calculated using regulatory surplus as a starting point, with appropriate deferred tax adjustments for IFRS. Beginning in 2013, under new UK life tax rules, shareholders' profits will be calculated using accounting profit or loss as a starting point. As the 2012 Finance Act had been enacted at the balance sheet date, the effects of these changes are reflected in the financial statements for the year ended 31 December 2012 but with no material impact on the Group's net assets.

H: Other information on statement of financial position items continued

H4: Tax assets and liabilities continued

The two tables that follow provide a breakdown of the recognised deferred tax assets set out above for both the short-term timing differences and unused tax losses split by business unit. The table also shows the period of estimated recoverability for each respective business unit. For these and each category of deferred tax asset recognised their recoverability against forecast taxable profits is not significantly impacted by any current proposed changes to future accounting standards.

Short-term timing differences	2012 £m	Expected period of recoverability
Asia	42	1 to 3 years
JNL	1,800	With run-off of in-force book
UK long-term business	151	1 to 10 years
Other	104	1 to 10 years
Total	2,097	

Unused tax losses	2012 £m	Expected period of recoverability
Asia	36	3 to 5 years
UK long-term business	18	1 to 3 years
Other	45	1 to 3 years
Total	99	

Liabilities

The current tax liability decreased to £445 million (2011: £930 million) reflecting the settlement of prior year balances in the UK and Asia following the agreement of tax positions.

Deferred tax liability

	2012 £m	2011* £m	2010* £m
Unrealised gains on investments	1,814	1,566	1,678
Balances relating to investment and insurance contracts	432	667	801
Short-term timing differences	1,715	1,687	1,477
Capital allowances	9	9	12
Total	3,970	3,929	3,968

* The 2011 and 2010 comparative results have been adjusted from those previously published for the retrospective application of the change in accounting policy described in note A5.

Under IAS 12, 'Income Taxes', 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 the tax rates (and laws) that have been enacted or are substantively enacted at the end of the reporting periods.

The UK government's tax rate change to 23 per cent (from the 24 per cent effective from 1 April 2012) has had the effect of reducing the UK with-profits and shareholder-backed business element of the net deferred tax balances as at 31 December 2012 by £52 million. The tax change to 23 per cent is effective from 1 April 2013 but has been enacted at 31 December 2012.

The subsequent proposed phased rate changes to 21 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 2012 by £52 million.

H5: Accrued investment income and other debtors

	2012 £m	2011 £m
Accrued investment income		
Interest receivable	2,015	1,919
Other	783	791
Total	2,798	2,710
Other debtors		
Amounts due from:		
Policyholders	271	227
Intermediaries	27	27
Reinsurers	23	11
Other	1,040	722
Total	1,361	987
Total accrued investment income and other debtors	4,159	3,697

Of the £4,159 million (2011: £3,697 million) of accrued investment income and other debtors, £538 million (2011: £162 million) is expected to be settled after one year or more.

H6: Property, plant and equipment

Property, plant and equipment comprise Group occupied properties 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:

	2012 £m			2011 £m		
	Group occupied property	Tangible assets	Total	Group occupied property	Tangible assets	Total
At 1 January						
Cost	262	915	1,177	197	764	961
Accumulated depreciation	(29)	(400)	(429)	(24)	(383)	(407)
Net book amount	233	515	748	173	381	554
Year ended 31 December						
Opening net book amount	233	515	748	173	381	554
Exchange differences	(9)	(8)	(17)	(2)	(7)	(9)
Depreciation charge	(10)	(80)	(90)	(5)	(69)	(74)
Additions	4	135	139	5	119	124
Arising on acquisitions of subsidiaries	–	(1)	(1)	69	99	168
Disposals and transfers	(2)	(12)	(14)	(7)	(8)	(15)
Closing net book amount	216	549	765	233	515	748
At 31 December						
Cost	255	999	1,254	262	915	1,177
Accumulated depreciation	(39)	(450)	(489)	(29)	(400)	(429)
Net book amount	216	549	765	233	515	748

Capital expenditure: property, plant and equipment by segment

The capital expenditure of £135 million (2011: £124 million) arose as follows: £80 million in UK, £24 million in US and £20 million in Asia in insurance operations with the remaining balance of £11 million arising from asset management operations and unallocated corporate expenditure (2011: £69 million in UK, £20 million in US, £21 million in Asia insurance operations and £14 million in other).

H: Other information on statement of financial position items continued

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:

	2012 £m	2011 £m
At 1 January	10,757	11,247
Additions:		
Resulting from acquisitions	1,025	393
Resulting from expenditure capitalised	118	45
Disposals	(695)	(1,439)
Net (loss) gain from fair value adjustments	(175)	522
Net foreign exchange differences	(53)	(41)
Transfers (to)/from held for sale assets	(97)	25
Transfers from owner occupied properties	–	5
At 31 December	10,880	10,757

The income statement includes the following items in respect of investment properties:

	2012 £m	2011 £m
Rental income from investment properties	559	606
Direct operating expenses (including repairs and maintenance expenses) arising from investment properties that generated rental income during the year	64	128

Further information on the investment property held by the UK insurance operations further information is included in note D2(a).

Investment properties of £3,845 million (2011: £3,439 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:

	2012 £m	2011 £m
Future minimum lease payments at 31 December	988	1,071
Future finance charges on finance leases	(877)	(944)
Present value of minimum lease payments	111	127
Future minimum lease payments are due as follows:		
Less than 1 year	6	7
1 to 5 years	23	26
Over 5 years	959	1,038
Total	988	1,071
The present values of these minimum lease payments are:		
Less than 1 year	6	6
1 to 5 years	19	23
Over 5 years	86	98
Total	111	127

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 2012 and 2011.

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 of the Group's freehold investment properties are receivable in the following periods:

	2012 £m	2011 £m
Less than 1 year	451	430
1 to 5 years	1,541	1,407
Over 5 years	3,785	3,304
Total	5,777	5,141

The total minimum future rentals to be received on non-cancellable sub-leases for the Group's investment properties held under finance leases at 31 December 2012 are £2,439 million (2011: £2,553 million).

H8: Investments in associates and joint ventures

Investments in associates

The Group had two associates at 31 December 2012 (31 December 2011: one) that were accounted for under the equity method. The Group's associates at 31 December 2012 are a 25 per cent interest in PruHealth Holdings Limited and a 49.99 per cent interest in PPM South Africa, following the dilution of the Group's holding in the period (see note I2). The Group's share of the profit during the year was a profit of £8 million (full year 2011: a loss of £3 million). The total carrying value of these associates are £113 million (2011: £70 million). This is reflected in the Group's profit after tax attributable to equity holders during the year.

Associates accounted for using the equity method

A summary of the movements in investments in associates accounted for using the equity method in 2012 and 2011 is set out below:

	Share of share capital and share premium £m	Share of retained earnings £m	Share of net assets £m	Goodwill £m	Total carrying value £m
Balance at 31 December 2010	101	(31)	70	1	71
Capital injection	4	–	4	–	4
Disposals	(1)	–	(1)	–	(1)
Goodwill write off	–	–	–	(1)	(1)
Share of loss for the year after tax	–	(3)	(3)	–	(3)
Balance at 31 December 2011	104	(34)	70	–	70
Transfer of PPMSA as an associate[12]	–	39	39	–	39
Exchange translation and other movements	–	(6)	(6)	–	(6)
Share of profit for the year after tax	–	10	10	–	10
Balance at 31 December 2012	104	9	113	–	113

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 2012 and 2011 is as follows:

	2012 £m	2011 £m
Financial position		
Total assets (excluding goodwill)	162	109
Total liabilities	(49)	(39)
Net assets	113	70
Results of operations		
Revenue	96	81
Profit (loss) in the year	10	(3)

There are several minor service agreements in place between the associates and the Group. During 2012, the aggregate amount of the transactions was £42 million (2011: £33 million) and the balance due to the Group as at 31 December 2012 was £73.2 million (2011: £74.2 million).

Associates and joint ventures carried at fair value through profit and loss

In addition to the above the Group has associates that are carried at fair value through profit and loss, as allowed under IAS 28, that comprise investments in open-ended investment companies (OEICs), unit trusts, funds holding collateralised debt obligations, property unit trusts and venture capital investments of the PAC with-profits funds 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 2012 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 £0.8 billion (2011: £4.8 billion) at 31 December 2012.

The aggregate assets of these associates are approximately £2.2 billion (2011: £3.4 billion). Aggregate liabilities, excluding liabilities to unit holders and shareholders for unit trusts and OEICs, are approximately £0.8 billion (2011: £1.1 billion). Fund revenues, with revenue arising in unit trusts and OEICs deemed to constitute the investment return for these vehicles, were approximately £0.1 billion (2011: £0.3 billion) and net profit in the year, excluding unit trusts and OEICs where all investment returns accrue to unit holders or shareholders respectively, was approximately £0.1 billion (2011: 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

The Group owns a number of 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 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
ICICI Prudential 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 (Hong Kong)
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 ICICI Prudential 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.

Joint ventures contributed £98 million (31 December 2011: £54 million) to profit after tax attributable to equity holders during the period. The year-on-year movement in these contributions reflect the growth in their operating profit based on longer-term investment returns and the increase in short-term fluctuations in investment returns by these joint ventures.

Further, in June 2012, the PAC with-profits fund, via its venture fund holdings and as part of its investment portfolio, entered into a joint venture to acquire control of Veolia Water RegCo (now renamed Affinity Water), the UK regulated water business of Veolia Environnement S.A. This joint venture investment is carried at fair value through profit and loss in the Group's financial statements, as allowed under IAS 28. The results of this operation are reflected in the movement in the unallocated surplus of the PAC with-profits fund and therefore do not affect shareholders' results.

The summarised financial data for the Group's share of investments in joint ventures is as follows:

	2012 £m	2011 £m
Financial position		
Current assets	442	706
Non-current assets	3,504	2,757
Total assets	3,946	3,463
Current liabilities	(375)	(301)
Non-current liabilities	(3,220)	(2,799)
Total liabilities	(3,595)	(3,100)
Net equity	351	363

	2012 £m	2011 £m
Results of operations		
Revenue	1,040	1,056
Expenses	(942)	(1,002)
Net profit	98	54

The joint ventures have no significant contingent liabilities or capital commitments to which the Group is exposed nor does the Group have any significant contingent liabilities or capital commitments 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 2012 the value of assets held for sale was £98 million (2011: £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:

	2012 £m	**2011** £m
Cash	4,884	6,338
Cash equivalents	1,500	919
Total cash and cash equivalents	6,384	7,257

Cash and cash equivalents held centrally are considered to be available for general use by the Group. These funds amount to £482 million and £309 million at 31 December 2012 and 2011, 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

A summary of the ordinary shares in issue is set out below:

Share capital and share premium

	Number of ordinary shares	Share capital £m	Share premium £m
Issued shares of 5p each fully paid:			
At 1 January 2011	2,545,594,506	127	1,856
Shares issued under share option schemes	2,444,824	–	17
At 31 December 2011	2,548,039,330	127	1,873
Shares issued under share option schemes	9,203,022	1	16
At 31 December 2012	2,557,242,352	128	1,889

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.

At 31 December 2012, there were options outstanding under Save As You Earn schemes to subscribe for shares as follows:

	Number of shares to subscribe for	Share price range from	Share price range to	Exercisable by year
31 December 2012	9,396,810	288p	629p	2018
31 December 2011	13,329,709	288p	572p	2017

H: Other information on statement of financial position items continued

H11: Shareholders' equity: share capital, share premium and reserves continued

Transactions by Prudential plc and its subsidiaries in Prudential plc shares

The Group buys and sells Prudential plc ('own shares') either in relation to its employee share schemes or via transactions undertaken by authorised investment funds that the Group is deemed to control. Further information about these transactions is set out below.

The cost of own shares of £97 million as at 31 December 2012 (2011: £109 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 2012, 8.0 million (2011: 8.1 million) Prudential plc shares with a market value of £69 million (2011: £52 million) were held in such trusts. Of this total, 8.0 million (2011: 8.0 million) shares were held in trusts under employee incentive plans.

In 2012, the Company purchased the following number of shares in respect of employee incentive plans.

	Number of shares purchased (in millions)*	Cost £m
2012	9.4	76.1
2011	8.2	54.7

* The maximum number of shares held in 2012 was 8.0 million which was in December 2012.

Of the total shares held in trust no shares were held by a qualifying employee share ownership trust (2011: 0.1 million).

The shares purchased each month are as follows:

	2012 Number of shares	2012 share price Low £	2012 share price High £	2012 Cost £	2011 Number of shares	2011 share price Low £	2011 share price High £	2011 Cost £
January	15,573	6.40	6.40	99,589	12,723	6.83	6.83	86,834
February	12,678	7.33	7.33	92,930	11,688	7.13	7.13	83,376
March	4,022,002	7.10	8.03	32,058,297	2,106,702	7.04	7.14	15,253,240
April	368,901	7.27	7.67	2,712,460	263,361	7.40	7.49	1,960,300
May	939,541	6.80	7.26	6,407,556	174,614	7.46	7.53	1,307,410
June	482,377	6.61	6.84	3,208,338	1,418,209	7.07	7.18	10,141,069
July	15,047	7.26	7.26	109,166	98,334	6.89	7.34	683,084
August	28,488	7.88	8.12	228,176	1,520,620	5.77	6.32	9,051,804
September	712,649	8.16	8.25	5,829,154	19,273	5.85	6.00	115,022
October	12,549	8.39	8.39	105,329	15,385	6.07	6.07	93,310
November	492,993	8.55	9.15	4,502,129	110,951	6.15	6.33	692,501
December	2,277,012	8.86	9.27	20,706,597	2,456,692	6.07	6.55	15,226,106
Total	9,379,810			76,059,721	8,208,552			54,694,056

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 2012 was 4.5 million (2011: 8.6 million) and the cost of acquiring these shares of £27 million (2011: £52 million) is included in the cost of own shares. The market value of these shares as at 31 December 2012 was £39 million (2011: £54 million).

During 2012, these funds made net disposals of 4,143,340 Prudential shares (2011: net disposals of 1,171,635) for a net decrease of £25.1 million to book cost (2011: net increase of £4.8 million).

All share transactions were made on an exchange other than the Stock Exchange of Hong Kong.

Other than set out above the Group did not purchase, sell or redeem any Prudential plc listed securities during 2012 or 2011.

Reserves

The translation reserve of £66 million (2011: £282 million) 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 2011	171,291	10,253
Income and expense included in the income statement	8,748	(1,025)
Foreign exchange translation differences	324	(13)
At 1 January 2012	180,363	9,215
Income and expense included in the income statement	32,760	1,381
Foreign exchange translation differences	(4,539)	(7)
At 31 December 2012	208,584	10,589

Notes B5, D2b, D3b and D4b provide further analysis of the movement in the year of the Group's policyholder liabilities and unallocated surplus of the with-profits funds.

H13: Borrowings

Core structural borrowings of shareholder-financed operations

	2012 £m				2011 £m
	Innovative Tier 1*	Lower Tier 2*	Senior†	Total	Total
Central operations					
Subordinated debt:					
€20m Medium Term Subordinated Notes 2023 note (i)		16		16	17
£435m 6.125% Subordinated Notes 2031		429		429	428
£400m 11.375% Subordinated Notes 2039		386		386	384
US$1,000m 6.5% Perpetual Subordinated Capital Securities	615			615	644
US$250m 6.75% Perpetual Subordinated Capital Securities note (ii)	154			154	161
US$300m 6.5% Perpetual Subordinated Capital Securities note (ii)	185			185	193
US$750m 11.75% Perpetual Subordinated Capital Securities	458			458	477
US$550m 7.75% Perpetual Subordinated Capital Securities note (ii)	334			334	348
	1,746	831	–	2,577	2,652
Senior debt:					
£300m 6.875% Bonds 2023			300	300	300
£250m 5.875% Bonds 2029			249	249	249
	–	–	549	549	549
Total central operations	1,746	831	549	3,126	3,201
£275m bank loan note (iii)			275	275	250
US$250m 8.15% Surplus Notes 2027 note (iv)		153		153	160
Total notes (v), (vi)	1,746	984	824	3,554	3,611

* These debt classifications are consistent with the treatment of capital for regulatory purposes, as defined in the FSA handbook. 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 (£340 million) and were used to finance the repayments of the €500 million Tier 2 subordinated debt in December 2011.

The Group has designated US$2.85 billion (2011: US$2.85 billion) of its Tier 1 subordinated debt as a net investment hedge under IAS 39 to hedge the currency risks related to the net investment in Jackson.

† The senior debt ranks above subordinated debt in the event of liquidation.

H: Other information on statement of financial position items continued

H13: Borrowings continued

Notes

(i) 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.

(ii) The US$250 million 6.75 per cent borrowings, the US$300 million 6.5 per cent borrowings and the US$550 million 7.75 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, into one or more series of Prudential preference shares.

(iii) The PruCap bank loan was increased from £250 million to £275 million on 20 December 2012. The loan has been made in two tranches: a £160 million loan maturing in June 2014, currently drawn at a cost of 12 month £LIBOR plus 0.6 per cent and a £115 million loan maturing on 20 December 2017 and currently drawn at a cost of 12 month £LIBOR plus 0.79 per cent.

(iv) The Jackson borrowings are unsecured and subordinated to all present and future indebtedness, policy claims and other creditor claims of Jackson.

(v) Maturity analysis
The following table sets out the contractual maturity analysis of the Group's core structural borrowings:

	2012 £m	2011 £m
Less than 1 year	115	115
1 to 2 years	160	–
2 to 3 years	–	135
3 to 4 years	–	–
4 to 5 years	–	–
Over 5 years	3,279	3,361
Total	3,554	3,611

(vi) Management analyses the net core structural borrowings position as follows:

	2012 £m	2011 £m
Total core structural borrowings (as above)	3,554	3,611
Less: Holding company cash and short-term investments (recorded within the consolidated statement of financial position)	(1,380)	(1,200)
Net core structural borrowings of shareholder-financed operations	2,174	2,411

(vii) In January 2013, the Company issued core structural borrowings of US$700 million Tier 1 perpetual subordinated capital securities. The proceeds, net of costs, were US$689 million.

Operational borrowings attributable to shareholder-financed operations

	2012 £m	2011 £m
Borrowings in respect of short-term fixed income securities programmes		
Commercial paper	1,535	2,706
Medium-Term Notes 2013 note (vi)	250	250
Medium-Term Notes 2015	299	–
	2,084	2,956
Borrowings of US operations		
Investment subsidiaries (non-recourse) note (i)	19	20
Piedmont and CDO funds (non-recourse) notes (i), (ii)	1	1
	20	21
Other borrowings		
Bank loans and overdrafts	1	13
Obligations under finance leases	1	1
Other borrowings note (iii)	139	349
	141	363
Total	2,245	3,340

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) 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.

(iii) Other borrowings mainly include amounts whose repayment to the lender is contingent upon future surplus emerging from certain contracts specified under the arrangement. If insufficient surplus emerges on those contracts, there is no recourse to other assets of the Group and the liability is not payable to the degree of shortfall.

The Group has chosen to designate as a fair value hedge under IAS 39 certain fixed to floating rate swaps which hedge the fair value exposures to interest rate movements of these borrowings.

In addition, other borrowings include senior debt issued through the Federal Home Loan Bank of Indianapolis (FHLB), secured by collateral posted with the FHLB by Jackson.

(iv) In addition to the debt listed above, £200 million Floating Rate Notes were issued by Prudential plc in October 2012 which will mature in April 2013. 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.

(v) Maturity analysis
The following table sets out the contractual maturity analysis of the Group's operational borrowings attributable to shareholder-financed operations:

	2012 £m	2011 £m
Less than 1 year	1,920	3,169
1 to 2 years	6	140
2 to 3 years	309	10
3 to 4 years	9	10
4 to 5 years	1	11
Over 5 years	–	–
Total	2,245	3,340

(vi) In January 2013 the Company repaid on maturity, £250 million Medium-Term Notes included within borrowings in respect of short-term fixed income securities in the table above.

Borrowings attributable to with-profits operations

	2012 £m	2011 £m
Non-recourse borrowings of consolidated investment funds note(i)	823	747
£100m 8.5% undated subordinated guaranteed bonds of Scottish Amicable Finance plc note(ii)	100	100
Other borrowings (predominantly obligations under finance leases)	110	125
Total note(iii)	1,033	972

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:

	2012 £m	2011 £m
Less than 1 year	288	297
1 to 2 years	82	75
2 to 3 years	124	30
3 to 4 years	46	110
4 to 5 years	61	31
Over 5 years	432	429
Total	1,033	972

H14: Provisions and contingencies

Provisions

	2012 £m	2011 £m
Provision in respect of defined benefit pension schemes:[13]		
(Surplus) deficit gross of deferred tax, based on scheme assets held, including investments in Prudential insurance policies:		
Attributable to PAC with-profits fund	37	41
Attributable to shareholder-financed operations	(1)	23
	36	64
Add back investments in Prudential insurance policies	169	165
Provision after elimination of investments in Prudential insurance policies and matching policyholder liabilities from Group statement of financial position	205	229
Other provisions (see below)	396	300
Total provisions	601	529

H: Other information on statement of financial position items continued

H14: Provisions and contingencies continued

Analysis of other provisions:

	Note	2012 £m	2011 £m
At 1 January	**I3**	300	282
Charged to income statement:			
Additional provisions		237	144
Unused amounts released		(12)	(29)
Used during the year		(124)	(97)
Exchange differences		(5)	–
At 31 December		396	300
Comprising:			
Legal provisions		20	14
Restructuring provisions		27	23
Other provisions		349	263
Total		396	300

Other provisions

The movement in other provisions is shown in the table below:

	2012 £m			2011 £m		
	Legal provisions note (i)	Restructuring provisions note (ii)	Other provisions note (iii)	Legal provisions note (i)	Restructuring provisions note (ii)	Other provisions note (iii)
At 1 January	14	23	263	20	26	236
Charged to income statement:						
Additional provisions	10	14	213	–	5	139
Unused amounts released	(1)	(4)	(7)	–	(5)	(24)
Used during the year	(2)	(6)	(116)	(6)	(3)	(88)
Exchange differences	(1)	–	(4)	–	–	–
Total at 31 December	20	27	349	14	23	263

Notes

(i) Total legal provisions at 31 December 2012 of £20 million related 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. Of the £20 million legal provision as at 31 December 2012, £18 million has been established to cover this potential litigation and is expected to be utilised over the next five years.

(ii) Restructuring provisions 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.

(iii) Other provisions comprise staff benefits provisions of £286 million, provisions for onerous contracts of £61 million and regulatory and other provisions of £2 million. Staff benefits are generally expected to be paid out within the next three years.

The provision balance is expected to be paid out within the next five years.

Contingencies and related obligations

In addition to the legal proceedings relating to Jackson mentioned under the legal provisions section above, the Group is involved in other litigation and regulatory issues.

Whilst the outcome of such litigation and regulatory issues cannot be predicted with certainty, the Company believes that their ultimate outcome 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.

At 31 December 2012 the pension mis-selling provision was £306 million (31 December 2011: £362 million).

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 2012 of £306 million is stochastically determined on a discounted basis. The average discount rate implied in the movement in the year is 2.3 per cent (2011: 2.6 per cent).

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.

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

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.

Guaranteed annuities

Prudential Assurance used to sell guaranteed annuity products in the UK and at 31 December 2012 held a provision of £47 million (2011: £90 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 2012 a provision of £371 million (2011: £370 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.

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 Scottish Amicable Life Assurance Society (SALAS), a mutual society, was transferred to PAC. In effecting the transfer, a separate sub-fund, Scottish Amicable Insurance 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.

SAIF with-profits policies contain minimum levels of guaranteed benefit to policyholders. In addition, as mentioned earlier in this note, certain pensions products have guaranteed annuity rates at retirement. Should the assets of SAIF be inadequate to meet the guaranteed benefit obligations of the policyholders of SAIF, the PAC long-term fund would be liable to cover any such deficiency in the first instance. 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.

H: Other information on statement of financial position items continued

H14: Provisions and contingencies continued

Unclaimed property provision

Jackson has received regulatory enquiries on an industry-wide matter relating to claims settlement practices and compliance with unclaimed property laws. Concurrently, some regulators and state legislatures have required and others are considering proposals that would require life insurance companies to take additional steps to identify unreported deceased policy and contract holders. Additionally, numerous states are contracting with independent firms to perform specific unclaimed property audits or targeted market conduct examinations covering claims settlement practices and procedures for escheating unclaimed property. One such firm has been contracted by treasury departments of 26 states to perform an examination of the Jackson's practices for handling unclaimed property. Any regulatory audits, related examination activity and internal reviews may result in additional payments to beneficiaries, escheatment of funds deemed abandoned under state laws, administrative penalties and changes in the Jackson's procedures for the identification of unreported claims and handling of escheatable property.

In 2011, Jackson initiated a project to compare its entire policy master file to vendors' databases of known deaths and accrued a £16 million provision for potential claims at 31 December 2011. In 2012, Jackson recognised a charge of £18 million, net of policy reserves released upon death, as a result of the project. At 31 December 2012, based on its current analysis, Jackson has accrued £17 million for estimated remaining claims that have not yet been positively identified.

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 £31 million at 31 December 2012 (2011: £17 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 2012, Jackson has unfunded commitments of £325 million (2011: £341 million) related to its investments in limited partnerships and of £86 million (2011: £77 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 2012, 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 £31 million (2011: £71 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

	2012 £m	2011 £m
Creditors arising from direct insurance and reinsurance operations	1,134	970
Interest payable	62	67
Other items*	2,258	212
Total	3,454	1,249

* Of the £2,258 million other items as at 31 December 2012, £2,021 million related to liabilities for funds withheld under reinsurance arrangement of the Group's US operations from the purchase of REALIC, as discussed in note I1.

I: Other notes

I1: Acquisition of subsidiaries

a Acquisition of Reassure America Life Insurance Company (REALIC)

On 4 September 2012, the Group through its indirect wholly-owned subsidiary, Jackson National Life Insurance Company (JNLI) completed the acquisition of 100 per cent issued share capital of SRLC America Holding Corp. (SRLC), and its primary operating subsidiary, Reassure America Life Insurance Company (REALIC). The purchase consideration which remains subject to final agreement under the terms of the transaction with Swiss Re, is £370 million (US$587 million). The acquisition increases the scale of the Group's life business in the US, helping Jackson to diversify earnings by increasing the amount of income from underwriting activities thereby enhancing the quality of earnings in a capital efficient manner. Immediately prior to the acquisition, SRLC entered into a reinsurance arrangement with Swiss Re, the former ultimate parent company facilitating Swiss Re to retain a portion of the REALIC business. As collateral for this reinsurance arrangement, REALIC holds £2.1 billion of policy loans, bonds and short-term investments, which are offset by a funds withheld liability.

REALIC was a US-based insurance company whose business model was to acquire, through purchase or reinsurance, closed blocks of insurance business, primarily life assurance risks. REALIC did not write new business.

The purchase consideration paid is equivalent to the fair value of the identifiable acquired assets and liabilities assumed and accordingly no goodwill is recognised under IFRS on the date of completion of the acquisition.

In addition to the purchase consideration, the Group incurred £9 million of acquisition related costs that have been recognised as an expense during the year, in the consolidated income statement.

The provisional fair value of the acquired assets and liabilities are shown in the table below.

	Fair value recognised at acquisition date £m
Identifiable assets	
Intangible assets attributable to shareholders:	
Acquired value of in-force business	5
Other non-investment and non-cash assets:	
Reinsurers' share of insurance contract liabilities	5,444
Deferred tax	390
Current tax recoverable	44
Accrued investment income	58
Other debtors	38
Investments of long-term business and other operations:	
Loans	2,204
Equity securities and portfolio holdings in unit trusts	69
Debt securities	7,177
Cash and cash equivalents	147
Total identifiable assets	15,576
Identifiable liabilities	
Policyholder liabilities:	
Insurance contract liabilities	12,912
Other non-insurance liabilities	2,294
Total identifiable liabilities	15,206
Net identifiable assets acquired and liabilities assumed	370
Purchase consideration	370

I: Other notes continued

I1: Acquisition of subsidiaries continued

At the date the financial statement were approved, the fair value of the identifiable acquired assets and liabilities and the consideration were subject to finalisation. In accordance with accounting guidance for business combinations, the Company will continue to review the balance sheet and record required adjustments, for up to a 12 month period following the acquisition close date, in order to reflect updated information on certain accruals, related expenses, or other potential valuation adjustments, if further information becomes available about facts and circumstances that existed as of the acquisition date. Any measurement period adjustments determined to be material will be applied retrospectively to the acquisition date in the Company's consolidated financial statements and depending on the nature of the adjustment, the Company's results subsequent to the acquisition period could be affected.

Reserves were initially valued consistent with existing IFRS guidance. Accordingly, as for the Group's measurement of Jackson's insurance assets and liabilities, under IFRS 4, a 'grandfathered' US GAAP basis has been applied. For instance the traditional products were valued using standard modeling techniques with assumptions updated to match current interest rate environment or be consistent with Jackson's assumptions where appropriate. Base reserves on interest sensitive products were set equal to the account value and the reserves accounted for under FASB ASC Subtopic 944-80 Financial Services – Insurance – Separate Accounts (formerly SOP 03-1) were adjusted to reflect Jackson's assumptions where appropriate. In addition, provision has been made for the effects of fair valuing the acquired policyholder liabilities and value of in force business in accordance with IFRS 3.

Included within the identifiable assets as shown above are loans and other debtors acquired with fair values of £2,204 million and £38 million, respectively. These values represent the gross contractual amounts all of which are expected to be collected. The majority of the loans of £2,204 million were held to back liabilities for funds withheld under reinsurance arrangements as described above.

The consolidated statement of cash flows contains a £224 million net cash outflow in respect of this acquisition representing cash consideration of £371 million (based on the preliminary purchase price of £417 million with a deferred consideration of £46 million) less cash and cash equivalents acquired of £147 million.

Impact of acquisition on the results of the Group

	Actual £m	Estimated £m
	Post acquisition period from 4 Sept to 31 Dec 2012	**Full Year 2012** note (i)
Revenue	184	695
Operating profit based on longer-term investment returns	67	
Short-term fluctuations in investment returns	13	
Amortisation of acquisition accounting on the purchase of REALIC note (ii)	(19)	
Profit before tax	61	123

Notes

(i) Estimation of the REALIC business' contribution to the Group's consolidated revenue and profit before tax for the year if the acquisition had occurred on 1 January 2012. In determining these amounts, it has been assumed that the fair value adjustments which arose on the date of acquisition would have been the same if the acquisition had occurred on 1 January 2012.

(ii) The profit of £61 million for the period has been determined after a charge of £(19) million for amortisation of acquisition accounting adjustments. This charge reflects the net effect of:

(a) The difference between the yield on the acquired debt securities (excluding those held to back funds withheld for reinsurance contracts) determined by reference to their market value at acquisition as required by the IFRS 3 purchase GAAP purposes and the book yield on a historic GAAP basis;

(b) Amortisation of the fair value adjustments on policyholder liabilities; and

(c) Amortisation of the acquired value of in-force business.

This charge has been shown separately within Group's supplementary analysis of profit, as explained in note B1.

b Acquisition of Thanachart Life Assurance Company Limited

On 5 November 2012, Prudential plc, through its subsidiary Prudential Life Assurance (Thailand) Public Company Limited (Prudential Thailand) entered into an agreement to acquire 100 per cent of Thanachart Life Assurance Company Limited (Thanachart Life), a wholly-owned life insurance subsidiary of Thanachart Bank Public Company limited (Thanachart Bank). The consideration for Thanachart Life is THB 17.5 billion (£352 million at the year end exchange rate) settled in cash on completion, with a further payment of THB 0.5 billion (£10 million) payable 12 months after completion, subject to a post-completion adjustment to reflect the net asset value as at the completion date. The transaction is subject to regulatory approval and is expected to close in the first half of 2013. Upon completion of the transaction, Thanachart Life will become a wholly-owned subsidiary of Prudential Thailand.

As part of the deal, Prudential Thailand and Thanachart Bank have entered into an agreement to establish an exclusive 15-year partnership to develop jointly their bancassurance business in Thailand. This transaction builds on Prudential's strategy of focusing on the highly attractive markets of South-east Asia and is in line with the Group's multichannel distribution strategy.

c PAC with-profits funds acquisitions

2012:
The PAC with-profits fund, via its venture fund holdings and as part of its investment portfolio, has made an acquisition of a joint venture, see note H8. There were no acquisitions of subsidiaries made during the year.

2011:
The PAC with-profits fund, via its venture fund holdings and as part of its investment portfolio, made acquisitions during the period. These were acquisitions for a 100 per cent interest of Earth & Wind Energias Renovables SL, a company which invests in solar panel parks, in March 2011 and a 100 per cent interest of Alticom Holdings BV, a company investing in telecommunication towers, in June 2011. The Earth & Wind portfolio of solar panel parks was further expanded with the acquisition of a 100 per cent interest in Promociones Fotovoltaicas Betula SL, Promociones Fotovoltaicas Castanea SL, Promociones Fotovoltaicas Corylus SL and Promociones Fotovoltaicas Fagus SL in July 2011 and a 50 per cent controlling interest in Sarinena Solar SL in October 2011.

As these transactions are within the with-profits fund, they have no impact on shareholders' profit or equity for the year ended 31 December 2011. The impact on the Group's consolidated revenue, including investment returns, is not material. Had the acquisitions been effected at 1 January 2011, the revenue and profit of the Group for the year ended 31 December 2011 would not have been materially different.

A summary of the consideration, goodwill and net assets acquired relating to these four acquisitions is provided in the table below:

	2011 Total £m
Cash consideration paid	67
Net assets acquired:	
Property, plant and equipment	190
Other non-investment and non-cash assets	16
Cash and cash equivalents	14
Borrowings attributable to with-profits funds	(114)
Derivative liabilities	(2)
Other non-insurance liabilities	(49)
Fair value of net assets acquired	55
Total goodwill arising on acquisition attributable to the with-profits fund	12

I2: Changes to Group's holdings

PPM South Africa

On 22 February 2012, M&G completed transactions to (i) exchange bonus share rights for equity holdings with the employees of PPM South Africa and (ii) the sale of a 10 per cent holding in the majority of the business to Thesele Group, a minority shareholder, for cash. Following these transactions M&G's majority holding in the business reduced from 75 per cent to 49.99 per cent. Under IFRS requirements, the divestment is accounted for as the disposal of the 75 per cent holding and an acquisition of a 49.99 per cent holding at fair value resulting in a reclassification of PPM South Africa from a subsidiary to an associate. As a consequence of the IFRS application, the transactions gave rise to a gain on dilution of £42 million. This amount is shown separately and in the Group's 2012 supplementary analysis of profit excluded from the Group's IFRS operating profit based on longer-term investment returns. The net cash outflow arising from this change to the Group's holdings, as shown in the consolidated statement of cash flows, of £23 million, comprised the net effect of cash and cash equivalents no longer consolidated and the cash proceeds received.

I: Other notes continued

I3: Staff and pension plans

a Staff and employment costs

The average number of staff employed by the Group during the year was:

	2012	2011
Business operations:		
Asia operations	18,584	17,001
US operations	4,000	3,785
UK operations	5,035	4,628
Total	27,619	25,414

The costs of employment were:

	2012 £m	2011 £m	2010 £m
Business operations:			
Wages and salaries	1,204	1,101	1,052
Social security costs	85	75	69
Other pension costs:			
Defined benefit schemes*:			
Defined benefit schemes – PSPS†	17	22	27
Defined benefit schemes – Other schemes*	21	(34)	31
Defined contribution schemes:			
Defined contribution schemes – Domestic	12	12	11
Defined contribution schemes – Overseas	35	29	26
Pension actuarial and other (gains) losses charged to income statement*	(145)	(37)	26
	(60)	(8)	121
Total	1,229	1,168	1,242

* The derivation of these amounts is shown in note (b)(i)4(i).
† Consistent with the derecognition of the Company's interest in the underlying IAS 19 surplus of Prudential Staff Pension Scheme (PSPS) as described in note (b)(i)1 below, the other pension costs 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.

b Pension plans

i Defined benefit plans

1 Summary

The Group asset (liability) in respect of defined benefit pension schemes is as follows:

	2012 £m			2011 £m
	PSPS	Other schemes	Total	Total
Underlying economic surplus[note 4(i)]	1,174	(36)	1,138	1,543
Less: unrecognised surplus and adjustment for obligation under IFRIC 14 for deficit funding (2011 only)[note 4(i)]	(1,010)	–	(1,010)	(1,607)
Economic surplus (deficit) (including investment in Prudential insurance policies)[note 4(i)]	164	(36)	128	(64)
Attributable to:				
PAC with-profits fund	115	(37)	78	(41)
Shareholder-backed operations	49	1	50	(23)
Consolidation adjustment against policyholder liabilities for investment in Prudential insurance policies	–	(169)	(169)	(165)
IAS 19 pension asset (liability) on the Group statement of financial position*	164	(205)	(41)	(229)

* At 31 December 2012, the PSPS pension asset of £164 million and the other schemes' pension liabilities of £205 million were included within 'Other debtors' and 'Provisions' respectively on the consolidated statement of financial position. The comparative liabilities of £229 million as at 31 December 2011 were included within 'Provisions'.

The Group's businesses 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), which PSPS accounts for 86 per cent (2011: 86 per cent) of the underlying scheme liabilities of the Group defined benefit schemes.

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 with a negligible deficit.

Triennial actuarial valuations

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.

The last completed actuarial valuation of PSPS was as at 5 April 2011 by CG Singer, Fellow of the Institute of Actuaries, of Towers Watson Limited. This valuation was finalised in the first half of 2012 and demonstrated the scheme to be 111 per cent funded by reference to the Scheme Solvency Target that forms the basis of the scheme's funding objective. As a result of this valuation, future contributions into the scheme have been reduced to the minimum level of contributions required under the scheme rules effective from July 2012.

Excluding expenses, the contributions fell to approximately £6 million per annum from the £50 million per annum paid previously. The new contributions are only for ongoing service of current employees that are active members of the scheme. No deficit type funding is required. Deficit funding for PSPS, where applicable, as applied in 2011, is apportioned in the ratio of 70/30 between the PAC with-profits 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 2012, total contributions paid in the year including expenses were £36 million (2011: £54 million).

The market value of PSPS scheme assets as at the 5 April 2011 valuation was £5,255 million. The actuarial assumptions used in determining benefit obligations and the net periodic benefit costs for the purposes of the 2011 valuation were as follows:

Rate of increase in salaries	Nil
Rate of inflation:	
Retail Prices Index (RPI)	3.7
Consumer Prices Index (CPI)	3.0
Rate of increase of pensions in payment for inflation:	
Guaranteed (maximum 5%)	3.0
Guaranteed (maximum 2.5%)	2.5
Discretionary	Nil
Expected returns on plan assets	4.2

Mortality assumptions:

The tables used for PSPS pensions in payment at 5 April 2011 were:

Base post retirement mortality

For current male (female) pensioners 113% (108%) of the mortality rates of the 2000 series mortality tables (PNMA00/PNFA00), published by the Continuous Mortality Investigation Bureau (CMI).

For male (female) non-pensioners 107% (92%) of the 2000 series rates (PNMA00/PNFA00).

Allowance for future improvements to post retirement mortality

For males (females) 100% (75%) of Medium Cohort subject to a minimum rate of improvement of 2.00% (1.25%) up to the age of 90, decreasing linearly to zero by age of 120 with a long-term rate of 1.75% pa (1.5% pa) but adjusted as follows:

- period improvements are blended between ages 60 to 80 to the long-term improvement rate over a 15 year period (compared with a 20 year period in the core CMI model) and;
- cohort improvements are assumed to dissipate over a 30 year period, or by age 90 if earlier (compared with a 40 year period, or by age 100 if earlier, in the core CMI model).

The last completed actuarial valuation of the Scottish Amicable Pension Scheme (SAPS) was as at 31 March 2011 by Jonathan Seed, Fellow of the Institute and Faculty of Actuaries, of Xafinity Consulting. This valuation was finalised in the second half of 2012 and demonstrated the scheme to be 85 per cent funded. Based on this valuation, it was agreed with the Trustees that the existing level of deficit funding of £13.1 million per annum continues to be paid into the scheme over the next six years, to eliminate the actuarial deficit.

The last completed actuarial valuation of the M&G pension scheme was as at 31 December 2011 by Paul Belok, Fellow of the Institute and Faculty of Actuaries, of AON Hewitt Limited. This valuation was finalised in the second half of 2012 and demonstrated the scheme to be 83 per cent funded. Based on this valuation, deficit funding amounts designed to eliminate the actuarial deficit over a three year period are being made from January 2013 of £18.6 million per annum for the first two years and £9.3 million in the third year. This compares to the £10.5 million of deficit funding paid by the Group in 2012.

I: Other notes continued

I3: Staff and pension plans continued

Summary economic and IAS 19 financial positions

Under the IAS 19 'Employee Benefits' 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, a surplus is only recognised to the extent that the Company is able to access the surplus either through an unconditional right of refund to the surplus or through reduced future contributions relating to ongoing service, which have been substantively enacted or contractually agreed. Further, the IFRS financial position recorded, reflects the higher of any underlying IAS 19 deficit and any obligation for committed deficit funding where applicable.

For PSPS, the Group does not have an unconditional right of refund to any surplus of the scheme. Accordingly, prior to the finalisation of the 5 April 2011 triennial valuation, the Group had not recognised the underlying surplus of PSPS (31 December 2011: £1,588 million gross of deferred tax) and had recognised an economic liability for deficit funding (31 December 2011: £19 million gross of deferred tax).

The underlying IAS 19 surplus for PSPS at 31 December 2012 was £1,174 million. The finalisation of the 5 April 2011 triennial valuation was accompanied by an agreement with the Trustees that additional deficit type funding would no longer be necessary and furthermore, the level of contributions for ongoing service of current employees was reduced to the minimum level required by the scheme rules. As a consequence, a portion of the surplus, being £164 million, is now recognised as recoverable. The £164 million represents the present value of the economic benefits available from the reductions to future ongoing contributions to the scheme. Accordingly, a net surplus of £164 million gross of deferred tax was recognised at 31 December 2012. Of this amount, £115 million was allocated to the PAC with-profits fund and £49 million was allocated to the shareholders' fund.

The IAS 19 deficit of the Scottish Amicable Pension Scheme at 31 December 2012 was £74 million (31 December 2011: deficit of £55 million) and has been allocated approximately 50 per cent to the PAC with-profits fund and 50 per cent to the shareholders' fund.

The IAS 19 surplus of the M&G pension scheme on an economic basis at 31 December 2012 was £38 million (31 December 2011: surplus of £10 million) and is wholly attributable to shareholders. The underlying position on an economic basis reflects the assets (including investments in Prudential insurance policies that are offset against liabilities to policyholders on the Group consolidation) and the liabilities of the schemes. As at 31 December 2012, the M&G pension scheme has invested £169 million in Prudential insurance policies (31 December 2011: £165 million). After excluding these investments that are offset against liabilities to policyholders, the IAS 19 basis position of the M&G pension scheme is a deficit of £131 million (31 December 2011: deficit of £155 million).

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:

	2012 %	2011 %
Discount rate*	4.4	4.7
Rate of increase in salaries	2.7	2.9
Rate of inflation†		
Retail prices index (RPI)	2.7	2.9
Consumer prices index (CPI)	2.0	1.9
Rate of increase of pensions in payment for inflation:		
Guaranteed (maximum 5%)	2.5	2.5
Guaranteed (maximum 2.5%)‡	2.5	2.5
Discretionary‡	2.5	2.5
Expected returns on plan assets	3.1	5.1

* 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 rate of inflation reflects the long-term assumption for the UK RPI or CPI depending on the tranche of the schemes.

‡ The rates of 2.5 per cent are those for PSPS. Assumed rates of increase of pensions in payments for inflation for all other schemes are 2.7 per cent in 2012 (2011: 2.9 per cent).

The calculations are based on current actuarially calculated mortality estimates with a specific allowance made for future improvements in mortality. The specific allowance for 2012 and 2011 is in line with a custom calibration of the 2009 mortality model from the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries (CMI). The tables used for PSPS immediate annuities in payment at 31 December 2012 and 2011 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 assumed life expectancies on retirement at age 60, based on the mortality table used was:

	2012 years		2011 years	
	Male	Female	Male	Female
Retiring today	28.0	29.1	27.8	29.0
Retiring in 20 years' time	30.6	31.2	30.5	31.1

The mean term of the current PSPS liabilities is around 17 years.

Using external actuarial advice provided by the scheme actuaries being Towers Watson for the valuation of PSPS, Xafinity Consulting for SAPS and Aon Hewitt Limited for the M&G scheme, the most recent full valuations have been updated to 31 December 2012, applying the principles prescribed by IAS 19.

4 Group economic and IAS 19 financial position

This section illustrates the financial position of the Group's defined benefit pension schemes on an economic basis and the IAS 19 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 2012, the investments in Prudential insurance policies comprise £123 million (2011: £112 million) for PSPS and £169 million (2011: £165 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, where relevant (as previously described).

I: Other notes continued

I3: Staff and pension plans continued

(i) 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:

	2012 £m				
		(Charge) credit to income statement			
	Surplus (deficit) in scheme at 1 January 2012	Operating results (based on longer-term investment returns)	Actuarial and other gains and losses	Contributions paid	Surplus (deficit) in scheme at 31 Dec 2012
All schemes					
Underlying position (without the effect of IFRIC 14)					
Surplus	1,543	(166)	(311)	72	1,138
Less: amount attributable to PAC with-profits fund	(1,083)	105	222	(31)	(787)
Shareholders' share:					
Gross of tax surplus	460	(61)	(89)	41	351
Related tax	(117)	25	20	(9)	(81)
Net of shareholders' tax	343	(36)	(69)	32	270
Effect of IFRIC 14					
Derecognition of surplus and set up of additional funding obligation (1 Jan 2012 only)	(1,607)	136	461	–	(1,010)
Less: amount attributable to PAC with-profits fund	1,124	(93)	(322)	–	709
Shareholders' share:					
Gross of tax deficit	(483)	43	139	–	(301)
Related tax	123	(22)	(32)	–	69
Net of shareholders' tax	(360)	21	107	–	(232)
With the effect of IFRIC 14					
(Deficit) surplus	(64)	(30)	150	72	128
Less: amount attributable to PAC with-profits fund	41	12	(100)	(31)	(78)
Shareholders' share:					
Gross of tax (deficit) surplus	(23)	(18)	50	41	50
Related tax	6	3	(12)	(9)	(12)
Net of shareholders' tax	(17)	(15)	38	32	38

Underlying investments and liabilities of the schemes

On the 'economic basis', after including the underlying assets represented by the investments in Prudential insurance policies as scheme assets, the plan's net assets at 31 December comprise the following investments and liabilities:

	2012 £m				2011 £m			
	PSPS £m	Other schemes £m	Total £m	%	PSPS £m	Other schemes £m	Total £m	%
Equities	43	321	364	5	210	273	483	7
Bonds	5,440	418	5,858	81	5,547	407	5,954	83
Properties	290	40	330	5	297	20	317	4
Other assets[note (i)]	627	18	645	9	378	31	409	6
Total value of assets	6,400	797	7,197	100	6,432	731	7,163	100

Note

(i) The PSPS scheme 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 other assets 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 2012, the nominal value of the interest and inflation-linked swaps amounted to £0.9 billion (2011: £0.9 billion) and £2.0 billion (2011: £2.0 billion) respectively.

(ii) IAS 19 basis financial position as consolidated

The movements in the pension schemes' surplus and deficit between scheme assets and liabilities as consolidated in the financial statements were:

	2012 £m					
	PSPS	Other schemes		Total		Total
	Asset/ (liability)	Plan assets	Present value of benefit obligations	Economic basis net surplus (deficit)	Adjust for investments in Prudential insurance policies	IAS 19 basis net deficit
Net deficit, beginning of year	(19)	731	(776)	(64)	(165)	(229)
Current service cost			(11)	(11)		(11)
Other finance income		35	(37)	(2)	(8)	(10)
Cash costs and unwind of discount on opening provision for deficit funding for PSPS	(17)			(17)		(17)
Benefit payments		(17)	17			–
Contributions	36	36		72		72
Actuarial and other gains and losses	164	12	(26)	150	(5)	145
Transfer out of investment in Prudential insurance policies					9	9
Net surplus (deficit), end of year	164	797	(833)	128	(169)	(41)

I: Other notes continued

I3: Staff and pension plans continued

	2011 £m					
	PSPS	Other schemes		Total		Total
	Provision of deficit funding	Plan assets	Present value of benefit obligations	Economic basis net surplus (deficit)	Adjust for investments in Prudential insurance policies	IAS 19 basis net deficit
Net deficit, beginning of year	(47)	653	(826)	(220)	(227)	(447)
Current service cost			(13)	(13)		(13)
Negative past service cost (RPI to CPI inflation measure change)			66	66		66
Other finance income		41	(45)	(4)	(15)	(19)
Cash costs and unwind of discount on opening provision for deficit funding for PSPS	(22)			(22)		(22)
Benefit payments		(15)	15		5	5
Contributions	54	40	(1)	93	(21)	72
Actuarial and other gains and losses	(4)	12	28	36	1	37
Transfer out of investment in Prudential insurance policies					92	92
Net deficit, end of year	(19)	731	(776)	(64)	(165)	(229)

The IAS 19 basis pensions deficit can be summarised as follows:

	2012		2011		2010		2009		2008	
	£m	%	£m	%	£m	%	£m	%	£m	%
Plan assets (IAS 19 basis before effect of IFRIC 14):										
Equities	**202**	**5**	336	5	610	11	917	18	875	17
Bonds	**5,728**	**84**	5,826	85	4,095	72	3,587	69	2,619	52
Properties	**330**	**5**	317	4	206	4	278	5	290	6
Other assets	**645**	**6**	407	6	748	13	442	8	1,273	25
Fair value of plan assets, end of year*	**6,905**	**100**	6,886	100	5,659	100	5,224	100	5,057	100
Present value of benefit obligation	**(6,059)**		(5,620)		(5,438)		(4,951)		(4,493)	
Funded status (wholly or partly funded)	**846**		1,266		221		273		564	
Present value of unfunded obligations (M&G scheme)†	**–**		–		(254)		(223)		(180)	
	846		1,266		(33)		50		384	
Effect of the application of IFRIC 14 for pension schemes										
Derecognition of PSPS' surplus	**(1,010)**		(1,588)		(485)		(513)		(728)	
Set up obligation for deficit funding for PSPS	**–**		(19)		(47)		(75)		(65)	
Adjustment in respect of investment of PSPS in Prudential policies	**123**		112		118		101		103	
Deficit recognised in the statement of financial position	**(41)**		(229)		(447)		(437)		(306)	
Experience adjustments:										
Experience adjustments on scheme liabilities‡	**(4)**		314		(4)		76		145	
Percentage of scheme liabilities at 31 December	**(0.07)%**		(5.59)%		(0.07)%		1.47%		3.10%	
Experience adjustments on scheme assets (IAS 19 basis)	**(39)**		998		287		100		(277)	
Percentage of scheme assets at 31 December	**(0.57)%**		14.49%		5.07%		1.91%		(5.48)%	

* The IAS 19 basis plan assets at 31 December 2012 of £6,905 million is different from the economic basis plan assets of £7,197 million as show in section 4(i) above due to the exclusion of investment in Prudential insurance policies of £292 million comprising £123 million for PSPS and £169 million for the M&G scheme.

† The M&G pension scheme invests in Prudential insurance policies. On Prudential Group consolidation these assets are eliminated against liabilities in the statement of financial position of UK insurance operations. Up until 2011 all of the M&G scheme assets were invested in this way thus giving rise to an unfunded status on a Prudential Group consolidated basis. At 31 December 2012 and 2011, only £169 million (2011: £165 million) out of the M&G scheme assets of £297 million (2011: £257 million) was invested in Prudential insurance policies, thereby switching its status to a partly funded scheme.

‡ The experience adjustments on scheme liabilities in 2011 of £314 million related mainly to the 'true-up' reflecting improvements in data consequent upon the ongoing 2011 triennial valuations of PSPS and the Scottish Amicable pension scheme. 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.

I: Other notes continued

I3: Staff and pension plans continued

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 above.

	2012 %	2011 %
Long-term expected rate of return:		
Equity	6.8	8.2
Bonds	3.0	4.6
Properties	5.6	6.9
Other assets	2.0	4.8
Weighted average long-term expected rate of return	3.1	5.1

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 £189 million (gain of 2011: £1,290 million) on an IAS 19 basis.

None of the scheme assets included shares in Prudential plc or property occupied by the Prudential Group.

(iii) Credit (charge) to the income statement

The components of the credit (charge) for the net periodic pension cost (comprising amounts attributable to the PAC with-profits fund and shareholder-backed operations) are as follows:

	2012 £m	2011 £m
Pension cost		
Current service cost	(32)	(35)
Past service cost:[note (a)]		
RPI to CPI inflation measure change in 2011	–	282
Exceptional discretionary pension increase for PSPS in 2012	(106)	–
Finance (expense) income:		
Interest cost	(263)	(299)
Expected return on assets – IAS 19 basis	227	283
Add: expected return on investments of scheme assets in Prudential insurance policies	8	25
Expected return on assets – economic basis	235	308
Total (charge) credit without the effect of IFRIC 14	(166)	256
Effect of the application of IFRIC 14	136	(229)
Pension cost – economic basis[note (i) above and note (b)]	(30)	27
Adjustment for investments in Prudential insurance policies[note (d)]	(8)	(15)
Pension cost - IAS 19 basis (as recognised in the income statement and referred to in note I3a)	(38)	12
Actuarial and other gains and losses		
Actual less expected return on assets	(34)	982
Losses on changes of assumptions for plan liabilities	(273)	(414)
Experience (losses) gains on liabilities	(4)	314
Total (charge) credit without the effect of IFRIC 14	(311)	882
Effect of the application of IFRIC 14	461	(846)
Actuarial gains and losses – economic basis[note (i) above and note (c)]	150	36
Adjustment for investments in Prudential insurance policies[note (d)]	(5)	1
Actuarial gains and losses - IAS 19 basis (as recognised in the income statement and referred to in note I3a)	145	37
Net periodic pension cost (included within acquisition and other operating expenditure in the income statement)	107	49

Notes

(a) Past service cost

– RPI/CPI inflation measure change in 2011

During 2011 the Group altered its inflation measure basis for future statutory increases to pension payments for certain tranches of its UK defined benefit pension schemes. This reflected the UK Government's decision to replace the basis of indexation from RPI with CPI.

The £282 million credit in 2011 shown above comprised £216 million for PSPS and £66 million for other schemes. As noted earlier, the PSPS scheme surplus was not recognised for accounting purposes due to the application of IFRIC 14. The £66 million for other schemes was allocated as £24 million to PAC with-profits fund and £42 million to shareholders as referred to in note C.

– Exceptional discretionary pension increase for PSPS in 2012

During the first half of 2012, an exceptional discretionary increase to pensions in payment of PSPS was awarded which resulted in a past service cost of £106 million.

As the PSPS scheme surplus is substantially not recognised for accounting purposes, these two items had negligible impact on the Group's results.

(b) Consistent with the derecognition of a substantial portion of the Company's interest in the underlying IAS 19 surplus of PSPS, the charge to operating profit based on longer-term investment returns for PSPS reflects the cash cost of contributions for ongoing service of active members (2012: £17 million; 2011: £20 million). 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 (2012: £nil; 2011:£2 million).

(c) The net credit (charge) for actuarial and other gains and losses is recorded within the income statement. Within the Group's supplementary analysis of profit, the shareholders' share of actuarial and other gains and losses (ie net of allocation of the share to the PAC with-profits funds) of £50 million as shown in note ii above (2011:£21 million) is excluded from operating profit based on longer-term investment returns as shown in note B1.

The 2012 actuarial and other gains reflects the positive impact of inflation rate movements in the period, offset by lower discount rates as interest rate falls, and partial recognition of actuarial surplus in PSPS described above.

(d) The adjustments for investments in Prudential insurance policies are consolidation adjustments with no net impact to the operating results.

Total employer contributions expected to be paid into the Group defined benefit schemes for the year ending 31 December 2012 amounts to £56 million (2011: £94 million).

5 Sensitivity of the pension scheme liabilities to key variables

The total underlying Group pension scheme liabilities of £6,059 million (2011: £5,620 million) comprise £5,226 million (2011: £4,844 million) for PSPS and £833 million (2011: £776 million) for the other schemes. The table below shows the sensitivity of the underlying PSPS and the other scheme liabilities at 31 December 2012 and 2011 to changes in discount rates, inflation rates and mortality rates.

	Assumption applied					
	2012	2011	Sensitivity change in assumption	Impact of sensitivity on scheme liabilities on IAS 19 basis	2012	2011
Discount rate	4.4%	4.7%	Decrease by 0.2%	Increase in scheme liabilities by:		
				PSPS	3.3%	3.3%
				Other schemes	4.9%	4.8%
Discount rate	4.4%	4.7%	Increase by 0.2%	Decrease in scheme liabilities by:		
				PSPS	3.1%	3.1%
				Other schemes	4.6%	4.5%
Rate of inflation	RPI: 2.7%	RPI: 2.9%	RPI: Decrease by 0.2%	Decrease in scheme liabilities by:		
				PSPS	0.6%	0.6%
	CPI: 2.0%	CPI: 1.9%	CPI: Decrease by 0.2% with consequent reduction in salary increases	Other schemes	4.3%	4.1%
Mortality rate			Increase life expectancy by 1 year	Increase in scheme liabilities by:		
				PSPS	2.6%	2.7%
				Other schemes	2.4%	2.4%

The sensitivity of the underlying pension scheme liabilities to changes in discount, inflation and mortality rates as shown above does not directly equate to the 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.

I: Other notes continued

I3: Staff and pension plans continued

6 Transfer value of PSPS scheme

At 31 December 2012, it is estimated that the assets of the scheme are broadly sufficient to cover the liabilities of PSPS on a 'buy-out' 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 2012 was £47 million (2011: £40 million).

I4: Share-based payments

a Description of the plans

The Group maintains a number of main share award and share option plans relating to Prudential plc shares, which are described below.

(i) Group Performance Share Plan, previously Restricted Share Plan

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 have been 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.

(ii) Business Unit Performance Plan

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 were based on growth in shareholder capital value on the European Embedded Value basis with performance measured over three years. All awards made are 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. The BUPP awards for the UK business unit are based on the same relative TSR measure applied to GPSP awards. As a result, awards made under the UK BUPP reflect those TSR conditions applied to GPSP awards.

(iii) Savings-related options

The Group maintains four share option schemes satisfied by the issue of new shares: UK-based executive directors and eligible employees are eligible to participate in the Prudential HM Revenue & Customs (HMRC) approved UK savings-related share option scheme. Asia-based executive directors and eligible employees can participate in the equivalent International savings-related share option 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 options are normally exercisable during the six month period following either the third or fifth anniversary of the start of the relevant savings contract. 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.

(iv) Share Incentive Plan

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

(v) Performance-related share awards
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.

(vi) Long-term Incentive Plan
The Prudential Corporation Asia Long-Term Incentive Plan (PCA LTIP) is an incentive plan created in 2008 for senior employees and chief executive officers. Awards under this plan will vest after three years subject to the employee being in employment at the time of vesting without any performance conditions. Awards are 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.

(vii) Annual Incentive Plan
Certain senior executives have Annual Incentive Plans (AIP) 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.

(viii) Other Share awards
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.

b Outstanding options and awards

The following table shows movement in options outstanding under the Group's share-based compensation plans at 31 December 2012 and 2011:

	2012		2011	
Options outstanding under SAYE schemes	**Number of options** millions	**Weighted average exercise price** £	**Number of options** millions	**Weighted average exercise price** £
Beginning of year:	13.3	3.55	12.8	3.4
Granted	2.4	6.29	2.1	4.66
Exercised	(5.7)	2.99	(0.6)	3.98
Forfeited	(0.2)	4.29	(0.2)	3.17
Cancelled	(0.2)	4.32	(0.4)	3.56
Lapsed	(0.2)	4.39	(0.4)	3.94
End of year	9.4	4.54	13.3	3.55
Options immediately exercisable, end of year	0.2	3.88	0.4	4.54

The weighted average share price of Prudential plc for the year ended 31 December 2012 was £7.69 compared to £6.86 for the year ended 31 December 2011.

Movements in share awards outstanding under the Group's share-based compensation plans relating to Prudential plc shares at 31 December 2012 and 2011 were as follows:

	2012	2011
Awards outstanding under incentive plans including conditional options	**Number of awards** millions	**Number of awards** millions
Beginning of year:	26.7	23.9
Granted	8.8	10.3
Exercised	(9.4)	(4.2)
Forfeited	(1.4)	(0.1)
Expired	(1.0)	(3.2)
End of year	23.7	26.7

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 2012.

	Outstanding			Exercisable	
Range of exercise prices	Number Outstanding millions	Weighted average remaining contractual life years	Weighted average exercise prices £	Number exercisable millions	Weighted average exercise prices £
Between £2 and £3	2.8	2.0	2.88	0.1	2.88
Between £4 and £5	4.1	2.3	4.61	0.1	4.24
Between £5 and £6	0.1	0.6	5.60	–	5.67
Between £6 and £7	2.4	3.6	6.29	–	–
	9.4	2.6	4.54	0.2	3.88

The following table provides a summary of the range of exercise prices for Prudential plc options outstanding at 31 December 2011.

	Outstanding			Exercisable	
Range of exercise prices	Number Outstanding millions	Weighted average remaining contractual life years	Weighted average exercise prices £	Number exercisable millions	Weighted average exercise prices £
Between £2 and £3	8.2	1.6	2.88	–	–
Between £3 and £4	–	0.8	3.73	–	3.43
Between £4 and £5	5.0	3.1	4.58	0.3	4.40
Between £5 and £6	0.1	0.9	5.58	0.1	5.53
	13.3	2.2	3.55	0.4	4.54

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

c Fair value of options and awards

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

2012 £			2011 £		
Weighted average fair value			Weighted average fair value		
GPSP	SAYE Options	Awards	GPSP	SAYE Options	Awards
3.91	2.28	6.72	3.88	2.63	6.28

The fair value amounts estimated on the date of grant 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:

	2012		2011	
	GPSP	SAYE Options	GPSP	SAYE Options
Dividend yield (%)	–	3.63	–	3.33
Expected volatility (%)	33.03	34.33	28.90	62.67
Risk-free interest rate (%)	0.31	0.39	1.32	0.89
Expected option life (years)	–	3.24	–	3.48
Weighted average exercise price (£)	–	6.29	–	4.66
Weighted average share price (£)	6.78	8.26	7.32	6.06

Compensation costs for all share-based compensation plans are determined using the Black-Scholes model, Monte Carlo model or other market consistent valuation methods. 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 and UK BUPP, 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.

For the SAYE options, the expected volatility is based on the market implied volatilities for Prudential shares as quoted on Bloomberg. This change (from an estimate based on historic volatility) brings the methodology into line with the approach used to determine the volatility for the GPSP and UK BUPP awards. The Prudential specific at-the-money implied volatilities are adjusted to allow for the different term and discounted exercise price on SAYE options by using information on the volatility surface of the FTSE 100.

Risk-free interest rates are UK gilt rates with projections for three-year and five-year terms to match corresponding vesting periods. Dividend yield is determined as the average yield over a period of 12 months up to and including the date of grant. For the GPSP, volatility and correlation between Prudential and an index constructed from a simple average of the TSR growth of 10 companies is required. For grants in 2012, an average index volatility and correlation of 32 per cent and 76 per cent respectively, were used. For the GPSP, market implied volatilities are used for both Prudential and the components of the index. Changes to the subjective input assumptions could materially affect the fair value estimate.

d Share-based payment expense charged to the income statement

Total expense recognised in the year in the consolidated financial statements related to share-based compensation is as follows:

	2012 £m	2011 £m
Share-based compensation expense	58	48
Amount accounted for as equity-settled	42	44
Carrying value at 31 December of liabilities arising from share-based payment transactions	24	15
Intrinsic value of above liabilities for which rights had vested at 31 December	16	6

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 can be broken down in the following table:

	2012 £	2011 £
Salaries and short-term benefits	13,793,000	12,192,000
Post-employment benefits	1,206,000	1,189,000
Share-based payments	11,787,000	9,734,000
	26,786,000	23,115,000

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 £7,992,000 (2011: £6,571,000), which is determined in accordance with IFRS 2, 'Share-based payments' (see note I4) and £3,795,000 (2011: £3,163,000) of deferred share awards.

Total key management remuneration includes total directors' emoluments of £18,505,000 (2011: £16,212,000) 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.

I: Other notes continued

I6: Fees payable to auditor

	2012 £m	2011 £m
Fees payable to the Company's auditor for the audit of the Company's annual accounts	2.0	2.1
Fees payable to the Company's auditor and its associates for other services:		
Audit of subsidiaries pursuant to legislation	6.5	6.1
Audit-related assurance services	3.2	2.6
Tax compliance services	0.5	0.6
Other assurance services	0.5	0.5
Services relating to corporate finance transactions	0.4	0.5
All other services	1.2	0.3
Total	14.3	12.7

In addition, there were fees incurred of £0.1 million (2011: £0.1 million) for the audit of pension schemes.

The above audit fees for 2012 and 2011, reflect the new disclosure requirements of SI2011/2198 – The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) (Amendment) Regulations 2011.

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, Open-Ended Investment Companies (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.

In 2012 and 2011, 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.

Apart from these transactions with directors, 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.

I8: Subsidiary undertakings

i Principal subsidiaries
The principal subsidiary undertakings of the Company at 31 December 2012, 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.

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 2013, the maximum amount of dividends that could be paid by the US insurance sub-group, subject to the availability of earned surplus, without prior regulatory approval is US$352 million (£216 million) (in 2012: US$411 million (£264 million)). The Group's subsidiaries in Asia may remit dividends to the Group, in general, provided the statutory insurance fund meets the capital adequacy standard required under local statutory regulations and has sufficient distributable reserves.

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.

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.

	2012 £m	2011 £m
Future minimum lease payments for non-cancellable operating leases fall due during the following periods:		
Not later than 1 year	74	66
Later than 1 year and not later than 5 years	199	173
Later than 5 years	116	72

The total minimum future sublease rentals to be received on non-cancellable operating leases for land and buildings for the year ended 31 December 2012 were £18 million (2011: £18 million).

Minimum lease rental payments for the year ended 31 December 2012 of £73 million (2011: £74 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 2012 were £5 million (2011: £9 million).

I: Other notes continued

I10: Cash flows

Structural borrowings of shareholder-financed operations comprise of core debt of the parent company, the PruCap bank loan 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.

I11: Post balance sheet events

In January 2013, the Company issued US$700 million 5.25 per cent Tier 1 perpetual subordinated capital securities. The proceeds, net of costs, were US$689 million. The Company also repaid on maturity, the £250 million Medium-Term Notes 2013, included within operational borrowings in note H13 in January 2013.