

**Registered Number 2554213**

**Prudential Annuities Limited**

**Annual Report and Financial Statements  
For the year ended 31 December 2012**

# Prudential Annuities Limited

Incorporated and registered in England and Wales Registered Number 2554213  
Registered Office: Laurence Pountney Hill, London, EC4R 0HH

<b>Contents</b>	<b>Page</b>
Directors and officers	2
Directors' report	3-12
Statement of directors' responsibilities	13
Independent auditor's report	14-15
Profit and loss account	16-17
Reconciliation of movement in Shareholders' Funds	17
Balance sheet	18-19
Notes to the financial statements	20-49

## **Prudential Annuities Limited**

### **Directors**

R A Devey (Chairman)  
D J Belsham  
A M Crossley  
F A O'Dwyer

### **Secretary**

Prudential Group Secretarial Services Limited

### **Auditors**

KPMG Audit Plc, London

# Prudential Annuities Limited

## Directors' report for the year ended 31 December 2012

### Company Registration number

The Company Registration number is 2554213.

### Principal activity

The principal activity of Prudential Annuities Limited (the Company) is to pay annuities to existing annuitants as it is not currently writing new business. This will continue in 2013.

The Company ceased to accept annuity business reassured from group companies during 2004. This represented the majority of the Company's new business.

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

### Business review

Following the recapture of the majority of the annuities reinsured from the Prudential Assurance Company (PAC) into the Company in 2011, the remaining annuities reinsured from the With-Profits Sub Fund (WPSF) of PAC into the Company were recaptured as at 30 September 2012. As at 31 October 2012 the remaining annuities, net of a small outward reinsurance, insured by the Company were 100% reinsured on a quota share basis to the WPSF of PAC; this arrangement allows for the reinsured assets to be deposited back with the Company. The Boards of PAC and the Company agreed that the recapture and reinsurance premiums should be equal to the value of business transferring or being reinsured into PAC, as measured on the prudent statutory basis ('Pillar I, Peak 1'). As the value of premiums paid to PAC was greater than the reduction in the UK GAAP valuation of the net of reinsurance liabilities, this resulted in a loss on ordinary activities.

The remaining assets and liabilities of the Company have increased during 2012 as a result of a decrease in the yield on the underlying assets, partially offset by the payment of annuity claims.

The Company's conventional annuities include level, fixed increase and inflation linked annuities. The fixed increase annuities incorporate automatic increases in annuity payments by fixed amounts over the policyholder's life. The inflation linked annuities that the Company offers provide for a regular annuity payment which changes periodically based on the change in UK inflation, which, for the majority of policies, is determined by reference to the Retail Price Index (RPI).

The Company remained in a satisfactory financial position at 31 December 2012.

### Performance and measurement

The following table sets out the key performance indicators for the Company.

Key Performance Indicators	2012 £m	2011 £m
Loss on ordinary activities before tax	(454)	(21)
Shareholder funds	1,085	1,422
Dividends paid	-	400

# **Prudential Annuities Limited**

## **Directors' report for the year ended 31 December 2012 (continued)**

### **Results and dividends**

The state of affairs of the Company at 31 December 2012 is shown in the balance sheet on pages 18 and 19. The profit and loss account appears on pages 16 and 17. No dividends were paid during the year (2011: £400m).

### **Share capital**

There were no changes in share capital during the year (2011: 100,000,000 £1 Ordinary shares were issued at par during the year).

### **Risks and uncertainties**

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

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

A number of risk factors (both financial and non-financial) affect the Company's results and financial condition. The key risk factors of the Company, mentioned below, should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties. The Company's exposure to financial risk through its financial assets and liabilities is provided in detail in Note 8 of the notes to the financial statements.

#### Financial risks

The Company is exposed to financial risk through its financial assets, financial liabilities, and policyholder liabilities. The key financial risk factors affecting the Company are longevity risk, credit risk and market risk.

The current uncertainty in local and international economic and investment climates has increased financial risks and this could adversely affect the Company's business and profitability. Since 2008 the Company has had to operate against a challenging background of periods of unprecedented volatility in global capital and equity markets, interest rates, liquidity, and the broader economic environment. Government interest rates have also fallen to historic lows in the US and the UK.

In recent times, the global financial markets have experienced, further volatility brought on, in particular, by concerns over European sovereign debt, as well as concerns about a general slowing of global demand reflecting an increasing lack of confidence among consumers, companies and governments. The demand for insurance products may also be adversely affected. If sustained, this environment is likely to have a negative impact on the insurance sector over time and may consequently have a negative impact on the Company's profitability. New challenges related to market fluctuations and general economic conditions may continue to emerge.

## Prudential Annuities Limited

### Directors' report for the year ended 31 December 2012 (continued)

#### Risks and uncertainties (continued)

##### Financial risks (continued)

###### (a) Market risk

*Market risk is the risk of loss for the Company, or of adverse change in the financial situation, resulting directly or indirectly, from fluctuations in the level of volatility of market prices of assets and liabilities and changes in interest rates and exchange rates.*

The Company is exposed to market risk as a result of its holdings in property assets and mismatch between asset and liability interest rates and inflation exposures.

The current uncertainty in local and international economic and investment climates has increased market risk due to uncertainty in levels of asset returns, interest rates and inflation. The Company aims to manage these risks by having investment limits in place for property investments and closely matching its asset and liability cashflows.

In common with other industry participants, the profitability of the Company's businesses ultimately depends on a mix of factors including investment performance and impairments, longevity trends and unit cost of administration.

###### (b) Credit risk

*Credit risk is the risk of loss to the Company resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors in the form of default or other significant credit event (e.g. downgrade or spread widening).*

The Company is exposed to significant credit risk which is also one of the largest risks for the Company. Credit risk arises mainly from the corporate bond holdings backing the annuity business.

The global financial crisis has exacerbated credit risk as corporate borrowers are experiencing a challenging business environment and volatile profits and cash flows. This has resulted in increased risk of credit losses through defaults and widening of credit spreads on corporate bonds. This is a material risk for the Company and is managed by careful management of the corporate bond portfolio and having appropriate concentration and credit rating limits in place.

###### (c) Insurance risk

*Insurance risk is the risk of loss or of adverse change in the value of insurance liabilities of the Company, resulting from changes in the level, trend or volatility of a number of insurance risk drivers. This includes adverse longevity, mortality, morbidity, persistency and expense experience.*

The Company is exposed to significant insurance risk which is also one of the largest risks for the Company. Insurance risk arises mainly in the form of longevity risk, which is the risk that the Company's annuity customers live longer than allowed for in the Company's pricing and reserving assumptions and as a result future reserving and capital assumptions are changed. The Company conducts rigorous research into longevity risk, using data from its annuitant portfolio. As part of its pension annuity pricing and reserving policy, the Company assumes that current rates of mortality continue to improve over time at levels based on the Company's calibration of the Continuous Mortality Investigations (CMI) 2011 mortality projection model as published by the Institute and Faculty of Actuaries. If mortality improvement rates significantly exceed the improvement assumed, the Company's operating results could be adversely affected. Also any major medical breakthrough (for example in the treatment of cancer or other life-threatening diseases) that would require the Company to strengthen its longevity assumptions will have an impact on the Company's results.

## Prudential Annuities Limited

### Directors' report for the year ended 31 December 2012 (continued)

#### Risks and uncertainties (continued)

##### Financial risks (continued)

##### (c) Insurance risk (continued)

The Company is also exposed to expense risk which is the risk of the actual expenses exceeding the assumptions in pricing and reserving. If the actual expenses exceed these assumptions, the Company's operating results could be adversely impacted.

##### (d) Liquidity risk

*Liquidity risk is the risk that the Company, although solvent on a balance sheet basis, does not have sufficient cash resources available to meet its obligations as they fall due, or can secure them only at excessive cost.*

Liquidity risk is not a material risk for the Company. This risk is managed through careful management of bank balances, cash-flow forecasting, appropriate fund management (to ensure that assets are not unduly concentrated in less liquid investments) and detailed cash-flow matching for the annuity business

##### Non-financial risk

The Company is exposed to business environment, strategic, operational and group risk.

##### (a) Business environment risk

*Business environment risk is the exposure to forces in the external environment that could significantly change the fundamentals that drive the Company's overall strategy.*

The Company conducts its business subject to regulation and the associated regulatory risks, and is therefore exposed to changes in laws and regulations that affect the products and markets in which it operates.

Changes in government policy, legislation (including tax) or regulatory interpretation applying to UK insurance companies may be applied retrospectively, may adversely affect the Company's product range, distribution channels, capital requirements and, consequently, reported results and financing requirements.

The material regulatory and legal change risks currently faced by the Company are:

- Solvency II - The EU is harmonising the solvency framework for insurance companies across Europe based on the concept of three pillars — minimum capital requirements, supervisory review of firms' risk management system, and enhanced disclosure requirements. This will cover valuations, the treatment of insurance groups and companies, the definition of capital and the level of capital required. A key aspect of Solvency II is that the assessment of risks and capital requirements will be aligned more closely with economic capital methodologies, and may allow the Company to make use of its internal economic capital models, if approved by the relevant supervisory authority. Although the Solvency II Directive was formally approved by the Economic and Financial Affairs Council in November 2009 the Solvency II implementation date has been postponed from 1<sup>st</sup> January 2014 and the new date is yet to be confirmed.

## Prudential Annuities Limited

### Directors' report for the year ended 31 December 2012 (continued)

#### Risks and uncertainties (continued)

##### Non-financial risk (continued)

##### (a) Business environment risk (continued)

- Discussions are on-going within the European Parliament to agree the Omnibus II Directive and to develop the detailed rules that will complement the high-level principles of the Directive, referred to as 'implementing measures'. Agreement to the Omnibus II Directive is now expected to be finalised during 2013 with the implementing measures expected to be finalised later in 2013 or 2014. There is significant uncertainty regarding the final outcome of this process. As a result there is a risk that the effect of the measures finally adopted could be adverse for the Company, including potentially a significant increase in capital required to support its business and that the Company may be placed at a competitive disadvantage to other European and non-European financial services groups.
- The split of regulation in the UK in 2013 between the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) may give rise to new requirements and regulatory expectation of the Company.
- Any further changes or modification to Financial Reporting Standards, or adoption of International Financial Reporting Standards (IFRS) may require a change in the reporting basis of future results, or a restatement of reported results.
- Changes in tax legislation could affect the Company's financial condition and results of operations.

The annuities market in the UK is highly competitive affecting the Company's ability to sell its products and its continued profitability. Gender Neutral Pricing from the end of 2012, and the growth in more selective annuity providers focusing on impaired life annuities, may increase the Company's exposure to anti-selection risk in the future.

The uncertain economic environment and low interest rates may reduce consumer confidence and their propensity to buy retirement products. The customer demographics and the employment and retirement preferences are changing and this may lead to individuals deferring their retirement; that could alter the profile of pension maturities in the future, such that it does not materialise in line with the projections planned.

##### (b) Strategic risk

*Strategic risk is the risk of ineffective, inefficient or inadequate senior management processes for the development and implementation of business strategy in relation to the business environment and the Company's capabilities.*

The strategic importance of annuity products means the Company is dependent on being able to continue to deliver profitable volumes from these lines of business and that unplanned regulatory or legal changes do not adversely impact customer or advisor behaviour for this business. The concentration leaves the Company's UK business at risk to a significant change in its business model arising from future regulatory developments.



## **Prudential Annuities Limited**

### **Directors' report for the year ended 31 December 2012 (continued)**

#### **Risks and uncertainties (continued)**

##### Non-financial risk (continued)

##### (c) Operational risk

*Operational risk is the risk of loss arising from inadequate or failed internal processes, or from personnel and systems, or from external events.*

The Company is exposed to operational risk in the ordinary course of its business and as a result may be subject to unplanned costs, regulatory fines or legal actions and disputes.

The Company operates in a mature and highly regulated environment where the pace of regulatory change has intensified making regulatory compliance a key risk. In addition to the level of change experienced, regulatory relationships have become more intrusive particularly around product development, distribution processes, complaint handling and breach management. There has been an increase in fines and regulatory sanctions imposed on firms.

The Company's activities involve processing annuities in payment and as a result it is exposed to the risks of data integrity and transaction processing errors. The Company outsources inter-company and intra-group several operations, including investment management, customer-facing functions, support and IT activities. The Company is therefore reliant upon the operational processing performance of its outsourcing partners, and their performance is monitored carefully.

The Company's systems and processes incorporate controls which are designed to manage the operational risks associated with its activities as any weakness in the administration systems, finance systems and processes or actuarial reserving process could have an impact on its results during the effected period.

Further, because of the long-term nature of much of the Company's business, accurate records have to be maintained for significant periods.

##### (d) Group risk

Group risk is the risk associated with being part of a group, particularly as a result of contagion.

Being a member of a group can provide significant advantages for the Company in terms of diversification of risk, financial strength, technical expertise and management experience. It can also give rise to risks; if a guarantee of financial support given by the parent were removed, or from particular transactions arising from an impaired parent or affiliate within the group. The independent capitalisation of the Company as well as the risk management processes and internal control mechanisms within the Company ensure group risk is appropriately managed.

#### **Corporate responsibility**

The Company is a wholly owned subsidiary within the Prudential Group and Corporate Responsibility (CR) is integral to the way the Group does business.

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

## **Prudential Annuities Limited**

### **Directors' report for the year ended 31 December 2012 (continued)**

#### **Corporate responsibility (continued)**

As a business that provides savings, income, investment and protection products and services the Group creates social value through its day-to-day operations. First, the Group provides customers with ways to help manage uncertainty and build a more secure future. Second, by playing a key role in financial markets, the Group provides long-term capital that finances businesses, builds infrastructure and fosters growth in both developed and developing countries.

The Group aims to be sustainable in the broadest sense – financially, socially and environmentally. Sustainability is integral to the way it does business. Prudential has long-term liabilities and investments, and its commitments to its customers and its employees, as well as its support for communities and its responsibility towards the environment, are rooted in its aim of continuing to deliver strong financial performance sustainably.

The Group believes that CR is best managed on the ground by those closest to the customer and local stakeholders. Underpinning this approach are the Group's four global CR themes:

1. Customers: Using the Group's financial strength, knowledge and skills to provide fair and transparent products, which meet customers' needs;
2. People: Recruiting, developing and retaining the best people for the best-performing business;
3. The environment: Increasing the efficiency of the Group's business by reducing the direct impact of the properties it occupies and the properties it manages as part of its investment portfolio;
4. Communities: Supporting its communities through donations, employee volunteering and long-term partnerships with charitable organisations that make a real difference.

These themes demonstrate the Group's CR commitments and principles to its stakeholders and provide clarity to its businesses, including the Company, on where they should focus their CR efforts and resources in the context of their individual markets.

The Prudential plc Board discusses Prudential's performance in the areas of social and environmental management at least once a year and also reviews and approves Prudential's corporate responsibility report and strategy on an annual basis.

#### **Solvency II and other global regulatory developments**

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

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

## **Prudential Annuities Limited**

### **Directors' report for the year ended 31 December 2012 (continued)**

#### **Solvency II and other global regulatory developments (continued)**

A key aspect of Solvency II is that the assessment of risks and capital requirements are intended to be aligned more closely with economic capital methodologies and may allow Prudential to make use of internal economic capital models if approved by the FSA or other relevant supervisory authority.

Representatives from the European Parliament, the European Commission and the Council of the European Union are currently discussing the Omnibus II Directive which, once approved, will amend certain aspects of the original Solvency II Directive. In addition the European Commission is continuing to develop, in consultation with stakeholders including industry, the detailed rules that will complement the high-level principles in the Solvency II Directive, referred to as 'implementing measures'. The Omnibus II Directive is not currently scheduled to be finalised until late 2013, while the implementing measures cannot be finalised until after Omnibus II.

There is a significant uncertainty regarding the final outcome from this process. In particular, the Solvency II rules relating to the determination of the liability discount rate remain unclear and the capital position of the Prudential Group, of which the Company is a part, is sensitive to these outcomes. With reference to the liability discount rate, solutions to remove artificial volatility from the balance sheet have been suggested by policymakers as the regulations continue to evolve. These solutions are continuing to be considered by policymakers as part of the process to reach agreement on the Omnibus II Directive. There is a risk that the effect of the measures finally adopted could be adverse for the Prudential Group and the Company, including potentially that a significant increase in capital may be required to support its business and that the Prudential Group and the Company may be placed at a competitive disadvantage to other European and non-European financial services groups. The Prudential Group is actively participating in shaping the outcome through its involvement in industry bodies and trade associations, including the Chief Risk Officer and Chief Financial Officer Forums, together with the Association of British Insurers and Insurance Europe (formerly known as the Comité Européen des Assurances).

The delays in finalising the Omnibus II Directive and implementing measures are expected to result in a deferral of the Solvency II implementation date for firms beyond the previously anticipated date of 1 January 2014. At this stage, it remains unclear exactly when Solvency II will come into force, although a deferral until 1 January 2016 or beyond appears likely.

Having assessed the requirements of Solvency II, an implementation programme was initiated with dedicated teams to manage the required work across the Group. The activity of the local Solvency II teams is being coordinated centrally to achieve consistency in the understanding and application of the requirements. The Prudential Group is continuing its preparations to adopt the regime when it eventually arrives and is undertaking in parallel an evaluation of the possible actions to mitigate its effects. The Prudential Group regularly reviews its range of options to maximise the strategic flexibility of the Group. This includes consideration of optimising the Group's domicile as a possible response to an adverse outcome on Solvency II.

Over the coming months the Prudential Group will be progressing its implementation plans and remain in regular contact with the FSA as it continues to engage in the 'pre-application' stage of the approval process for the internal model.

Currently there are also a number of other prospective global regulatory developments which could impact the way in which the Prudential Group and the Company is supervised. These include the work of the Financial Stability Board (FSB) on Globally Systemically Important Financial Institutions (G-SIFIs) and the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) being developed by the International Association of Insurance Supervisors (IAIS).

## **Prudential Annuities Limited**

### **Directors' report for the year ended 31 December 2012 (continued)**

#### **Solvency II and other global regulatory developments (continued)**

As part of a global initiative to identify G-SIFIs, in May 2012, the IAIS published proposed assessment methodology for designating Globally Systematically Important Insurers (G-SIIs). For those groups that are designated by the FSB as G-SII then additional policy measures including enhanced supervision and higher loss absorbency requirements could be proposed. Further detail of the proposals is expected during 2013 and implementation is likely to be over a period of years. Furthermore, the FSA is considering the designation of Domestically Systemically Important Insurer (DSII) for those UK insurers that are significant in UK terms. It is not yet clear what the impact of this designation may be.

ComFrame is also being developed by the IAIS to provide common global requirements for supervision of insurance groups. The framework is designed to develop common principles for supervision and so may increase the focus of regulators in some jurisdictions. It is also possible that some prescriptive requirements, including group capital, could be proposed. Further clarity on ComFrame is expected during the second half of 2013.

#### **Payment policy**

The Company does not have any trade creditors and therefore codes or standards on payment practice and disclosure of trade creditor days are not applicable.

#### **Directors**

The present directors are shown on page 2. There have been no changes during the year.

#### **Disclosure to auditors**

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

#### **Auditor**

In accordance with section 487(2) of the Companies Act 2006, KPMG Audit Plc will be deemed to be re-appointed auditors of the Company for the current financial year.

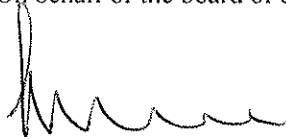
## **Prudential Annuities Limited**

### **Directors' report for the year ended 31 December 2012 (continued)**

#### **Directors' and officers' protection**

Prudential plc has arranged appropriate insurance cover in respect of legal action against directors and senior managers of companies within the Prudential Group. In addition, the Articles of Association of the Company permit for the directors, officers and employees of the Company to be indemnified in respect of liabilities incurred as a result of their office. Prudential plc also provides protections for directors and senior managers of companies within the Group against personal financial exposure they may incur in their capacity as such. These include qualifying third party indemnity provisions (as defined by the relevant Companies Act) for the benefit of directors of Prudential plc including, where applicable, in their capacity as a director of the Company and other companies within the Group. These indemnities were in force during 2012 and remain in force.

On behalf of the board of directors.



S D Windridge  
Prudential Group Secretarial Services Limited  
Company Secretary  
25 March 2013

## **Prudential Annuities Limited**

### **Statement of directors' responsibilities in respect of the Directors' report and the financial statements**

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

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

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

In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

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

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



A M Crossley  
Director

25 March 2013

## **Prudential Annuities Limited**

### **Independent Auditor's report to the members of Prudential Annuities Limited**

We have audited the financial statements of Prudential Annuities Limited for the year ended 31 December 2012 set out on pages 16 to 49. The financial reporting framework that has been applied in their preparation is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

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

#### **Respective responsibilities of directors and auditor**

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

Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

#### **Scope of the audit of the financial statements**

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at [www.frc.org.uk/auditscopeukprivate](http://www.frc.org.uk/auditscopeukprivate)

#### **Opinion on financial statements**

In our opinion the financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 December 2012 and of its loss for the year then ended;
- have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

#### **Opinion on other matter prescribed by the Companies Act 2006**

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

## **Prudential Annuities Limited**

### **Independent Auditor's report to the member of Prudential Annuities Limited (continued)**

#### **Matters on which we are required to report by exception**

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

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



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

25 March 2013



## Prudential Annuities Limited

### Profit and Loss Account for the year ended 31 December 2012

<b>Long Term Business - Technical Account</b>	Note	2012 £m	2011 £m
Intragroup reinsurance accepted	2(a)	(47)	(7,650)
Outward reinsurance premium		(5,944)	-
<b>Earned premium, net of reinsurance</b>		<b>(5,991)</b>	<b>(7,650)</b>
Investment income	3	1,466	1,303
Unrealised (losses) on investments		(931)	(45)
		535	1,258
<b>Claims incurred, net of reinsurance</b>			
Claims paid		(266)	(697)
<b>Change in other technical provisions, net of reinsurance</b>			
Long term business provision, net of reinsurance	11	3,468	6,674
Technical provision for linked liabilities, net of reinsurance	11	1,847	280
		5,315	6,954
<b>Net operating expenses</b>			
Administrative expenses		(3)	(11)
Investment expenses and charges		(112)	(9)
		(115)	(20)
<b>Tax attributable to the long term business</b>		<b>132</b>	<b>53</b>
<b>Balance on the technical account – long term business</b>		<b>(390)</b>	<b>(102)</b>

The amounts shown above are in respect of continuing operations.

The accounting policies and notes on pages 20 to 49 form an integral part of these financial statements.

## Prudential Annuities Limited

### Profit and Loss Account for the year ended 31 December 2012 (continued)

<b>Non-Technical Account</b>	Note	<b>2012 £m</b>	<b>2011 £m</b>
<b>Balance on the long term business technical account</b>		<b>(390)</b>	<b>(102)</b>
Tax attributable to the balance on the long term business technical account		<b>(132)</b>	<b>(53)</b>
Investment income	3	<b>41</b>	101
Unrealised gains on investments		<b>28</b>	34
Investment expenses and charges		<b>(1)</b>	<b>(1)</b>
<b>(Loss) on ordinary activities before tax</b>		<b>(454)</b>	<b>(21)</b>
Tax on (loss) on ordinary activities	5(a)	<b>117</b>	19
<b>Loss for the financial year</b>	11	<b>(337)</b>	<b>(2)</b>

The Company has no recognised gains or losses other than those reported in the profit and loss account.

In accordance with the amendment to Financial Reporting Standard 3 (FRS 3) published in June 1999 no note of historical cost profits has been prepared as the Company's only material gains and losses on assets relate to the holding and disposal of investments.

### Reconciliation of movement in Shareholders' Funds

Year ended 31 December 2012

	<b>2012 £m</b>	<b>2011 £m</b>
Shareholders' capital and reserves at beginning of year	<b>1,422</b>	1,824
Dividend Paid	-	(400)
Retained (loss) for the financial year	<b>(337)</b>	<b>(2)</b>
<b>Shareholders' capital and reserves at end of year</b>	<b>1,085</b>	1,422

The amounts shown above are in respect of continuing operations.

The accounting policies and notes on pages 20 to 49 form an integral part of these financial statements.

## Prudential Annuities Limited

### Balance sheet as at 31 December 2012

ASSETS	Note	2012 £m	2011 £m
<b>Investments</b>			
Land and buildings		588	579
Other financial investments		4,929	4,690
	8	5,517	5,269
<b>Assets held to cover linked liabilities</b>			
	10	-	1,847
<b>Reinsurers' share of technical provisions</b>			
Long term business provision	11	3,639	5
Technical provision for linked liabilities	11	1,921	2
		5,560	7
<b>Debtors</b>			
Other debtors	13	5	11
<b>Other assets</b>			
Cash at bank and in hand	17	164	191
<b>Prepayments and accrued income</b>			
Accrued interest and rent		72	70
<b>Total assets</b>	2(b)	<b>11,318</b>	<b>7,395</b>

The accounting policies and notes on page 20 to 49 form an integral part of these financial statements.

## Prudential Annuities Limited

### Balance sheet as at 31 December 2012 (continued)

<b>LIABILITIES</b>	Note	<b>2012 £m</b>	<b>2011 £m</b>
<b>Capital and reserves</b>			
Called up share capital	18	650	650
Profit and loss account	11	435	772
<b>Total shareholders' funds</b>		<b>1,085</b>	<b>1,422</b>
<b>Technical provisions</b>			
Long term business provision	11	3,639	3,473
Claims outstanding	11	1	1
<b>Technical provisions for linked liabilities</b>	11	<b>1,921</b>	<b>1,849</b>
<b>Provision for other risks and charges</b>			
Deferred tax	14	-	133
<b>Creditors</b>			
Derivative liabilities	8	200	237
Creditors arising out of reinsurance operations		44	-
Deposits from ceding undertakings	15	4,116	-
Amounts owed to credit institutions		295	229
Other creditors including taxation and social security	16	17	51
		<b>4,672</b>	<b>517</b>
<b>Total liabilities</b>		<b>11,318</b>	<b>7,395</b>

The financial statements on pages 16 to 49 were approved by the board of directors on 25 March 2013.



A M Crossley  
Director

The accounting policies and notes on page 20 to 49 form an integral part of these financial statements.

# Prudential Annuities Limited

## Notes to the financial statements for the year ended 31 December 2012

### 1. Accounting Policies

#### (a) Changes in accounting policies

In 2012, the Company adopted "Amendments to FRS29 (IFRS 7) - Financial Instruments: Disclosures - Disclosures - Transfers of Financial Assets", which had no material impact on the financial statements of the Company.

#### (b) Basis of preparation

The financial statements are prepared in accordance with Part 15 of the Companies Act 2006 and Schedule 3 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

The financial statements comply with applicable accounting standards and the 2005 ABI SORP, updated on 21 December 2006, and have been prepared under the historical cost accounting rules, modified to include the revaluation of investments.

The Company has not presented a capital position statement with supporting disclosures under FRS 27 on the basis that the Company is more than 90 per cent owned within a group and the Company is included in the publicly available Prudential Group financial statements which provide information on a group basis complying with this requirement. The process for setting assumptions and determining liabilities, as required to be disclosed by FRS 27, is described in Note 12 of the financial statements (together with key assumptions).

The directors have a reasonable expectation that the Company will be able to continue in operational existence for the foreseeable future and thus continue to adopt the going concern basis of accounting in preparing the financial statements.

This conclusion has been based upon the following: the Company is a subsidiary within the Prudential Group and it, its parent company and the ultimate parent company are continuing to trade and there are no plans for liquidation, the Company has a healthy solvency margin, well in excess of the Minimum Capital Requirement (MCR) and Enhanced Capital Requirement (ECR) (Note 9), and has very low debt financing. In addition consideration has also been given to the Company's performance, the market in which it operates, its strategy and risks and uncertainties, as set out in the Business Review on page 3, and the management of financial risk as set out in Note 8, including its exposure to liquidity risk and credit risk.

#### (c) Long term business

Under FRS 26, the measurement basis of assets and liabilities of long term business contracts is dependent upon the classification of the contracts as either insurance contracts, if the level of insurance risk is significant, or investment contracts if the risk is insignificant. The Company's contracts are all classed as insurance contracts.

Annuity considerations are accounted for when due. Annuities are accounted for when the annuity becomes due for payment. Surrenders are accounted for when paid. Death claims and all other claims are accounted for when notified. Index linked business has been disclosed as linked for the purposes of these financial statements. Investment income and realised and unrealised investment gains attributable to long term business are credited to the long term business technical account.

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 1. Accounting Policies (continued)

##### (d) Investments

###### (i) *Land and buildings*

Land and buildings are valued annually by a number of different professional external valuers on a Market Value basis, as defined in the Appraisal and Valuation Manual issued by the Royal Institute of Chartered Surveyors, in particular Practice Statement 3.2. No depreciation is provided on land and buildings, held for investment purposes, in accordance with Statement of Standard Accounting Practice 19, Accounting for Investment Properties.

On a historical cost basis buildings are depreciated over 40 years. Leasehold buildings are depreciated over 40 years, or if the lease is less than 40 years, over the length of the lease.

###### (ii) *Realised gains and losses on investments*

Realised gains and losses on investments represent the difference between net proceeds on disposal and the purchase price.

###### (iii) *Unrealised gains and losses on investments*

Unrealised gains and losses on investments represent the difference between the change in the value of investments held at the balance sheet date and the reversal of unrealised investment gains and losses recognised in earlier accounting periods in respect of investment disposals.

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

###### (iv) *Financial investments at fair value through profit and loss*

This comprises assets designated by management as fair value through profit and loss on inception and derivatives which are deemed to be held for trading. These investments are valued at fair value with all changes thereon being recognised in the profit and loss account.

The Company uses bid prices to value its quoted financial investments. Actively traded investments without quoted prices are valued using external broker bid prices. If there is no active established market for an investment, the Company applies an appropriate valuation technique such as discounted cash flow technique.

###### (v) *Loans and receivables*

This comprises investments that have fixed or determinable payments and are not designated as fair value through profit and loss or available-for-sale. These investments include loans secured by mortgages, deposits and other unsecured loans and receivables. These investments are carried at amortised cost using the effective interest method and subject to impairment reviews. The Company measures the amount of the impairment loss by comparing the amortised cost with the present value of its estimated future cash flows discounted at the original effective interest rate.

## **Prudential Annuities Limited**

### **Notes to the financial statements for the year ended 31 December 2012 (continued)**

#### **1. Accounting Policies (continued)**

##### **(e) Long term business provision**

The long term business provision is determined by the Company's directors based on advice from the Company's Actuarial Function Holder, who determined the provision using recognised actuarial methods, with due regard to the actuarial principles laid down in Directive 2002/83/EC.

It is calculated initially on a statutory solvency basis to comply with the reporting requirements under the Financial Services and Markets Act 2000. The valuation is then modified to remove certain resilience, contingency and other reserves required by the Prudential Sourcebook for Insurers and the General Prudential Sourcebook issued by the Financial Services Authority.

The technical provisions are the discounted value of future claim payments, adjusted for investment expenses and future administration costs. Claim payments allow for the effects of mortality in line with the bases set out in Note 12. These bases have been derived from an analysis of recent population and internal mortality experience and include an allowance for improvements in mortality in the future.

The interest rates used for discounting claim payments are derived from the yield on the assets held and make allowance for potential defaults on those assets (see Note 12). Long term rates of default appropriate to the assets held have been set based on an investigation into historic rates of default by credit rating, term to redemption and security. An additional short term default provision is held to reflect market conditions at the valuation date.

##### **(f) Cash flow statement**

The Company has availed itself of the exemption from preparing a cash flow statement allowed under section 5(a) of FRS 1, "Cash Flow Statements", on the grounds that it is a wholly owned subsidiary of Prudential plc which publishes a consolidated cash flow statement incorporating the cash flows of the Company.

##### **(g) Taxation**

Tax is charged on all taxable profits arising in the accounting period.

The UK Government has made substantial changes to the rules relating to the taxation of life insurance companies, effective from 1 January 2013. Until the end of 2012, shareholders' taxable profits are calculated using regulatory surplus as a starting point, with appropriate deferred tax adjustments for UK GAAP. Beginning in 2013, under new life tax rules, taxable profits will be calculated using accounting profit or loss as a starting point.

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

##### **(h) Foreign Currencies**

Foreign currency revenue transactions are translated at the rate applied at the time of execution. Monetary foreign currency assets and liabilities are translated at year end exchange rates. Exchange differences are included in the profit and loss account.

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 1. Accounting Policies (continued)

##### (i) Reinsurance

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

#### 2. Segmental analysis

##### (a) Intragroup reinsurance accepted

	2012 £m	2011 £m
<b>Recapture of Annuities to a related party:</b>		
- Immediate annuities	(47)	(7,650)

All premiums are single premium business written in the United Kingdom. Group pension schemes included in external premiums are £Nil (2011: £Nil). The above amounts represent the recapture of the majority of the annuities reinsured from PAC into the Company in 2011, and the remainder were recaptured as at 30 September 2012.

##### (b) Assets attributable to the long term business fund

Of the total assets shown on page 18, £10,233m (2011: £6,606m) is attributable to the long term business fund.



## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 3. Investment income

	Long term business technical account		Non technical account	
	2012 £m	2011 £m	2012 £m	2011 £m
Income from equity securities	9	14	1	-
Income from land and buildings	37	38	-	-
Income from debt securities	220	513	36	41
Income from mortgage loans and other loans	2	7	-	-
Income from derivatives	(5)	4	-	-
Gains on the realisation of investments other than derivatives	1,127	725	4	60
Gains on the realisation of derivatives	74	-	-	-
Exchange gains	2	2	-	-
	<b>1,466</b>	<b>1,303</b>	<b>41</b>	<b>101</b>

#### 4. Staff costs

The Company has no employees (2011: Nil). Included within net operating expenses are amounts paid in return for management services provided to the Company by other group companies.

#### 5. Tax on profit on ordinary activities

##### (a) Analysis of charge in the period

	2012 £m	2011 £m
<b>Current Tax</b>		
UK Corporation tax on profits of the period	19	86
Adjustments in respect of previous periods	(2)	-
	<b>17</b>	<b>86</b>
<b>Deferred Tax</b>		
Origination and reversal of timing differences	(134)	(105)
	<b>(134)</b>	<b>(105)</b>
Tax (credit) on (losses) on ordinary activities	<b>(117)</b>	<b>(19)</b>

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 5. Tax on profit on ordinary activities (continued)

##### (b) Factors affecting tax charge for the period

	2012 £m	2011 £m
(Loss) on ordinary activities before tax	(454)	(21)
(Loss) on ordinary activities multiplied by effective rate of corporation tax in the UK of 24.5% (2011: 26.5%)	(111)	(6)
<i>Effects of</i>		
Adjustments in respect of previous periods	(2)	-
Timing differences		
- Transfer from the non-technical account in excess of the statutory surplus	130	100
Utilisation of tax losses brought forward	-	(8)
Current tax charge for the period	17	86

#### 6. Auditors' remuneration

Fees payable to KPMG Audit Plc (KPMG) for the audit of the Company's accounts and the Company's reporting pack for the Parent's consolidated accounts were £16,000 (2011: £24,000). Fees payable to KPMG for other services pursuant to legislation, including the audit of the regulatory return were £4,000 (2011: £6,000).

#### 7. Directors' emoluments

During the year, the directors received the following emoluments in respect of work on behalf of the Company.

	2012 £	2011 £
Aggregate emoluments and non-pension benefits	29,416	84,269

During the year four (2011: four) directors were entitled to shares under the Prudential's main long term incentive scheme. Two directors are entitled to retirement benefits under defined benefit schemes and three directors participate in the defined contribution scheme.

The aggregate of emoluments and amounts receivable under long term incentive schemes of the highest paid director included in the above figure was £13,386 (2011: £35,299). During the year the highest paid director did not exercise any share options or receive any shares under a long term incentive scheme.

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments

	Cost		Current Value	
	2012 £m	2011 £m	2012 £m	2011 £m
Freehold land and buildings	311	247	312	284
Leasehold land and buildings	274	272	276	295
Equity securities	62	224	62	191
Debt securities and other fixed income securities	4,379	3,499	4,427	4,038
Derivative assets	-	-	198	183
Loans secured by mortgages	49	59	49	59
Other loans	9	10	9	10
Deposits with credit institutions	184	209	184	209
	<b>5,268</b>	<b>4,520</b>	<b>5,517</b>	<b>5,269</b>

The change in current value of investments included in the profit and loss account was a loss of £516m (2011: loss of £22m) analysed between a loss of £544m (2011: loss of £56m) included in the Long term business technical account and a gain of £28m (2011: gain of £34m) included in the Non-technical account. The change in current value of £544m (2011: loss of £56m) included a loss of £64m (2011: gain of £14m) in respect of land and buildings, a gain of £54m (2011: gain of £35m) in respect of derivatives, a gain of £32m (2011: gain of £2m) in respect of equity securities and a loss of £566m (2011: loss of £107m) in respect of debt securities.

Amounts included in the above ascribed to listed investments:

	Current Value	
	2012 £m	2011 £m
Equity securities	29	149
Debt securities and other fixed income securities	3,082	3,698
	<b>3,111</b>	<b>3,847</b>

All Leasehold land and buildings are classed as long lease as their term is greater than 50 years.

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

	Freehold and leasehold land and buildings	
	2012 £m	2011 £m
At cost	585	519
Aggregated depreciation	(92)	(67)
<b>Net book value based on historical cost</b>	<b>493</b>	<b>452</b>

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (a) Financial instruments

##### (i) Designation and fair values

All financial assets of the Company are designated as either fair value through profit and loss or loans and receivables. Financial liabilities are designated as either fair value through profit and loss or amortised cost.

2012	Fair value through profit and loss	Loans and receivables	Total carrying value	Fair value
£m				
<b>Financial Assets:</b>				
Deposits with credit institutions	-	184	184	184
Equity securities	62	-	62	62
Debt securities	4,427	-	4,427	4,427
Loans:				
Loans secured by mortgages	-	49	49	49
Other loans	-	9	9	9
Derivative assets	198	-	198	198
Accrued investment income	-	72	72	72
Other debtors	-	5	5	5
Cash at bank and in hand	-	164	164	164
	4,687	483	5,170	5,170
	Fair value through profit and loss	Amortised cost	Total carrying value	Fair value
£m				
<b>Financial Liabilities:</b>				
Derivative liabilities	200	-	200	200
Creditors arising out of reinsurance operations	-	44	44	44
Deposits from ceding undertakings	-	4,116	4,116	4,116
Other creditors	-	312	312	312
	200	4,472	4,672	4,672

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (a) Financial instruments (continued)

##### (i) Designation and fair values (continued)

2011	Fair value through profit and loss	Loans and receivables	Total carrying value	Fair value
			£m	
<b>Financial Assets:</b>				
Deposits with credit institutions	-	209	209	209
Equity securities	191	-	191	191
Debt securities	4,038	-	4,038	4,038
<b>Loans :</b>				
Loans secured by mortgages	-	59	59	60
Other loans	-	10	10	9
Derivatives assets	183	-	183	183
Accrued investment income	-	70	70	70
Other debtors	-	11	11	11
Cash at bank and in hand	-	191	191	191
Assets held to cover linked liabilities	1,847	-	1,847	1,847
	6,259	550	6,809	6,809
			£m	
	Fair value through profit and loss	Amortised cost	Total carrying value	Fair value
<b>Financial Liabilities:</b>				
Derivative liabilities	237	-	237	237
Other creditors	-	237	237	237
	237	237	474	474

As at 31 December 2012 there were no convertible bonds included in debt securities (2011: £Nil). There were no convertible bonds included in borrowings (2011: £Nil).

For financial liabilities designated as fair value through profit and loss there was no material impact on profit from movements in credit risk during 2012 and 2011.

## **Prudential Annuities Limited**

### **Notes to the financial statements for the year ended 31 December 2012 (continued)**

#### **8. Investments (continued)**

##### **(a) Financial instruments (continued)**

###### *(ii) Determination of fair values*

The fair values of the financial values of the financial assets and liabilities as shown in the tables on the previous pages have been determined on the following bases.

The fair values of the financial instruments for which fair valuation is required under UK GAAP are determined by the use of current market bid prices for quoted investments, or by using quotations from independent third parties, such as brokers and pricing services or by using appropriate valuation techniques. Investments valued using valuation techniques include financial investments which by their nature do not have an externally quoted price based on regular trades and financial investments for which markets are no longer active as a result of market conditions e.g. market illiquidity. The valuation techniques used include comparison to recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option adjusted spread models and, if applicable, enterprise valuation. These techniques may include a number of assumptions relating to 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 valuation techniques used priority is given to publicly available prices from independent sources, when available but overall, the source of pricing is chosen with the objective of arriving at a fair value measurement which reflects the price at which an orderly transaction would take place between market participants on the measurement date.

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

The loans and receivables have been shown net of provisions for impairment, where applicable. 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 instruments reflects the estimated amount the Company would receive or pay in an arm's length transaction. The amount is determined using quoted prices if exchange listed, quotations from independent third parties or valued internally using standard market practices.

The fair value of borrowings is based on quoted market prices, where available.

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

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (a) Financial instruments (continued)

###### *(iii) Level 1, 2 and 3 fair value measurement hierarchy of financial instruments*

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

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

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

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

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

The nature of the Company's operations in the UK mean that a significant proportion of the assets backing non-linked shareholder backed business are held in corporate bonds, structured securities and other non-national government debt securities. These assets, in line with market practice, are generally valued using third party broker quotes in the UK either directly or via third parties such as IDC or Bloomberg. Such assets have generally been classified as level 2 as the nature of broker quotations means that it does not strictly meet the definition of a level 1 asset. However these valuations are determined using independent external quotations from multiple sources and are subject to a number of monitoring controls such as monthly price variances, stale price reviews and variance analysis on prices achieved on subsequent trades.

In addition level 2 includes debt securities that are valued internally using standard market practices. Of the total level 2 debt securities of £3,510m (2011: £2,954m), £331m (2011: £302m) are valued internally. The majority of such securities use matrix pricing, which is based on assessing the credit quality of the underlying borrower to derive a suitable discount rate relative to government securities. Under matrix pricing, the debt securities are priced taking the credit spreads on comparable quoted public debt securities and applying these to the equivalent debt instruments factoring a specified liquidity premium. The significance of the parameters used in this valuation technique are readily observable in the market and, therefore, are not subject to interpretation.

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (a) Financial instruments (continued)

(iii) Level 1, 2 and 3 fair value measurement hierarchy of financial instruments (continued)

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

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

Of the £4m (2011: £80m) level 3 items which support non-linked annuities backed business Nil% (2011: 1%) of the total assets net of derivative liabilities backing this business), £Nil (2011: £76m) are externally valued and £4m (2011: £4m) are internally valued. Internal valuations, which represent only 2.4% (2011: 0.1%) of the total assets net of derivative liabilities supporting non-linked annuities backed business, are inherently more subjective than external valuations.

If the value of all level 3 investments backing non-linked annuities backed business was varied by 10%, the change in valuation would be £0.4m (2011: £8m), which would reduce or increase shareholders' equity by this amount before tax.

2012	Level 1	Level 2	Level 3	Total
	£m			
Equity securities	-	62	-	62
Debt securities	913	3,510	4	4,427
Other investments (including derivative assets)	-	198	-	198
Derivative liabilities	-	(200)	-	(200)
<b>Total financial investments, net of derivative liabilities</b>	<b>913</b>	<b>3,570</b>	<b>4</b>	<b>4,487</b>
<b>Percentage of total</b>	<b>20%</b>	<b>80%</b>	<b>0%</b>	<b>100%</b>

The difference in Assets held to cover linked liabilities shown in the above table compared to that shown in the Designation and fair values table earlier is due to assets not covered by the disclosure requirements of FRS29.



## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (a) Financial instruments (continued)

(iii) Level 1, 2 and 3 fair value measurement hierarchy of financial instruments (continued)

2011	Level 1	Level 2	Level 3	Total
£m				
Equity securities	-	191	-	191
Debt securities	1,004	2,954	80	4,038
Other investments (including derivative assets)	-	183	-	183
Assets held to cover linked liabilities	206	1,528	-	1,734
Derivative liabilities	-	(237)	-	(237)
<b>Total financial investments, net of derivative liabilities</b>	<b>1,210</b>	<b>4,619</b>	<b>80</b>	<b>5,909</b>
Percentage of total	21%	78%	1%	100%

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

The following table reconciles the value of level 3 financial instruments at 1 January 2012 to that presented at 31 December 2012. Total gains and losses recorded in the long-term technical account in the period represents realised gains and losses, including interest and dividend income, unrealised gains and losses on financial instruments classified at fair value through profit and loss and foreign exchange movements on overseas investments. All these amounts are included within "investment income" and "unrealised gains (losses)" in the long-term technical account.

2012	At 1 Jan 2012	Total gains in long-term technical account	Purchases	Sales	Transfers into level 3	Transfers out of level 3	At 31 Dec 2012
£m							
Debt securities	80	1	75	(77)	-	(75)	4
<b>Total financial investments net of derivative liabilities</b>	<b>80</b>	<b>1</b>	<b>75</b>	<b>(77)</b>	<b>-</b>	<b>(75)</b>	<b>4</b>

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (a) Financial instruments (continued)

(iii) Level 1, 2 and 3 fair value measurement hierarchy of financial instruments (continued)

##### Reconciliation of movements in level 3 financial instruments measured at fair value (continued)

2011	At 1 Jan 2011	Total gains in long- term technical account	Purchases	Sales	Transfers into level 3	Transfers out of level 3	At 31 Dec 2011
£m							
Debt securities	122	10	-	(52)	-	-	80
Total financial investments net of derivative liabilities	122	10	-	(52)	-	-	80

Of the total net gains of £1m (2011: £10m gain) in the period, a £1m gain (2011: £11m gain) relates to level 3 financial instruments still held at the end of the year, all of which relate to debt securities.

##### Transfers between level 1 and level 2

There have been no significant transfers between level 1 and level 2 during the year.

##### (iv) Interest income and expense

The interest income on financial assets not at fair value through profit and loss was £8m for the year ended 31 December 2012 (2011: £8m).

There was no interest expense on financial liabilities not at fair value through profit and loss for the year ended 31 December 2012 (2011: £Nil).

##### (b) Market risk

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

Market risk comprises four types of risk, namely:

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

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (b) Market risk (continued)

The financial assets covering the Company's liabilities are subject to market risk. The liabilities for annuity contracts are subject to market risk arising from changes in the returns of the attaching assets. Except mainly to the extent of any minor asset/liability duration mismatch, and exposure to credit risk, the sensitivity of the Company's annuity business' results to market risk for movements in the carrying value of liabilities and covering assets is broadly neutral on a net basis.

The principal items affecting the results of the Company are mortality experience and assumptions and credit risk.

##### (i) Interest rate risk

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

2012	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
				£m
<b>Financial Assets:</b>				
Deposits with credit institutions	-	184	-	184
Equity securities	-	-	62	62
Debt securities	4,061	366	-	4,427
Loans:				
Loans secured by mortgages	49	-	-	49
Other loans	9	-	-	9
Derivatives assets	198	-	-	198
Cash at bank and in hand	-	164	-	164
	4,317	714	62	5,093
				£m
	Fair value through profit and loss	Amortised cost	Total carrying value	Fair value
<b>Financial Liabilities:</b>				
Derivative liabilities	200	-	-	200
	200	-	-	200

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (b) Market risk (continued)

##### (i) Interest rate risk (continued)

2011	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
	£m			
<b>Financial Assets:</b>				
Deposits with credit institutions	-	209	-	209
Equity securities	-	-	191	191
Debt securities	3,657	381	-	4,038
<b>Loans:</b>				
Loans secured by mortgages	59	-	-	59
Other loans	10	-	-	10
Derivatives assets	183	-	-	183
Cash at bank and in hand	-	191	-	191
	3,909	781	191	4,881
	Fair value through profit and loss	Amortised cost	Total carrying value	Fair value
	£m			
<b>Financial Liabilities:</b>				
Derivative liabilities	237	-	-	237
	237	-	-	237

##### (ii) Maturity analysis of derivatives

The net derivative position as at 31 December 2012 was a liability of £2m (2011: liability of £54m)

The net derivative positions as stated above comprise the following derivative assets and liabilities:

	2012 £m	2011 £m
Derivative assets	198	183
Derivative liabilities	(200)	(237)
<b>Net Derivative position</b>	<b>(2)</b>	<b>(54)</b>

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

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (b) Market risk (continued)

###### (iii) Sensitivity to interest rate movement

The close matching by the Company of assets of appropriate duration to its annuity liabilities is based on maintaining economic and regulatory capital. The measurement of liabilities under capital reporting requirements and UK GAAP 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 UK GAAP reporting purposes. As a result UK GAAP's shareholders' funds are higher than regulatory capital and therefore more sensitive to interest rate risk.

The estimated sensitivity of the non-linked annuities backed business to a movement in the interest rates of 1% and 2% as at 31 December 2012 and 2011 are as follows:

2012	Fall of 2%	Fall of 1%	Rise of 1%	Rise of 2%
	£m			
Carrying value of debt securities and derivatives	2,178	954	(777)	(1,429)
Long term business provision	(1,817)	(801)	642	1,163
Related tax effects	(83)	(35)	31	61
Net sensitivity of profit after tax and shareholders' funds	278	118	(104)	(205)

2011	Fall of 2%	Fall of 1%	Rise of 1%	Rise of 2%
	£m			
Carrying value of debt securities and derivatives	2,089	905	(723)	(1,318)
Long term business provision	(1,669)	(738)	594	1,080
Related tax effects	(105)	(42)	32	60
Net sensitivity of profit after tax and shareholders' funds	315	125	(97)	(178)

###### (iv) Currency risk

As at 31 December 2012, the Company held 2% (2011: 11%) and 3% (2011: 51%) of its financial assets and financial liabilities respectively, in currencies, mainly US dollar and Euro, other than the functional currency, Sterling.

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

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (b) Market risk (continued)

###### (v) Other Price Risk – Equities and Property

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

2012	A decrease of 20%	A decrease of 10%
	£m	
Pre-tax profit	(130)	(65)
Related current tax effects	30	15
Net sensitivity of profit after tax and shareholders' funds	(100)	(50)

2011	A decrease of 20%	A decrease of 10%
	£m	
Pre-tax profit	(150)	(75)
Related deferred tax effects	37	19
Net sensitivity of profit after tax and shareholders' funds	(113)	(56)

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

In the equity and property risk sensitivity analysis shown the Company has, for 2012, considered the impact of an instantaneous 20 per cent fall in equity and property markets. If equity and property markets were to fall by more than 20 per cent, the Company believes that this would not be an instantaneous fall but rather this would be expected to occur over a period of time during which the Company would be able to put in place mitigating management actions.

##### (c) Derivatives and Hedging

The Company uses various derivative arrangements in order to assist in the matching of contractual liabilities.

Currency swap agreements involve the exchange of payments in different currencies over the life of the agreement. The Company enters into currency swap transactions to hedge foreign currency risk on overseas investments. Interest rate and inflation swap agreements involve the exchange of fixed and floating payments over the life of the agreements without an exchange of the underlying principal amount. The Company has entered into credit default swap arrangements only in respect of sovereign government debt obligations.

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (c) Derivatives and Hedging (continued)

The swap agreements are accounted for on a market value basis, consistent with the assets and liabilities hedged. All over-the-counter derivative transactions are conducted under standardised ISDA (International Swaps and Derivatives Association Inc) master agreements and the Group has collateral agreements between the individual group entities, of which the Company is one, and relevant counterparties in place under each of these master market agreements.

##### (d) Credit risk

###### (i) Debt securities and other fixed income securities

The following table summarises by the rating, the securities held by the Company as at 31 December 2012 and 2011:

	<b>Total 2012 £m</b>	Total 2011 £m
S&P – AAA	471	528
S&P – AA+ to AA-	555	478
S&P – A+ to A-	1,091	898
S&P – BBB+ to BBB-	370	315
S&P –Other	2	22
	<b>2,489</b>	<b>2,241</b>
Moody's – Aaa	949	909
Moody's –Aa1 to Aa3	135	31
Moody's –A1 to A3	43	63
Moody's – Baa1 to Baa3	90	63
Moody's – Other	-	5
	<b>1,217</b>	<b>1,071</b>
Fitch	35	38
Other	686	688
<b>Total debt securities</b>	<b>4,427</b>	<b>4,038</b>

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

Where no external ratings are available, internal ratings produced by the Prudential's asset management operations, which are prepared on a comparable basis to external ratings, are used where possible. Of the total debt securities held at 31 December 2012 which are not externally rated, £686m (2011: £436m) were internally rated AAA to A-, £492m (2011: £228m) were internally rated BBB to B-, £170m (2011: £13m) were internally rated Other, and £24m (2011: £11m) were unrated.

In 2011 S&P withdrew its ratings of debt securities issued by a number of sovereigns. Where these are no longer available, Moody's ratings have been used.

The Company has no exposure to the eurozone sovereigns of Portugal, Italy, Ireland, Greece and Spain (PIIGS) and no exposure to banking operations in these eurozone countries.

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 8. Investments (continued)

##### (d) Credit risk (continued)

###### *(ii) Loans and receivables*

Of the total loans and receivables held £Nil (2011: £Nil) are past their due date but have not been impaired. Of the total past due but not impaired, £Nil (2011: £Nil) are less than 1 year past their due date. The Company expects full recovery of these loans and receivables. In accordance with accounting policy, impairment reviews were performed for loans and receivables. During the year ended 31 December 2012, no impairment losses (2011: £Nil) were recognised for loans and receivables.

###### *(iii) Securities lending and reverse repurchase agreements*

The Company has entered into securities lending (including repurchase agreements) whereby blocks of securities are loaned to third parties, primarily major brokerage firms. The amounts above the fair value of the loaned securities required to be held as collateral by the agreements, depend on the quality of the collateral, calculated on a daily basis. The loaned securities are not removed from the Company's balance sheet, rather they are retained within the appropriate investment classification. Collateral typically consists of cash, debt securities, equity securities and letters of credit. At 31 December 2012, the Company had lent £196m (2011: £613m) of securities and held collateral under such agreements of £203m (2011: £647m).

At 31 December 2012, the Company had entered into reverse repurchase transactions, under which it purchased securities and had taken on the obligation to resell the securities for the purchase price, amounting to £58m (2011: £30m), together with accrued interest. Of this amount, £Nil (2011: £Nil) related to another group company.

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

###### *(iv) Collateral under derivative transactions*

At 31 December 2012, the Company had pledged £179m (2011: £110m) for liabilities and held collateral of £148m (2011: £64m) in respect of over-the-counter derivatives transactions.

###### *(v) Reinsurer's share of technical provisions*

Of the reinsurer's share of technical provisions at 31 December 2012 of £5,560m (2011: £7m), 0.1% (2011: 100%) of the balance relates to companies outside of the Prudential Group and of these 100% (2011: 100%) of the balance were from reinsurers with S&P's rating of AA- and above, based on the ratings at the date of signing these financial statements. The reinsurance deposit from PAC mitigates the credit exposure on the reinsurance.

##### (e) Risk management

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

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



## **Prudential Annuities Limited**

### **Notes to the financial statements for the year ended 31 December 2012 (continued)**

#### **8. Investments (continued)**

##### **(e) Risk management (continued)**

The Company uses derivatives to facilitate efficient portfolio management or to reduce investment risk. The most widely used derivatives by the Company are interest rate, currency and inflation-linked swaps.

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

Derivative financial instruments used to facilitate efficient portfolio management and for investment purposes are carried at fair value with changes in fair value included in the profit and loss account. The Company has not applied hedge accounting to its derivatives except as described in note C above.

##### Market risk

Market risk is the risk of loss for the Company, or of adverse change in the financial situation, resulting, directly or indirectly, from fluctuations in the level of volatility of market prices of assets and liabilities.

The primary market risks that the Company faces is interest rate risk because most of its assets are investments that are bonds, mortgages or cash deposits, the values of which are subject to interest rate risk. The Company has some liabilities that contain guaranteed returns which generally will be supported by fixed income investments.

##### Credit risk

Credit risk is the risk of loss for the Company or of adverse change in the financial position, resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors in the form of default or other significant credit event (e.g. downgrade or spread widening). The Company's long term fund holds large amounts of interest rate sensitive investments that contain credit risk on which a certain level of defaults is expected. These expected losses are considered when the Company determines the crediting rates, deposit rates and premium rates for the products that will be supported by these assets. Certain over-the-counter derivatives contain a credit risk element that is controlled through evaluation of collateral agreements and master netting agreements on interest rate and currency swaps. The Company is also exposed to credit-related losses in the event of non-performance by counterparties.

##### Liquidity risk

Liquidity risk is the risk that the Company may be unable to meet payment of obligations in a timely manner at a reasonable cost or the risk of unexpected increases in the cost of funding the portfolio at appropriate maturities or rates. The Company writes solely annuity business, which cannot be surrendered. Therefore liquidity risk is mitigated by cashflow matching the maturity profile of investments with the expected regular annuity payments.

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 9. Capital requirements and management

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

From this total, Prudential Group borrowings are deducted, other than subordinated debt issues which qualify as capital.

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

At the Company level, the FSA rules which govern the Prudential regulation of insurance form part of the Insurance Prudential Sourcebook, 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 Insurance Prudential Sourcebook 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.

The available capital of £1,078m (2011: £1,012m) reflects the excess of regulatory basis assets over liabilities of the fund, before deduction of the capital resources requirement of £208m (2011: £234m).

The capital resources requirement for this Company broadly reflects a formula which, for active funds, equates to a percentage of regulatory reserves plus a percentage of death strains.

	2012	2011
	£m	£m
<b>Shareholders' equity</b>		
Held outside long term funds:		
Net assets	1,016	968
Total	1,016	968
Held in long term funds	69	454
<b>Total shareholders' equity</b>	<b>1,085</b>	<b>1,422</b>
Adjustments to regulatory basis	(7)	(410)
<b>Total available capital resources on FSA regulatory bases</b>	<b>1,078</b>	<b>1,012</b>

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 10. Assets held to cover linked liabilities

	Cost		Current Value	
	2012 £m	2011 £m	2012 £m	2011 £m
Assets held to cover linked liabilities	-	1,356	-	1,847

The change in current value of assets held to cover linked liabilities included in the Long term business technical account was a loss of £387m (2011: gain of £11m).

#### 11. Reserves and policyholder liabilities (net of reinsurance)

	Claims outstanding	Technical provision for linked liabilities	Long term business provision	Profit and loss account
	£m			
Balance at 1 January 2012	1	1,847	3,468	772
Movement in technical provisions for the year	-	(1,847)	(3,468)	-
Profit and loss account	-	-	-	(337)
<b>Balance at 31 December 2012</b>	<b>1</b>	<b>-</b>	<b>-</b>	<b>435</b>

#### 12. Long term business provisions

The Company's liabilities are for contracts that provide individual immediate and bulk immediate and deferred annuities.

The immediate annuities are either fixed or retail price-index linked (referred to as RPI), where annuity payments are guaranteed from the outset. These products provide guaranteed income for a specified time, usually the life of the policyholder, in exchange for a lump sum capital payment. No surrender value is available under any of these products.

The deferred annuities are also either fixed or RPI linked, both during deferment and in payment.

The primary risks to the Company are therefore mortality, investment and credit risk.

The Company's fixed-increase annuities may incorporate automatic increases in annuity payments by fixed amounts over the policyholder's life. The Company's inflation linked annuity contracts provide for a regular annuity payment which changes periodically based on the change in UK inflation, which:

- (i) for the majority of contracts is measured by the Retail Price Index (RPI) and
- (ii) for some contracts are subject to pre-defined minima and maxima.

For bulk annuity business, the Company manages the assets and accepts the liabilities of a company pension scheme, to the extent to which they are funded, usually when it is wound up by the employer.

## **Prudential Annuities Limited**

### **Notes to the financial statements for the year ended 31 December 2012 (continued)**

#### **12. Long term business provisions (continued)**

The provisions are the present value of the annuity payments and expenses. The calculation of the provisions requires a number of actuarial assumptions regarding future experience to be made. The assumptions are set by the Directors having regard to actuarial advice and based on analysis of relevant past and current data and information on anticipated future trends.

The majority of the annuities previously reinsured from the With-Profits Sub Fund of the Prudential Assurance Company (PAC) to PAL were recaptured by PAC on 31 August 2011, with the remaining part being recaptured by PAC on 30 September 2012. These recaptured annuities were previously valued as part of the PAL business.

All remaining annuities in the Company, except for those that have been reinsured with a company that is not part of the Prudential Group, were reinsured to the With-Profits Sub Fund of the Prudential Assurance Company (PAC) on 31 October 2012.

The key assumptions made at 31 December 2011 and 31 December 2012 are shown below.

#### **Mortality**

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

The mortality assumptions also include an allowance for expected future improvements in longevity. For males, these future mortality improvements are in line with Prudential's own calibration of the CMI 2011 mortality model, with a long term improvement rate of 2.25% p.a. For females, the future mortality improvements are in line with Prudential's own calibration of the CMI 2011 mortality model, with a long term improvement rate of 1.5% p.a.

Compared with the core CMI mortality model, Prudential's calibration:

- (a) blends period improvements 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
- (b) assumes that cohort improvements 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 assumptions used (shown as a range of percentages of base tables with future improvements), before any allowance for impairment, are set out on the following page:

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 12. Long term business provisions (continued)

##### Mortality (continued)

	2012		2011	
	Males	Females	Males	Females
In payment: Business administered on GPDA system:	126% PNMA00 with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120.	117% PNFA00 with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120.	126% PNMA00 with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120.	117% PNFA00 with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120.
All other business:	93% – 99% PCMA00 with future improvements in line with Prudential's own calibration of the 2011 CMI 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 2011 CMI model, with a long term improvement rate of 1.5%.	92% – 98% PCMA00 with future improvements in line with Prudential's own calibration of the 2009 CMI 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 2009 CMI model, with a long term improvement rate of 1.25%.
In deferment:	AM92 - 4 years	AF92 - 4 years	AM92 - 4 years	AF92 - 4 years

##### Interest rate

The valuation interest rates comply with the requirements of Rule 1.2.33R of the Prudential Sourcebook for Insurers except that:

- additional margins for prudence required in setting the valuation interest rate for the valuation of liabilities for statutory solvency purposes have been removed;
- the Company is required, by an order issued under section 148 of the Financial Services and Markets Act 2000, to calculate the valuation rate of interest by reference to the aggregate yield on the assets rather than the market weighted gross redemption yield which is normally required by the Valuation Rules.

The valuation interest rates are adjusted to reflect investment management expenses and the risk of default on the assets.

The investment management expenses are reviewed annually and reflect the Company's costs.

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 12. Long term business provisions (continued)

##### Interest rate (continued)

The credit risk assumption is also reviewed annually and reflects the assets actually held. The assumption about the future level of defaults has been decreased to 51 basis points per annum (54 basis points per annum at 31 December 2011), which is able to cover a significantly adverse credit situation.

##### Credit risk provisions

For IFRS reporting, the results 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 down 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 fixed and linked annuity business at 31 December 2012 and 31 December 2011, based on the asset mix at the relevant balance sheet date are shown below.

	Pillar 1 Adjustment from		
	regulatory	regulatory to	IFRS
	basis	IFRS basis	IFRS
	(bps)	(bps)	(bps)
<b>31 December 2012</b>			
Bond spread over swap rates <sup>note (i)</sup>	150	-	150
Credit risk allowance			
Long-term expected defaults <sup>note (ii)</sup>	18	-	18
Additional provisions <sup>note (iii)</sup>	66	(33)	33
Total credit risk allowance	84	(33)	51
Liquidity premium	66	33	99

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 12. Long term business provisions (continued)

##### Credit risk provisions (continued)

31 December 2011	Pillar 1 regulatory basis (bps)	Adjustment from regulatory to IFRS basis (bps)	IFRS (bps)
Bond spread over swap rates <sup>note (i)</sup>	194	-	194
Credit risk allowance			
Long-term expected defaults <sup>note (ii)</sup>	20	-	20
Additional provisions <sup>note (iii)</sup>	68	(34)	34
<b>Total credit risk allowance</b>	<b>88</b>	<b>(34)</b>	<b>54</b>
Liquidity premium	106	34	140

##### 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 and 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 1 notch downgrade of the portfolio subject to credit risk, and an additional allowance for short-term defaults.

The very 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 the year ended 31 December 2012

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

	Pillar 1 Regulatory basis (bps) Total	IFRS (bps) Total
Total allowance for credit risk at 31 December 2011	88	54
Credit rating changes	6	4
De-risking	(9)	(4)
Other asset trading	(2)	(4)
Other	1	1
<b>Total allowance for credit risk at 31 December 2012</b>	<b>84</b>	<b>51</b>

In 2010 and prior periods, surplus from favourable default experience was retained within short-term allowances for credit risk on both the Pillar 1 and IFRS bases. For full years 2011 and 2012 the retention of such surpluses continues to be applied under IFRS but not under Pillar 1.

Overall the movement has led to the credit allowance for Pillar 1 purposes to be 56 per cent (2011: 45 per cent) of the bond spread over swap rates. For IFRS purposes it represents 34 per cent (2011: 28 per cent) of the bond spread over swap rates.

## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 12. Long term business provisions (continued)

##### Credit risk provisions (continued)

The reserve for credit risk allowance at 31 December 2012 on a Pillar 1 regulatory basis was £0.6bn and on an IFRS basis was £0.3bn.

##### Expenses

An allowance is made for expenses. This allowance is reviewed annually following an investigation into the Company's costs.

##### Other assumptions

A number of other, less financially significant, actuarial assumptions are made in calculating the provisions, including the likely marital status of joint-life policyholders on death and the future rates of escalation of certain benefits.

#### 13. Debtors

Other Debtors	2012 £m	2011 £m
Amounts due from group undertakings	3	11
Other debtors	2	-
	5	11

#### 14. Provision for deferred tax

	2012 £m	2011 £m
Unrealised gains on investments	-	(1)
Transfer to the non-technical account in excess of the statutory surplus	-	135
Capital allowances on items expensed in the accounts	-	(1)
Undiscounted provision for deferred tax	-	133
	2012 £m	2011 £m
Deferred tax liability at start of year	133	238
Deferred tax (credit) in profit and loss account	(133)	(105)
Deferred tax liability at end of year	-	133

From April 2012, the standard corporation tax rate for the UK changed from 26% to 24%. A further reduction in the standard corporation tax rate to 23% from April 2013 has also been enacted. Deferred tax at the end of 2012 has been provided wholly at the rate of 23% on the basis that all of the temporary differences will reverse at the new rate. The effect of this change on the deferred tax liabilities at 31 December 2012 is £Nil.

The Chancellor has proposed a further reduction to the UK corporation tax rate to 20% by 2015 however this is not reflected in the financial statements for the year ended 31 December 2012 as it has not yet been substantively enacted.



## Prudential Annuities Limited

### Notes to the financial statements for the year ended 31 December 2012 (continued)

#### 14. Provision for deferred tax (continued)

The UK Government has made substantial changes to the rules relating to the taxation of life insurance companies, effective from 1 January 2013. Until the end of 2012, shareholders' taxable profits are calculated using regulatory surplus as a starting point, with appropriate deferred tax adjustments for UK GAAP. Beginning in 2013, under new life tax rules, taxable profits will be calculated using accounting profit or loss as a starting point.

The effect of these changes is reflected in the financial statements for the year ended 31 December 2012 but has no material impact on the Company's net assets.

#### 15. Deposits from ceding undertakings

Deposits from ceding undertakings	2012 £m	2011 £m
Deposits from ceding undertakings	4,116	-

As at 31 October 2012 the remaining annuities following the recapture in 2011, net of a small outward reinsurance insured by the Company were 100% reinsured on a quota share basis to the WPSF of PAC; this arrangement allows for the reinsured assets to be deposited back with the Company.

#### 16. Other creditors

All creditors are payable within a period of five years.

Other creditors including taxation and social security	2012 £m	2011 £m
Taxation	12	43
Other creditors	5	8
	17	51

#### 17. Bank current accounts

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

#### 18. Called up share capital

The total number of issued and fully paid shares at the year end was 650,000,000 (2011: 650,000,000) £1 ordinary shares.

#### 19. Charges

In the normal course of business certain reinsurance liabilities were secured by a floating charge, ranking these liabilities equally with amounts due under unsecured direct (non-reassurance) policies, over the long term insurance assets of the Company. Amounts secured by charges of this nature was £53.2m (2011: £95.1m), representing liabilities to one customer.

## **Prudential Annuities Limited**

### **Notes to the financial statements for the year ended 31 December 2012 (continued)**

#### **20. Related party transactions**

The Company has taken advantage of the exemption under paragraph 3(c) of Financial Reporting Standard Number 8 from disclosing transactions with other subsidiary undertakings of the Prudential Group. There were no other transactions with related parties.

#### **21. Immediate and ultimate parent company**

The immediate parent company is The Prudential Assurance Company Limited. The ultimate parent company is Prudential plc, which is the only parent company which prepares group financial statements. Copies of these financial statements can be obtained from the Company Secretary, Laurence Pountney Hill, London, EC4R 0HH.