Generating value through selective exposure to risk

Introduction
2016 has been a year of extraordinary global change, starting with market turbulence in China, followed by the UK’s vote to leave the EU and ending with the election of a new president in the US. Even in such a year, we have maintained a strong and sustained focus on planning for the possibility of, and ultimately managing, the market volatility and macroeconomic uncertainty arising from these events. Our Risk Management Framework and risk appetite have allowed us to control successfully our risk exposure throughout the year. Our strong governance, processes and controls enable us to deal with the uncertainty ahead in order to continue helping our customers achieve their long-term financial goals.

For our shareholders, we generate value by selectively taking exposure to risks that are adequately rewarded and that can be appropriately quantified and managed. We retain risks within a clearly defined risk appetite, where we believe doing so contributes to value creation and the Group is able to withstand the impact of an adverse outcome. For our retained risks, we ensure that we have the necessary capabilities, expertise, processes and controls to manage appropriately the exposure.

In my report, I seek to explain the main risks inherent in our business and how we manage these evolving risks, with the aim of ensuring we maintain an appropriate risk profile.

Risk governance, culture and our risk management cycle
Prudential defines ‘risk’ as the uncertainty that we face in successfully implementing our strategies and objectives. This includes all internal or external events, acts or omissions that have the potential to threaten the success and survival of the Group. As such, material risks will be retained selectively where we think there is value to do so, and where it is consistent with the Group’s risk appetite and philosophy towards risk taking.

The following section provides more detail on our risk governance, culture and risk management process.
Risk governance
Our risk governance comprises the organisational structures, reporting relationships, delegation of authority, roles and responsibilities, and risk policies that the Group head office and the business units establish to make decisions and control their activities on risk-related matters. This encompasses individuals, Group-wide functions and committees involved in the management of risk.

Risk committees and governance structure
Our Risk governance structure is led by the Group’s Risk Committee, supported by independent non-executives on risk committees of major subsidiaries. These committees monitor the development of the risk management framework, and the Group’s risk appetites, limits, and policies as well as its risk culture. We have in place a comprehensive risk management cycle to identify, measure, manage and monitor our risk exposures.

In addition to the risk committees mentioned, there are various executive risk forums to ensure risk issues are shared and considered across the Group. These are led by the Group Executive Risk Committee which is supported by a number of specific committees including in relation to security and information security where specialist skills are required.

Risk Management Framework
The Group’s Risk Management Framework has been developed to monitor and manage the risk of the business at all levels and is owned by the Board. The aggregate Group exposure to the key risk drivers is monitored and managed by the Group Risk function whose responsibility it is to review, assess and report on the Group’s risk exposure and solvency position from the Group economic, regulatory and ratings perspectives.

The Framework requires that all our businesses and functions establish processes for identifying, evaluating and managing the key risks faced by the Group – the ‘Risk Management Cycle’ (see below) and is based on the concept of the ‘three lines of defence’, comprising risk taking and management, risk control and oversight, and independent assurance. A major part of the Risk Management Cycle is the annual assessment of the Group’s risks which are considered key. These key risks range from risks associated with the economic, market, political and regulatory environment; those that we assume when writing our insurance products and by virtue of the investments we hold; and those that are inherent in our business model and its operation. This is used to inform risk reporting to the risk committees and the Board for the year.

Risk appetite, limits and triggers
The extent to which we are willing to take risk in the pursuit of our objective to create shareholder value is defined by a number of risk appetite statements, operationalised through measures such as limits, triggers and indicators. The Group risk appetite is approved by the Board and is set with reference to economic and regulatory capital, liquidity and earnings volatility. The Group risk appetite is aimed at ensuring that we take an appropriate level of aggregate risk and covers all risks to shareholders, including those from participating and third party business. We have no appetite for material losses (direct or indirect) suffered as a result of failing to develop, implement and monitor appropriate controls to manage operational risks. Group limits operate within the risk appetite to constrain the material risks, while triggers and indicators provide further constraint and ensure escalation. The Group Chief Risk Officer determines the action to be taken upon any breaches.

The Group Risk function is responsible for reviewing the scope and operation of these measures at least annually, to determine that they remain relevant. The Board approves all changes made to the Group’s Risk Appetite Framework. We define and monitor aggregate risk limits based on financial and non-financial stresses for our earnings volatility, liquidity and capital requirements.

Earnings volatility
The objectives of the aggregate risk limits seek to ensure that:

— The volatility of earnings is consistent with the expectations of stakeholders;
— The Group has adequate earnings (and cash flows) to service debt, expected dividends and to withstand unexpected shocks; and
— Earnings (and cash flows) are managed properly across geographies and are consistent with funding strategies.

The two measures used to monitor the volatility of earnings are IFRS operating profit and EEV operating profit, although IFRS and EEV total profits are also considered.

Liquidity
The objective is to ensure that the Group is able to generate sufficient cash resources to meet financial obligations as they fall due in business as usual and stressed scenarios. Risk appetite with respect to liquidity risk is measured using a Liquidity Coverage Ratio which considers the sources of liquidity versus liquidity requirements under stress scenarios.

Capital requirements
The limits aim to ensure that:

— The Group meets its internal economic capital requirements;
— The Group achieves its desired target rating to meet its business objectives; and
— Supervisory intervention is avoided.

The two measures used at the Group level are Solvency II capital requirements and internal economic capital requirements. In addition, capital requirements are monitored on local statutory bases.

The Group Risk Committee is responsible for reviewing the risks inherent in the Group’s business plan and for providing the Board with input on the risk/reward trade-offs implicit therein. This review is supported by the Group Risk function, which uses submissions from our local business units to calculate the Group’s aggregated position (allowing for diversification effects between local business units) relative to the aggregate risk limits.

Risk policies
These set out the specific requirements which cover the fundamental principles for risk management within the Group Risk Framework. Policies are designed to give some flexibility so that business users can determine how best to comply with policies based on their local expertise.

There are core risk policies for credit, market, insurance, liquidity and operational risks and a number of internal control policies covering internal model risk, underwriting, dealing controls and tax risk management. They form part of the Group Governance Manual, which was developed to make a key contribution to the sound system of internal control that we maintain in line with the UK Corporate Governance Code and the Hong Kong Code on Corporate Governance Practices. Group Head Office and business units must confirm that they have implemented the necessary controls to evidence compliance with the Group Governance Manual on an annual basis.
Risk standards
The Group-wide Operating Standards provide supporting detail to the higher level risk policies. In many cases they define the minimum requirements for compliance with Solvency II regulations which in some areas are highly prescriptive. The standards are more detailed than policies.

Our risk culture
Culture is a strategic priority of the Board who recognise the importance of good culture in the way that we do business. Risk culture is a subset of broader organisational culture, which shapes the organisation-wide values that we use to prioritise risk management behaviours and practices.

An evaluation of risk culture is part of the Risk Management Framework and in particular seeks to identify evidence that:
— Senior management in business units articulate the need for good risk management as a way to realise long-term value and continuously support this through their actions.
— Employees understand and care about their role in managing risk – they are aware of and openly discuss risk as part of the way they perform their role; and
— Employees invite open discussion on the approach to the management of risk.

Key aspects of risk culture are also communicated through the Code of Conduct and the policies in the Group Governance Manual, including the commitments to the fair treatment of our customers and staff. The approach to the management of risk is also a key part of the evaluation of the remuneration of executives. Risk culture is an evolving topic across the financial services industry and we will be continuing work to evaluate and embed a strong risk culture through 2017.

The risk management cycle
The risk management cycle comprises processes to identify, measure and assess, manage and control, and monitor and report on our risks.

Risk identification
Group-wide risk identification takes place throughout the year, and includes processes such as our Own Risk and Solvency Assessment (ORSA) and the horizon-scanning performed as part of our emerging risk management process.

On an annual basis, a top-down identification of the Group’s key risks is performed which considers those risks that have the greatest potential to impact the Group’s operating results and financial condition. A bottom-up process of risk identification is performed by the business units who identify, assess and document risks, with appropriate coordination and challenge from the risk functions.

The Group ORSA report pulls together the analysis performed by a number of risk and capital management processes, which are embedded across the Group, and provides quantitative and qualitative assessments of the Group’s risk profile, risk management and solvency needs on a forward-looking basis. The scope of the report covers the full known risk universe of the Group.

In accordance with provision C.2.1 of the UK Code, the Directors have performed a robust assessment of the principal risks facing the Company, through the Group ORSA report and the risk assessments done as part of the business planning review, including how they are managed and mitigated.

Risks are assessed in terms of materiality.
Material risks which are modelled are included in capital models, including E-Cap.

Risks which cannot be quantified are assessed qualitatively.

Risk processes that support the management and controlling of risk exposures include:
— Risk appetite and limits
— Financial incidents procedures
— Large risk approval process
— Global counterparty limit framework
— Own risk and solvency assessment
— Reverse stress testing
Reverse stress testing, which requires us to work backwards from an assumed point of business model failure, is another tool that helps us to identify the key risks and scenarios that may materially impact the Group.

Our emerging risk management process identifies potentially material risks which have a high degree of uncertainty around timing, magnitude and propensity to evolve. The Group holds emerging risk sessions over the year to identify emerging risks which includes input from local subject matter and industry experts. We maintain contacts with thought leaders and peers to benchmark and refine our process.

The risk profile is a key output from the risk identification and risk measurement processes, and is used as a basis for setting Group-wide limits, management information, assessment of solvency needs, and determining appropriate stress and scenario testing. The risk identification processes support the creation of our annual set of key risks, which are then given enhanced management and reporting focus.

**Risk measurement and assessment**

All identified risks are assessed based on an appropriate methodology for that risk. All quantifiable risks which are material and mitigated by holding capital are modelled in the Group’s internal model, which is used to determine capital requirements under Solvency II and our own economic capital basis. Governance arrangements are in place to support the internal model, including independent validation and process and controls around model changes and limitations.

**Risk management and control**

The control procedures and systems established within the Group are designed to manage reasonably the risk of failing to meet business objectives and are detailed in the Group risk policies. This can of course only provide reasonable and not absolute assurance against material misstatement or loss. They focus on aligning the levels of risk taking with the achievement of business objectives.

The management and control of risks are set out in the Group risk policies, and form part of the holistic risk management approach under the Group’s ORSA. These risk policies define:

- The Group’s risk appetite in respect of material risks, and the framework under which the Group’s exposure to those risks is limited;
- The processes to enable Group senior management to effect the measurement and management of the Group material risk profile in a consistent and coherent way; and
- The flows of management information required to support the measurement and management of the Group material risk profile and to meet the needs of external stakeholders.

The methods and risk management tools we employ to mitigate each of our major categories of risks are detailed in section 4 below.

**Risk monitoring and reporting**

The identification of the Group’s key risks informs the management information received by the Group risk committees and the Board. Risk reporting of key exposures against appetite is also included, as well as ongoing developments in other key and emerging risks.

**Summary risks**

The table below is a summary of the key risks facing the Group, which can be grouped into those which apply to us because of the global environment in which we operate, and those which arise as a result of the business that we operate – including risks arising from our investments, the nature of our products and from our business operations.

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**Macro**' risks

Some of the risks that we are exposed to are necessarily broad given the external influences which may impact on the Group. These risks include:

**Global economic conditions**

Changes in global economic conditions can impact us directly; for example by leading to poor returns on our investments and increasing the cost of promises we have made to our customers. They can also have an indirect impact; for example economic pressures could lead to decreased savings, reducing the propensity for people to buy our products. Global economic conditions may also impact on regulatory risk for the Group by changing prevailing political attitudes towards regulation.

**Geopolitical risk**

The geopolitical environment is increasingly uncertain with political upheaval in the UK, the US and the Eurozone. Uncertainty in these regions, combined with conflict in the Middle East and increasing tensions in east Asia underline that geopolitical risks are truly global and their potential impacts are wide-ranging; for example through increased regulatory risk. The geopolitical and economic environments are increasingly closely linked, and changes in the political arena may have direct or indirect impacts on our Group.

**Digital disruption**

The emergence of advance technologies such as artificial intelligence and block chain is providing an impetus for companies to rethink their existing operating models and how they interact with their customers. Prudential is embracing the opportunities presented by digitalisation and is closely monitoring any risks which arise.
### Risks from our investments

Global economic conditions – see above – have a large impact on those risks from our investments.

Our fund investment performance is a fundamental part of our business in providing appropriate returns for our customers and shareholders, and so is an important area of focus.

**Credit risk**

Is the potential for reduced value of our investments due to the uncertainty around investment returns arising from the potential for defaults of our investment counterparties.

Invested credit risk arises from our asset portfolio. We increase sector focus where necessary.

The assets backing the UK and Jackson’s annuity business mean credit risk is a significant focus for the Group.

**Market risk**

Is the potential for reduced value of our investments resulting from the volatility of asset prices as driven by fluctuations in equity prices, interest rates, foreign exchange rates and property prices. In our Asia business, our main market risks arise from the value of fees from our fee-earning products.

In the US, Jackson’s fixed and variable annuity books are exposed to a variety of market risks due to the assets backing these policies.

In the UK, exposure relates to the valuation of the proportion of the with-profits fund’s future profits which is transferred to the shareholders (future transfers), which is dependent on equity, property and bond values.

M&G invests in a broad range of asset classes and its income is subject to the price volatility of global financial and currency markets.

**Liquidity risk**

Is the risk of not having sufficient liquid assets to meet our obligations as they fall, and incorporates the risk arising from funds composed of illiquid assets. It results from a mismatch between the liquidity profile of assets and liabilities.

### Risks from our products

**Insurance risks**

The nature of the products offered by the Group exposes it to insurance risks, which are a significant part of our overall risk profile.

The insurance risks that we are exposed to by virtue of our products include longevity risk (policyholders living longer than expected); mortality risk (policyholders with life protection dying); morbidity risk (policyholders with health protection becoming ill) and persistency risk (customers lapsing their policies).

From our health protection products, increases in the costs of claims (including the level of medical expenses) increasing over and above price inflation (claim inflation) is another risk.

The processes that determine the price of our products and reporting the results of our long-term business operations require us to make a number of assumptions. Where experience deviates from these assumptions our profitability may be impacted.

Across our business units, persistency and morbidity risks are among the largest insurance risks for our Asia business given our strong focus on health protection products in the region.

For the UK and Jackson, the most significant insurance risk is longevity risk driven by their annuity businesses.

### Risks from our business operations

**Operational risks**

As a Group, we are dependent on the appropriate and secure processing of a large number of transactions by our people, IT infrastructure and outsourcing partners, which exposes us to operational risks and reputational risks.

Information security risk is a significant consideration within operational risk, including both the risk of malicious attack on our systems as well as risks relating to data security and integrity and network disruption. The size of Prudential’s IT infrastructure and network, our move toward digitisation and the increasing number of high-profile cyber security incidents across industries means that this will continue to be an area of high focus.

**Regulatory risk**

We also operate under the ever-evolving requirements set out by diverse regulatory and legal regimes (including tax), as well as utilising a significant number of third parties to distribute products and to support business operations; all of which add to the complexity of the operating model if not properly managed.

The number of regulatory changes under way across Asia, in particular those focusing on consumer protection means that regulatory change in the region is also considered a key risk.

Both Jackson and the UK operate in highly regulated markets. Regulatory reforms could materially impact our businesses, and regulatory focus continues to be high.
Further risk information
In reading the sections below, it is useful to understand that there are some risks that our policyholders assume by virtue of the nature of their products, and some risks that the Company and its shareholders assume. Examples of the latter include those arising from assets held directly by and for the Company, or the risk that policyholder funds are exhausted. This report is focused mainly on risks to the shareholder, but will include those which arise indirectly through our policyholder exposures.

Risks from our investments
Market risk
The main drivers of market risk in the Group are:

- Investment risk (including equity and property risk);
- Interest rate risk; and
- Given the geographical diversity of our business, foreign exchange risk.

With respect to investment risk, equity and property risk arises from our holdings of equity and property investments, the prices of which can change depending on market conditions.

The valuation of our assets (particularly the bonds that we invest in) and liabilities are also dependent on market interest rates and exposes us to the risk of those moving in a way that is detrimental for us.

Given our global business, we earn our profits and hold assets in various currencies. The translation of those into our reporting currency exposes us to movements in foreign exchange rates.

Our main investment risk exposure arises from the portion of the profits from the UK with-profits fund to which we are entitled to receive; the value of the future fees from our fee-earning products in our Asia business; and from the asset returns backing Jackson’s variable annuities business.

Our interest rate risk is driven in the UK by our need to match our assets and liabilities; from the guarantees of some non unit-linked investment products in Asia; and the cost of guarantees in Jackson’s fixed, fixed index and variable annuity business. The methods that we use to manage and mitigate our market risks include the following:

- Our market risk policy;
- Risk appetite statements, limits and triggers that we have in place;
- The monitoring and oversight of market risks through the regular reporting of management information;
- Our asset and liability management programmes;
- Use of derivative programmes, including, for example, interest rate swaps, options and hybrid options for interest rate risk;
- Regular deep dive assessments; and
- Use of currency hedging.

Investment risk
(Audited)
In the UK business, our main investment risk arises from the assets held in the with-profits funds. Although this is mainly held by our policyholders, a proportion of the fund’s profit (one tenth) is transferred to us and so our investment exposure relates to the future valuation of that proportion (future transfers). This investment risk is driven mainly by equities in the fund, although there is some risk associated with other investments such as property and bonds. Some hedging to protect from a reduction in the value of these future transfers against falls in equity prices is performed outside the fund using derivatives. The with-profits funds’ large Solvency II own funds – estimated at £8.4 billion as at 31 December 2016 (31 December 2015: £7.6 billion) – helps to protect against market fluctuations and helps the fund to maintain appropriate solvency levels. The with-profits funds’ Solvency II own funds are partially protected against falls in equity markets through an active hedging programme within the fund.

In Asia, our shareholder exposure to equity price movements results from unit-linked products, where our fee income is linked to the market value of the funds under management. Further exposure arises from with-profits businesses where bonuses declared are broadly based on historical and current rates of return on equity.

In Jackson, investment risk arises from the assets backing customer policies. In the case of spread-based business, including fixed annuities, these assets are generally bonds, and shareholder exposure comes from the minimum returns needed to meet the guaranteed rates that we offer to policyholders. For our variable annuity business, these assets include both equities and bonds. In this case, the main risk to the shareholder comes from the guaranteed benefits that can be included as part of these products. Our exposure to this kind of situation is reduced by using a derivative hedging programme, as well as through the use of reinsurance to pass on the risk to third-party reinsurers.

Interest rate risk
(Audited)
While long-term interest rates in advanced economies have broadly increased since mid-2016, they remain close to historical lows. Some products that we offer are sensitive to movements in interest rates. We have already taken a number of actions to reduce the risk to the in-force business, as well as re-pricing and restructuring new business offerings in response to these historically low interest rates. Nevertheless, we still retain some sensitivity to interest rate movements.

Interest rate risk arises in our UK business from the need to match cash payments to meet annuity obligations with the cash we receive from our investments. To minimise the impact on our profit, we aim to match the duration (a measure of interest rate sensitivity) of assets and liabilities as closely as possible and the position is monitored regularly. Under the Solvency II regulatory regime, additional interest rate risk results from the way the balance sheet is constructed, such as the requirement for us to include a risk margin. The UK business continually assesses the need for any derivatives in managing its interest rate sensitivity. The with-profits business is exposed to interest rate risk because of underlying guarantees in some of its products. Such risk is largely borne by the with-profits fund itself but shareholder support may be required in extreme circumstances where the fund has insufficient resources to support the risk.

In Asia, our exposure to interest rate risk arises from the guarantees of some non unit-linked investment products. This exposure exists because it may not be possible to hold assets which will provide cash payments to us which match exactly those payments we in turn need to make to policyholders – this is known as an asset and liability mismatch and although it is small and appropriately managed, it cannot be eliminated.

Jackson is exposed to interest rate risk in its fixed, fixed index and variable annuity books. Movements in interest rates can impact on the cost of guarantees in these products, in particular the cost of guarantees may increase where interest rates fall. We actively monitor the level of sales of variable annuity products with guaranteed living benefits, and together with the risk limits we have in place this helps us to ensure that we are comfortable with the interest rate and market risks we incur as a result. The Jackson hedging programme in place includes hybrid derivatives to protect us from a combined fall in interest rates and equity markets since Jackson is exposed to the combination of these market movements.

Foreign exchange risk
(Audited)
The geographical diversity of our businesses means that we have some exposure to the risk of exchange rate fluctuations. Our operations in the US and Asia, which represent a large proportion of our operating profit and shareholders’ funds, generally write policies and invest in assets in local currencies. Although this limits the effect of exchange rate...
movements on local operating results, it can lead to fluctuations in our Group financial statements when results are reported in UK sterling.

We retain revenues locally to support the growth of our business and capital is held in the local currency of the business to meet local regulatory and market requirements. We accept the foreign exchange risk this can produce when reporting our Group balance sheet and income statement. In cases where a surplus arises in an overseas operation which is to be used to support Group capital, or where a significant cash payment is due from an overseas subsidiary to the Group, this foreign exchange exposure is hedged where we believe it is economically favourable to do so. Generally, we do not have appetite for significant direct shareholder exposure to foreign exchange risks in currencies outside local territories, but we do have some controlled appetite for this on fee income and non-sterling investments within the with-profits fund.

We use a number of risk management tools to manage and mitigate this credit risk, including the following:

- Our credit risk policy;
- Risk appetite statements and limits that we have defined on issuers, counterparties and the average credit quality of the portfolio;
- Collateral arrangements we have in place for derivative transactions;
- The Group Credit Risk Committee’s oversight of credit and counterparty credit risk and sector and/or name-specific reviews. During 2016, it has conducted sector reviews in the banking (UK and Asia) and energy sectors;
- Regular deep dive assessments; and
- Close monitoring or restrictions on investments that may be of concern.

Credit risk

We invest in bonds that provide a regular, fixed amount of interest income (fixed income assets) in order to match the payments we need to make to policyholders. We also enter into reinsurance and derivative contracts with third parties to mitigate various types of risk, as well as holding cash deposits at certain banks. As a result, we are exposed to credit risk and counterparty risk across our business.

Credit risk is the potential for reduction in the value of our investments which results from the perceived level of risk an investment issuer being unable to meet its obligations (defaulting). Counterparty risk is a type of credit risk and relates to the risk that the counterparty to any contract we enter into being unable to meet their obligations causing us to suffer loss.

Debt and loan portfolio (Audited)

Our UK business is mainly exposed to credit risk on fixed income assets in the shareholder-backed portfolio. At 31 December 2016, this portfolio contained fixed income assets worth £38.6 billion. Credit risk arising from a further £55.2 billion of fixed income assets is largely borne by the with-profits fund, to which the shareholder is not directly exposed although under extreme circumstances shareholder support may be required if the fund is unable to meet payments as they fall due.

The value of our debt portfolio in our Asia business was £36.5 billion at 31 December 2016. The majority (69 per cent) of the portfolio is in unit-linked and with-profits funds and so exposure of the shareholder to this component is minimal. The remaining 31 per cent of the debt portfolio is held to back the shareholder business.

<table>
<thead>
<tr>
<th>Shareholder exposure by rating</th>
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<tbody>
<tr>
<td>AAA</td>
<td>7%</td>
</tr>
<tr>
<td>AA</td>
<td>26%</td>
</tr>
<tr>
<td>A</td>
<td>35%</td>
</tr>
<tr>
<td>BBB</td>
<td>28%</td>
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<tr>
<td>BB or below or non-rated assets</td>
<td>4%</td>
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</tbody>
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<table>
<thead>
<tr>
<th>Shareholder exposure by sector</th>
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</thead>
<tbody>
<tr>
<td>Financial</td>
<td>19.63%</td>
</tr>
<tr>
<td>Government</td>
<td>18.71%</td>
</tr>
<tr>
<td>Real estate</td>
<td>8.52%</td>
</tr>
<tr>
<td>Utilities</td>
<td>8.34%</td>
</tr>
<tr>
<td>Consumer, non-cyclical</td>
<td>8.23%</td>
</tr>
<tr>
<td>Mortgage securities</td>
<td>3.85%</td>
</tr>
<tr>
<td>Industrial</td>
<td>4.69%</td>
</tr>
<tr>
<td>Energy</td>
<td>4.41%</td>
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<tr>
<td>Communications</td>
<td>3.61%</td>
</tr>
<tr>
<td>Consumer, cyclical</td>
<td>2.56%</td>
</tr>
<tr>
<td>Asset-backed securities</td>
<td>3.32%</td>
</tr>
<tr>
<td>Other</td>
<td>14.13%</td>
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</tbody>
</table>
Credit risk also arises in the general account of the Jackson business, where £40.7 billion of fixed income assets are held to support shareholder liabilities including those from our fixed annuities, fixed index annuities and life insurance products.

The shareholder-owned debt and loan portfolio of the Group’s asset management business of £2.3 billion as at 31 December 2016 mostly belongs to our Prudential Capital (PruCap) operations.

Certain sectors have been under pressure during 2016, including the European banking sector. Most of the focus on the latter was around UK banks due to Brexit concerns, Italian banks and certain banks at risk of fines for the mis-selling of mortgage securities leading up to the 2008 financial crisis. We subject these sectors to ongoing monitoring and regular management information reporting to the Group’s risk committees. Certain sectors are also subject to our watch list and early warning indicator monitoring processes.

Further details of the composition and quality of our debt portfolio, and exposure to loans, can be found in the IFRS financial statements.

Group sovereign debt
*(Audited)*

We also invest in bonds issued by national governments, that are traditionally seen as safer investments. This sovereign debt represented 19 per cent or £17.1 billion of the shareholder debt portfolio as at 31 December 2016 (31 December 2015: 17 per cent or £12.8 billion). 4 per cent of this was rated AAA and 92 per cent was considered investment grade (31 December 2015: 94 per cent investment grade). At 31 December 2016, the Group’s shareholder holding in Eurozone sovereign debt was £767 million. 75 per cent of this was rated AAA (31 December 2015: 75 per cent rated AAA). We do not have any sovereign debt investments in Greece.

The particular risks associated with holding sovereign debt are detailed further in our disclosures on risk factors.

The exposures held by the shareholder-backed business and with-profits funds in sovereign debt securities at 31 December 2016 are given in Note C3.2(f) of the Group’s IFRS financial statements.

Bank debt exposure and counterparty credit risk
*(Audited)*

Our exposure to banks is a key part of our core investment business, as well as being important for the hedging and other activities we undertake to manage our various financial risks. Given the importance of our relationship with our banks, exposure to the sector is a considered a key risk for the Group with an appropriate level of management information provided to the Group’s Risk Committees and the Board.

The exposures held by the shareholder-backed business and with-profits funds in bank debt securities at 31 December 2016 are given in Note C3.2(f) of the Group’s IFRS financial statements.

Our exposure to derivative counterparty and reinsurance counterparty credit risk is managed using an array of risk management tools, including a comprehensive system of limits.

Where appropriate, we reduce our exposure, buy credit protection or use additional collateral arrangements to manage our levels of counterparty credit risk.

At December 2016, shareholder exposures by rating and sector are shown below:

- 96 per cent of the shareholder portfolio is investment grade rated. In particular, 53 per cent of the portfolio is rated A- and above; and
- The Group’s shareholder portfolio is well diversified: no individual sector makes up more than 10 per cent of the total portfolio (excluding the financial and sovereign sectors).

**Liquidity risk**

Our liquidity risk arises from the need to have sufficient liquid assets to meet policyholder and third-party payments as they fall due. This incorporates the risk arising from funds composed of illiquid assets and results from a mismatch between the liquidity profile of assets and liabilities. Liquidity risk may arise, for example, where external capital is unavailable at sustainable cost, increased liquid assets are required to be held as collateral under derivative transactions or redemption requests are made against Prudential issued illiquid funds.

We have significant internal sources of liquidity, which are sufficient to meet all of our expected cash requirements for at least 12 months from the date the financial statements are approved, without having to resort to external sources of funding. In total, the Group has £2.6 billion of undrawn committed facilities that we can make use of, expiring in 2020. We have access to further liquidity by way of the debt capital markets, and also have in place an unlimited commercial paper programme and have maintained a consistent presence as an issuer in this market for the last decade.

Liquidity uses and sources are assessed at a Group and business unit level under both base case and stressed assumptions. We calculate a Liquidity Coverage Ratio (LCR) under stress scenarios as one measure of our liquidity risk, and this ratio and the liquidity resources available to us are regularly monitored and are assessed to be sufficient.

Our risk management and mitigation of liquidity risk include:

- Our liquidity risk policy;
- The risk appetite statements, limits and triggers that we have in place;
- The monitoring of liquidity risk we perform through regular management information to committees and the Board;
- Our Liquidity Risk Management Plan, which includes details of the Group Liquidity Risk Framework as well as gap analysis of our liquidity risks and the adequacy of our available liquidity resources under normal and stressed conditions;
- Regular stress testing;
- Our established contingency plans and identified sources of liquidity;
- Our ability to access the money and debt capital markets;
- Regular deep dive assessments; and
- The access we enjoy to external sources of finance through committed credit facilities.

**Risks from our products**

**Insurance risk**

Insurance risk makes up a significant proportion of our overall risk exposure. The profitability of our businesses depends on a mix of factors including levels of, and trends in, mortality (policyholders dying), morbidity (policyholders becoming ill) and persistency (customers lapsing their policies), and increases in the costs of claims, including the level of medical expenses increases over and above price inflation (claim inflation).

The key drivers of the Group’s insurance risks are persistency and morbidity risk in the Asia business; and longevity risk in the Jackson and Prudential UK & Europe businesses.

We manage and mitigate our insurance risk using the following:

- Our insurance and underwriting risk policies;
- The risk appetite statements, limits and triggers we have in place;
- Using longevity, morbidity and persistency assumptions that reflect recent experience and expectation of future trends, and industry data and expert judgement where appropriate;
- We use reinsurance to mitigate longevity and morbidity risks;
- Morbidity risk is also mitigated by appropriate underwriting when policies are issued and claims are received;
— Persistency risk is mitigated through the quality of sales processes and with initiatives to increase customer retention;
— Medical expense inflation risk mitigated through product re-pricing; and
— Regular deep dive assessments.

Longevity risk is an important element of our insurance risks for which we need to hold a large amount of capital under Solvency II regulations. Longevity reinsurance is a key tool for us in managing our risk. The enhanced pensions freedoms introduced in the UK during 2015 greatly reduced the demand for retail annuities and further liberalisation is anticipated. Although we have scaled down our participation in the annuity market by reducing new business acquisition, given our significant annuity portfolio the assumptions we make about future rates of improvement in mortality rates remain key to the measurement of our insurance liabilities and to our assessment of any reinsurance transactions.

We continue to conduct research into longevity risk using both experience from our annuity portfolio and industry data. Although the general consensus in recent years is that people are living longer, there is considerable volatility in year-on-year longevity experience, which is why we need expert judgement in setting our longevity basis.

Our morbidity risk is mitigated by appropriate underwriting when policies are issued and claims are received. Our morbidity assumptions reflect our recent experience and expectation of future trends for each relevant line of business.

In Asia, we write significant volumes of health protection business, and so a key assumption for us is the rate of medical inflation, which is often in excess of general price inflation. There is a risk that the expenses of medical treatment increase more than we expect, so the medical claim cost passed on to us is higher than anticipated. Medical expense inflation risk is best mitigated by retaining the right to re-price our products each year and by having suitable overall claim limits within our policies, either limits per type of claim or in total across a policy.

Our persistency assumptions similarly reflect a combination of recent past experience for each relevant line of business and expert judgement, especially where a lack of relevant and credible experience data exists. Any expected change in future persistency is also reflected in the assumption. Persistency risk is mitigated by appropriate training and sales processes and managed locally post-sale through regular experience monitoring and the identification of common characteristics of business with high lapse rates. Where appropriate, we make allowance for the relationship (either assumed or historically observed), between persistency and investment returns and account for the resulting additional risk. Modelling this dynamic policyholder behaviour is particularly important when assessing the likely take-up rate of options embedded within certain products. The effect of persistency on our financial results can vary but mostly depends on the value of the product features and market conditions.

### Risks from our business operations

#### Operational risk

Operational risk is the risk of loss (or unintended gain or profit) arising from inadequate or failed internal processes, personnel and systems, or from external events. This includes employee error, model error, system failures, fraud or some other event which disrupts business processes.

We manage and mitigate our operational risk using the following:
— Operational risk and outsourcing and third-party supply policies;
— Corporate insurance programmes to limit the impact of operational risks;
— Scenario analysis for operational risk capital requirements, which focus on extreme, yet plausible, events;
— Internal and external review of cyber security capability; and
— Regular testing of elements of the disaster-recovery plan.

An important element of operational risk relates to compliance with changing regulatory requirements. The high rate of global regulatory change, in an already complex regulatory landscape, increases the risk of non-compliance due to a failure to identify, correctly interpret, implement and/or monitor regulations. Legislative developments over recent years, together with enhanced regulatory oversight and increased capability to issue sanctions, have resulted in a complex regulatory environment that may lead to breaches of varying magnitude if the Group’s business-as-usual operations are not compliant. As well as prudential regulation, we focus on conduct regulation, including regulations related to anti-money laundering, bribery and corruption, and sales practices. We have a particular focus on these regulations in newer/emerging markets.

The performance of core activities places reliance on the IT infrastructure that supports day-to-day transaction processing. Our IT environment must also be secure and we must address an increasing cyber risk threat as our digital footprint increases – see separate Cyber risk section below.

The risk that our IT infrastructure does not meet these requirements is a key area of focus, particularly the risk that legacy IT infrastructure supporting core activities/processes affects business continuity or impacts on business growth.

As well as the above, other key areas of focus within operational risk include:
— The risk of a significant failure of a third-party outsourcing partner impacting critical services;
— The risk of trading or transaction errors having a material cost across Group;
— The risk that errors within models and user-developed applications used by the Group result in incorrect or inappropriate transactions being instructed;
— Departure of key persons or teams resulting in disruption to current and planned business activities;
— The risk that key people, processes and systems are unable to operate (thus impacting on the on-going operation of the business) due to a significant...
unexpected external event; for example pandemic, terrorist attack, natural disaster, or political unrest;
— The risk that a significant project fails or partially fails to meet its objectives, leading to financial loss; and
— The risk of inadequate or inappropriate controls, governance structures or communication channels in place to support the desired culture and ensure that the business is managed in line with the core business values, within the established risk appetite and in alignment with external stakeholder expectations.

Global regulatory and political risk
Our risk management and mitigation of regulatory and political risk includes the following:
— A Risk and Capital Plan that includes considerations of current strategies;
— Close monitoring and assessment of our business environment and strategic risks;
— Board strategy sessions that consider risk themes;
— A Systemic Risk Management Plan that details the Group’s strategy and Risk Management Framework; and
— A Recovery Plan covering corporate and risk governance for managing risks in a distressed environment, a range of recovery options, and scenarios to assess the effectiveness of these recovery options.

In June 2016, the UK voted to leave the EU. The potential outcome of the negotiations on UK withdrawal and any subsequent negotiations on trade and access to major trading markets, including the single EU market, is currently highly uncertain.

The ongoing uncertainty and likelihood of a lengthy negotiation period may increase volatility in the markets where we operate, creating the potential for a general downturn in economic activity and for further or prolonged falls in interest rates in some jurisdictions due to easing of monetary policy and investor sentiment.

We have several UK-domiciled operations, including Prudential UK and M&G, and these may be impacted by a UK withdrawal from the EU. However, our diversification by geography, currency, product and distribution should reduce some of the potential impact. Contingency plans were developed ahead of the referendum by business units and operations that may be immediately impacted by a vote to withdraw the UK from the EU, and these plans have been enacted since the referendum result.

The EU’s Solvency II directive came into effect on 1 January 2016; however, the UK’s vote to leave the EU has the potential to result in changes to future applicability of the regime in the UK. In September 2016, following the Brexit vote, the UK Treasury published terms of reference of its consultation into Solvency II to consider the options for British insurers and to assess the impact of the regime on the competitiveness of the UK insurance industry, the needs of UK consumers and the wider UK business economy. The outcome is likely to be dependent on the overall Brexit agreement reached between the UK and EU. Separately, the European Commission has commenced a review of some elements of the application of the Solvency II legislation with a particular focus on the Solvency Capital Requirement calculated using the standard formula.

National and regional efforts to curb systemic risk and promote financial stability are also underway in certain jurisdictions in which Prudential operates, including the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US, and other European Union legislation related to the financial services industry.

There are a number of ongoing policy initiatives and regulatory developments that are having, and will continue to have, an impact on the way Prudential is supervised. These include addressing Financial Conduct Authority (FCA) reviews, ongoing engagement with the Prudential Regulation Authority (PRA), and the work of the Financial Stability Board (FSB) and standard-setting institutions such as the International Association of Insurance Supervisors (IAIS). Decisions taken by regulators, including those related to solvency requirements and capital allocation may have an impact on our business.

The IAIS’s Global Systemically Important Insurers (G-SII) regime form additional compliance considerations for us. Groups designated as a G-SIIs are subject to additional regulatory requirements, including enhanced group-wide supervision, effective resolution planning, development of a Systemic Risk Management Plan, a Recovery Plan and a Liquidity Risk Management Plan. Prudential’s designation as a G-SII was reaffirmed by the IAIS in November 2016, based on the updated methodology published in June 2016. Prudential is monitoring the development and potential impact of the policy measures and is continuing to engage with the PRA on the implications of the policy measures and Prudential’s designation as a G-SII. We continue to engage with the IAIS on developments in capital requirements for groups with G-SII designation.

The IAIS is also developing a Common Framework (ComFrame) which is focused on the supervision of Internationally Active Insurance Groups. ComFrame will establish a set of common principles and standards designed to assist regulators in addressing risks that arise from insurance groups with operations in multiple jurisdictions. As part of this, work is underway to develop a global Insurance Capital Standard that is intended to apply to Internationally Active Insurance Groups. Once the development of the Insurance Capital Standard (ICS) has been concluded, it is intended to replace the Basic Capital Requirement as the minimum group capital requirement for G-SIIs.

A consultation on the ICS was concluded in 2016 and the IAIS intends to publish an interim version of ICS in 2017. Further field testing, consultations and private reporting to group-wide supervisors on the interim version of the ICS are expected over the coming years. It is currently planned to be adopted as part of ComFrame by the IAIS in late 2019.

The IAIS’s Insurance Core Principles, which provide a globally-accepted framework for the supervision of the insurance sector and ComFrame evolution, are expected to create continued development in both prudential and conduct regulations over the next two to three years.

In the US, the Department of Labor proposal in April 2016 to introduce new fiduciary obligations for distributors of investment products to holders of regulated accounts, which could dramatically reshape the distribution of retirement products. Jackson’s strong relationships with distributors, history of product innovation and efficient operations should help mitigate any impacts.

The US National Association of Insurance Commissioners (NAIC) is currently conducting an industry consultation with the aim of reducing the complexity in the variable annuity statutory balance sheet and risk management. Following an industry quantitative impact study, changes have been proposed to the current framework; however, these are considered to be at an early stage of development. Jackson continues to be engaged in the consultation and testing process. The proposal is currently planned to be effective from 2018.

With the new US administration having taken office in January 2017, the potential uncertainty as to the timetable and status of these key US reforms has increased given preliminary indications from Washington. Our preparations to manage the impact of these reforms will continue until further clarification is provided.
Group Chief Risk Officer’s report of the risks facing our business and how these are managed - Penny James

Continued

In Asia, regulatory regimes are developing at different speeds, driven by a combination of global factors and local considerations. New requirements could be introduced in these and other regulatory regimes that challenge legal structures and current sales practices.

Cyber risk
Cyber risk is an area of increased scrutiny for global regulators after a number of recent high profile attacks and data losses. The growing maturity and industrialisation of cyber-criminal capability, together with an increasing level of understanding of complex financial transactions by criminal groups are two reasons why risks to the financial services industry are increasing.

Given this, cyber security is seen as a key risk for the Group. Our current threat assessment is that, while we are not individually viewed as a compelling target for a direct cyber-attack, we are at risk of suffering attacks as a member of the global financial services industry, with potentially significant impact on business continuity, our customer relationship and our brand reputation.

The Board receives periodic updates on cyber risk management throughout the year. The current Group-wide Cyber Risk Management Strategy and the associated Group-wide Coordinated Cyber Defence Plan were approved by the Board in 2016.

The Cyber Risk Management Strategy includes three core objectives: to develop a comprehensive situational awareness of our business in cyberspace; to proactively engage cyber attackers to minimise harm to our business and to enable the business to grow confidently and safely in cyberspace.

The Cyber Defence Plan consists of a number of work-streams, including developing our ability to deal with incidents; alignment with our digital transformation strategy; and increasing cyber oversight and assurance to the Board.

Protecting our customers remains core to our business, and the successful delivery of the Cyber Defence Plan will reinforce our capabilities to continue doing so in cyberspace as we transition to a digital business.

Group functions work with each of the business units to address cyber risks locally within the national and regional context of each business, following the strategic direction laid out in the Cyber Risk Management Strategy and managed through the execution of the Cyber Defence Plan.

The Group Information Security Committee, which consists of senior executives from each of the businesses and meets on a regular basis, governs the execution of the Cyber Defence Plan and reports on delivery and cyber risks to the Group Executive Risk Committee. Both committees also receive regular operational management information on the performance of controls.

Viability statement
In accordance with provision C.2.2 of the UK code, the Directors have assessed the prospects of the Company and the Group for a period longer than the 12 months required by the going concern statement.

Period of assessment
The Directors performed the assessment by reference to the three-year period to December 2019. Three years is considered an appropriate period as it represents the period covered by the detailed business plan that is prepared annually on a rolling three-year basis. In approving the business plan the Director’s review the Group’s projected performance with regards to profitability, cash generation and capital position, together with the parent company’s liquidity over this three-year period. As well as implementing the Group’s strategic objectives, this projection involves setting a number of economic and other assumptions that are inherently volatile over a much longer reporting period. Such assumptions include foreign exchange rates, interest rates, economic growth rates and the impact on the business environment for events such as the exit of the United Kingdom from the European Union.

Although three years is regarded as an appropriate period for the assessment of the Group’s viability, the Directors regularly consider strategic matters that may affect the longer-term prospects of the Group.

Further, the Group as a whole and each of its life assurance operations are subject to extensive regulation and supervision, which are designed primarily to reinforce the company’s management of its long-term solvency, liquidity and viability to ensure that it can continue to meet obligations to policyholders.

In particular, the Group and UK insurance subsidiaries are subject to the capital adequacy requirements of the European Union Solvency II regulatory basis as implemented by the Prudential Regulation Authority in the UK. Capital requirements for the Group’s other subsidiaries are also monitored on their local regulatory bases. In addition to these external capital metrics, the Group uses an internal economic capital assessment to monitor its capital requirements across the Group. Further details on the capital strength of the Group are provided on pages 47 and 48.

Assessment of risks over the period
Assessment of the risks to achieving the projected performance remains an integral part of the planning process. The Group’s risk teams identify key risks to the delivery of the plan and set out mitigating actions where applicable. The Group’s business activities and the factors likely to affect its future development, successful performance and position in the current economic climate are set out on pages 4 to 36. The risks facing the Group’s capital and liquidity positions and their sensitivities are referred to on pages 50 to 60.
For the purposes of assessing the Group’s viability, the Directors further considered those risks where the impact of possible adverse external developments could be of such speed and severity to present a shock to the Group’s financial position. The risks further considered, from those detailed on page 54, are: market risk, credit risk, liquidity risk and regulatory risk.

To evaluate the Group’s resilience to significant deteriorations in market and credit conditions and other shock events, these risks are grouped together into severe but plausible scenarios which are then applied to the assumptions underlying the business plan. For example, the impacts of scenarios assuming a disorderly transition to a more normalised interest rate environment and an international recession were considered in the preparation of the most recent business plan, together with the impact on Group liquidity of a scenario assuming the closure of short-term debt markets for three months. In addition, the Group conducts an annual reverse stress test which gives the Directors an understanding of the maximum resilience of the Group to extremely severe adverse scenarios.

In considering these scenarios the impacts of mitigating management actions designed to maintain or restore key capital, liquidity and solvency metrics to the Group’s approved risk appetite are considered. In the scenarios tested, sufficient actions were available to management to maintain the viability of the Group over the three year period under assessment.

The impact on the business of known areas of regulatory change whose financial implications can be reasonably quantified is also considered as part of the plan. As well as known areas of regulatory change the Group is exposed to the risk of sudden and unexpected changes in regulatory requirements at the Group and local level. The risk of regulatory change is mitigated by capital held by the Group and its subsidiaries in excess of Group and local regulatory requirements, the Group’s ability to generate significant capital annually through its operational delivery and the availability of compensating actions designed to restore key capital and solvency metrics.

**Conclusion on viability**

Based on this assessment, the Directors have a reasonable expectation that the Company and the Group will be able to continue in operation and meet their liabilities as they fall due over the three-year plan period to December 2019.

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**Note**

1 Excludes Group’s proportionate share in joint ventures and unit-linked assets and holdings of consolidated unit trust and similar funds.