GROUP INVESTMENTS

IFRS DISCLOSURES

FROM THE 2007 ANNUAL REPORT

## GROUP INVESTMENTS

### Key messages

**Group Assets**

• The overall quality of the Group's investment portfolio supporting our liabilities to policyholders is strong and analysed in detail in the following schedules. The Group's investment strategy is generally to hold assets for the long-term to meet policyholder liabilities. The Group does not generally run trading positions and it does not write credit protection reinsurance or derivatives.

• The Group has £267 billion of funds under management, of which £204 billion are accounted for on the consolidated balance sheet and are held primarily to meet policyholder liabilities.

• 91 per cent of total Group investment and other assets of £220 billion held on the balance sheet are at fair value with the remaining assets valued at cost or amortised cost in accordance with IFRS.

• 94 per cent of the fair values of financial instruments for which fair valuation is required under IFRS of £175 billion are for securities in an active market 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.

**Debt Securities**

• The Group holds £84 billion of debt securities, of which 57 per cent is held within with-profits and unit-linked funds.

• None of the debt securities the Group held in 2007 defaulted.

• All debt securities are carried at fair value.

• 92 per cent of Group and 85 per cent of Jackson's debt securities are valued using quoted external prices with the remaining amounts almost wholly valued using market calibrated data under internal valuation techniques such as matrix pricing.

• Jackson held debt securities at 31 December 2007 whose fair value was lower than book value by £439 million and the fair value is reflected in IFRS shareholders' equity of £6.2 billion. Reflecting the nature of the value reductions these securities have been accounted for as temporarily reduced in value rather than as realised losses for permanent diminution in the income statement.

• Total shareholder exposure to sub-prime, Alt-A, direct monoline and CDO investments at 31 December 2007 was limited, as follows:

| | Market value £m |
|---|---|
| Sub-prime and Alt-A | |
| Jackson - Sub-prime (AAA) | 237 |
| - Alt-A (77% AAA, 17% AA) | 660 |
| Asian insurance operations | 15 |
| Direct monoline insurers | 27 |
| CDO funds - all without sub-prime exposure (59% AAA, 18% AA, 4% AA-, 4% A, 5% BBB | 377 |
| Total | 1,316 |

**Group results**

• Profit before tax attributable to shareholders

The Group prepares supplementary analysis of profit before tax attributable to shareholders that distinguishes operating profit based on longer-term investment returns from short-term fluctuations in investment returns.

Group short-term fluctuations in investment returns for 2007 were negative £137 million (2006: positive £155 million) and primarily reflect temporary value movements. Short-term fluctuations in investment returns for US insurance operations include a charge of £30 million for the excess of realised losses for debt securities of £78 million over the long-term risk margin charge included in operating profits based on longer-term investment returns.

• Movements in shareholders' equity.

In addition to profit effects, for assets classified as 'available-for-sale', which for the Prudential Group solely applies to its US insurance operations, unrealised gains and losses are accounted for as direct movements in shareholder equity. Movements in Group shareholders' equity for 2007 includes unrealised negative valuation movements of £244 million (2006: negative of £201 million) on securities of US operations classified as 'available-for-sale' securities under IAS 39.

## GROUP INVESTMENTS

**GROUP INVESTMENTS**
**IFRS DISCLOSURES FROM THE 2007 ANNUAL REPORT**

**Section 1 - Balance sheets at 31 December 2007**

**1.1 Group balance sheet - analysis by business unit**

For an appreciation of the shareholder exposure to investment value movements it is necessary to distinguish the effects of fund structure and type of business for the Group's operations. Analysis of the balance sheets which shows these features is shown in sections 1.2 to 1.5.

| | Insurance | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | UK (section 1.2) £m | US (section 1.3) £m | Asia (section 1.4) £m | Total insurance operations £m | Asset management operations (section 1.5) £m | Unallocated to a segment £m | Intra-group eliminations £m | 31 Dec 2007 Group total £m |
| **Assets** | | | | | | | | |
| Intangible assets attributable to shareholders (note 1.1a): | | | | | | | | |
| Goodwill | - | - | 111 | 111 | 1,230 | - | - | 1,341 |
| Deferred acquisition costs and other intangible assets value | 157 | 1,928 | 745 | 2,830 | 6 | - | - | 2,836 |
| Total | 157 | 1,928 | 856 | 2,941 | 1,236 | - | - | 4,177 |
| Intangible assets attributable to PAC with-profits fund: | | | | | | | | |
| In respect of acquired subsidiaries for venture fund and other investment purposes | 192 | - | - | 192 | - | - | - | 192 |
| Deferred acquisition costs | 19 | - | - | 19 | - | - | - | 19 |
| | 211 | - | - | 211 | - | - | - | 211 |
| Total | 368 | 1,928 | 856 | 3,152 | 1,236 | - | - | 4,388 |
| Other non-investment and non-cash assets | 4,433 | 1,651 | 762 | 6,846 | 521 | 4,457 | (5,499) | 6,325 |
| Investment of long-term business and other operations: | | | | | | | | |
| Investment property | 13,666 | 8 | 14 | 13,688 | – | – | | 13,688 |
| Investments accounted for using the equity method | – | – | – | - | – | 12 | – | 12 |
| Loans | 1,245 | 3,258 | 1,087 | 5,590 | 2,334 | – | – | 7,924 |
| Equity securities and portfolio holdings in unit trusts | 60,829 | 15,507 | 9,804 | 86,140 | 17 | - | – | 86,157 |
| Debt securities (see section 3 for analysis of credit quality) | 57,180 | 19,002 | 6,920 | 83,102 | 882 | - | – | 83,984 |
| Other investments | 3,391 | 762 | 42 | 4,195 | 155 | 46 | – | 4,396 |
| Deposits | 7,228 | 258 | 377 | 7,863 | 26 | – | – | 7,889 |
| Total Investments | 143,539 | 38,795 | 18,244 | 200,578 | 3,414 | 58 | - | 204,050 |
| Held-for-sale assets | 30 | - | - | 30 | - | - | - | 30 |
| Cash and cash equivalents | 1,869 | 169 | 679 | 2,717 | 1,840 | 394 | - | 4,951 |
| **Total assets** | **150,239** | **42,543** | **20,541** | **213,323** | **7,011** | **4,909** | **(5,499)** | **219,744** |
| **Equity and liabilities** | | | | | | | | |
| ***Equity*** | | | | | | | | |
| Shareholders' equity | 1,364 | 2,690 | 1,369 | 5,423 | 1,677 | (899) | - | 6,201 |
| Minority interests | 42 | 1 | 7 | 50 | 52 | - | - | 102 |
| Total equity | 1,406 | 2,691 | 1,376 | 5,473 | 1,729 | (899) | - | 6,303 |
| ***Liabilities*** | | | | | | | | |
| Policyholder liabilities and unallocated surplus of with-profits funds: | | | | | | | | |
| Insurance contract liabilities | 82,798 | 32,926 | 16,912 | 132,636 | - | - | - | 132,636 |
| Investment contract liabilities with discretionary participation features | 29,466 | - | 84 | 29,550 | - | - | - | 29,550 |
| Investment contract liabilities without discretionary participation features | 12,073 | 1,922 | 37 | 14,032 | - | - | - | 14,032 |
| Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds) | 14,205 | - | 146 | 14,351 | - | - | - | 14,351 |
| Total policyholder liabilities and unallocated surplus of with-profits funds | 138,542 | 34,848 | 17,179 | 190,569 | - | - | - | 190,569 |
| Core structural borrowings of shareholder-financed operations: | | | | | | | | |
| Subordinated debt | - | - | - | - | - | 1,570 | - | 1,570 |
| Other | - | 125 | - | 125 | - | 797 | - | 922 |
| Total | - | 125 | - | 125 | - | 2,367 | - | 2,492 |
| Operational borrowings attributable to shareholder-financed operations | 12 | 591 | - | 603 | 1 | 2,477 | - | 3,081 |
| Borrowings attributable to with-profits funds | 987 | - | - | 987 | - | - | - | 987 |
| Other non-insurance liabilities | 9,292 | 4,288 | 1,986 | 15,566 | 5,281 | 964 | (5,499) | 16,312 |
| Total liabilities | 148,833 | 39,852 | 19,165 | 207,850 | 5,282 | 5,808 | (5,499) | 213,441 |
| **Total equity and liabilities** | **150,239** | **42,543** | **20,541** | **213,323** | **7,011** | **4,909** | **(5,499)** | **219,744** |

**Notes**

**1.1a** Intangible assets attributable to shareholders comprise principally goodwill of acquired business of £1,341 million (of which £1,153 million related to the acquisition of M&G in 1999) and deferred acquisition costs for life assurance contracts which are recognised and amortised in line with the requirements of the IASB standards IFRS 4 and IAS 18.

## 1.2 UK insurance operations

Key points

- In order to explain the different types of UK business and fund structure, the balance sheet of the UK insurance operations requires analysis of the assets and liabilities between those of the Scottish Amicable Insurance Fund (SAIF), the PAC with-profits sub-fund (WPSF), Prudential Retirement Income Limited (PRIL), unit-linked and other business.
- £107 billion of the £144 billion of investments are held by SAIF and the PAC WPSF. Shareholders are exposed only indirectly to value movements on these assets.
- The majority of the remaining investments of shareholder-backed business are held to back unit-linked liabilities and policyholder liabilities of PRIL annuity business. Assets and liabilities for these types of business are closely matched.
- Credit quality details of the debt securities are shown in section 3.

The assets and liabilities of the funds and subsidiaries of UK insurance operations are shown in the table below:

| | | PAC with-profits sub-fund (WPSF) (note 1.2a) | | | Other funds and subsidiaries | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Scottish Amicable Insurance Fund (SAIF) (note 1.2b) | Excluding Prudential Annuities Limited | Prudential Annuities Limited (PAL) (note 1.2c) | Total (note 1.2d) | Prudential Retirement Income Limited (PRIL) | Other non-profit unit-linked business | Other long-term business | Total | **Total 2007** |
| | £m | £m | £m | £m | £m | £m | £m | £m | **£m** |
| **Assets** | | | | | | | | | |
| Intangible assets attributable to shareholders: | | | | | | | | | |
| Deferred acquisition costs and acquired in-force value of long-term business contracts | - | - | - | - | - | 55 | 102 | 157 | **157** |
| | - | - | - | - | - | 55 | 102 | 157 | **157** |
| Intangible assets attributable to With-profits funds: | | | | | | | | | |
| In respect of acquired venture fund investment subsidiaries | - | 192 | - | 192 | - | - | - | - | **192** |
| Deferred acquisition costs | 4 | 15 | - | 15 | - | - | - | - | **19** |
| | 4 | 207 | - | 207 | - | - | - | - | **211** |
| Total | 4 | 207 | - | 207 | - | 55 | 102 | 157 | **368** |
| Other non-investment and non-cash assets | 161 | 2,086 | 289 | 2,375 | 512 | 660 | 725 | 1,897 | **4,433** |
| Investments: | | | | | | | | | |
| Investment properties | 1,230 | 10,197 | 485 | 10,682 | 724 | 1,030 | - | 1,754 | **13,666** |
| Financial investments: | | | | | | | | | |
| Loans (note 1.2e) | 184 | 599 | 163 | 762 | 43 | - | 256 | 299 | **1,245** |
| Equity securities and portfolio holdings in unit trusts | 6,946 | 40,756 | 352 | 41,108 | 107 | 12,659 | 9 | 12,775 | **60,829** |
| Debt securities (note 1.2f) (see section 3 for analysis of credit quality) | 4,595 | 20,383 | 13,075 | 33,458 | 13,173 | 5,751 | 203 | 19,127 | **57,180** |
| Other investments (note 1.2g) | 244 | 2,531 | 127 | 2,658 | 90 | 115 | 284 | 489 | **3,391** |
| Deposits | 466 | 4,021 | 313 | 4,334 | 828 | 1,418 | 182 | 2,428 | **7,228** |
| Total investments | 13,665 | 78,487 | 14,515 | 93,002 | 14,965 | 20,973 | 934 | 36,872 | **143,539** |
| Held-for-sale assets | 30 | - | - | - | - | - | - | - | **30** |
| Cash and cash equivalents | 127 | 642 | 56 | 698 | 49 | 836 | 159 | 1,044 | **1,869** |
| **Total assets** | 13,987 | 81,422 | 14,860 | 96,282 | 15,526 | 22,524 | 1,920 | 39,970 | **150,239** |
| **Equity and liabilities** | | | | | | | | | |
| ***Equity*** | | | | | | | | | |
| Shareholders' equity | - | - | - | - | 1,125 | 194 | 45 | 1,364 | **1,364** |
| Minority interests | 22 | 20 | - | 20 | - | - | - | - | **42** |
| Total equity | 22 | 20 | - | 20 | 1,125 | 194 | 45 | 1,364 | **1,406** |
| ***Liabilities*** | | | | | | | | | |
| Policyholder liabilities and unallocated surplus of with-profits funds: | | | | | | | | | |
| Insurance contract liabilities | 12,927 | 34,988 | 12,564 | 47,552 | 13,402 | 8,766 | 151 | 22,319 | **82,798** |
| Investment contract liabilities with discretionary participation features | 693 | 28,773 | - | 28,773 | - | - | - | - | **29,466** |
| Investment contract liabilities without discretionary participation features | - | 14 | - | 14 | - | 12,059 | - | 12,059 | **12,073** |
| Unallocated surplus of with-profits funds (reflecting application of 'realistic' provisions for UK regulated with-profits funds) (note 1.2h) | | 12,486 | 1,719 | 14,205 | - | - | - | - | **14,205** |
| Total | 13,620 | 76,261 | 14,283 | 90,544 | 13,402 | 20,825 | 151 | 34,378 | **138,542** |
| Operational borrowings attributable to shareholder-financed operations | - | - | - | - | - | 12 | - | 12 | **12** |
| Borrowings attributable to with-profits funds | 112 | 875 | - | 875 | - | - | - | - | **987** |
| Other non-insurance liabilities | 233 | 4,266 | 577 | 4,843 | 999 | 1,493 | 1,724 | 4,216 | **9,292** |
| Total liabilities | 13,965 | 81,402 | 14,860 | 96,262 | 14,401 | 22,330 | 1,875 | 38,606 | **148,833** |
| **Total equity and liabilities** | **13,987** | **81,422** | **14,860** | **96,282** | **15,526** | **22,524** | **1,920** | **39,970** | **150,239** |

**Notes**

**1.2a** For the purposes of this table and subsequent explanation, references to the WPSF also include, for convenience, the amounts attaching to the Defined Charges Participating Sub-fund.

**1.2b** The SAIF is a separate sub-fund within the PAC long-term business fund. The fund is solely for the benefit of policyholders of SAIF. Shareholders have no interest in the profits of this fund although they are entitled to investment management fees on these assets.

**1.2c** Wholly-owned subsidiary of the PAC WPSF that writes annuity business.

**1.2d** Excluding policyholder liabilities of the Hong Kong branch of PAC.

**1.2e** The loans of the Group's UK insurance operations of £1,245 million comprise mortgage loans of £449 million, policy loans of £35 million and other loans of £761 million. The mortgage loans are collateralised by properties. Other loans are all commercial loans and comprise mainly syndicated loans held by the PAC with-profits fund.

**1.2f** Included in debt securities above are £3,511 million (2006: £3,341 million) of securities which are not quoted on active markets of which £3,002 million (2006: £2,945 million) related to assets held by with-profits operations and £509 million (2006: £396 million) related to assets held by shareholder-backed operations as discussed in section 2.

**1.2g** Other investments comprise:

| | **£m** |
|---|---|
| Derivative assets* | 571 |
| Partnerships in investment pools and other** | 2,820 |
| | 3,391 |

* In the UK, Prudential uses derivatives to reduce equity and credit risk, interest rate and currency exposures, and to facilitate efficient portfolio management. After derivative liabilities £689 million, which are also included in the balance sheet, the overall derivative position was a net liability of £118 million.

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

**1.2h** Unallocated surplus of with-profits funds

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

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

**1.3 US insurance operations**

| | Variable annuity separate account assets and liabilities (note 1.3a) £m | Fixed annuity, GIC and other business (note 1.3a) £m | **Total 2007 £m** |
|---|---|---|---|
| **Assets** | | | |
| Intangible assets attributable to shareholders: | | | |
| Deferred acquisition costs and other intangible assets | - | 1,928 | **1,928** |
| Total | - | 1,928 | **1,928** |
| Other non-investment and non-cash assets | - | 1,651 | **1,651** |
| Investments of long-term business and other operations: | | | |
| Investment properties | - | 8 | **8** |
| Financial investments: | | | |
| Loans (note 1.3b) | - | 3,258 | **3,258** |
| Equity securities and portfolio holdings in unit trusts | 15,027 | 480 | **15,507** |
| Debt securities (see section 3 for analysis of credit quality) | - | 19,002 | **19,002** |
| Other investments (note 1.3c) | - | 762 | **762** |
| Deposits | - | 258 | **258** |
| Total investments | 15,027 | 23,768 | **38,795** |
| Cash and cash equivalents | - | 169 | **169** |
| **Total assets** | 15,027 | 27,516 | **42,543** |
| **Equity and liabilities** | | | |
| ***Equity*** | | | |
| Shareholders' equity | - | 2,690 | **2,690** |
| Minority interests | - | 1 | **1** |
| Total equity | - | 2,691 | **2,691** |
| ***Liabilities*** | | | |
| Policyholder liabilities: | | | |
| Insurance contract liabilities | 15,027 | 17,899 | **32,926** |
| Investment contract liabilities without discretionary participation features (GIC and annuity certain) | - | 1,922 | **1,922** |
| Total | 15,027 | 19,821 | **34,848** |
| Core structural borrowings of shareholder-financed operations | - | 125 | **125** |
| Operational borrowings attributable to shareholder-financed operations | - | 591 | **591** |
| Other non-insurance liabilities | - | 4,288 | **4,288** |
| Total liabilities | 15,027 | 24,825 | **39,852** |
| **Total equity and liabilities** | 15,027 | 27,516 | **42,543** |

**Notes**

**1.3a** Assets and liabilities attaching to variable annuity business that are not held in the separate account are shown within other business.

**1.3b** Loans

The loans of Jackson of £3,258 million comprise mortgage loans of £2,841 million and policy loans of £417 million. All of the mortgage loans are commercial mortgage loans which are collaterised by properties. The property types are mainly industrial, multi-family residential, suburban office, retail and hotel.

Jackson's mortgage loan portfolio does not include any single-family residential mortgage loans and therefore are not directly exposed to the risk of defaults associated with residential sub-prime mortgage loans.

The policy loans are fully secured by individual life insurance policies or annuity policies.

These loans are accounted for at amortised cost, less any impairment.

**1.3c** Other investments comprise:

| | £m |
|---|---|
| Derivative assets* | 390 |
| Partnerships in investment pools and other** | 372 |
| | 762 |

* In the US, Prudential uses derivatives to reduce interest rate risk, to facilitate efficient portfolio management to match liabilities under annuity policies, and for certain equity-based product management activities. After taking account of the derivative liability of £158 million, which is also included in the balance sheet, the derivative position for US operations is an asset of £232 million.

** Partnerships in investment pools and other comprise primarily investments in limited partnerships. These include interests in the PPM America Private Equity Fund and diversified investments in 164 other partnerships by independent money managers that generally invest in various equities and fixed income loans and securities.

**1.4 Asian insurance operations**

| | With-profits business (note 1.4a) £m | Unit-linked assets and liabilities £m | Other £m | **Total 2007 £m** |
|---|---|---|---|---|
| **Assets** | | | | |
| Intangible assets attributable to shareholders: | | | | |
| Goodwill | - | - | 111 | **111** |
| Deferred acquisition costs and other intangible assets | - | - | 745 | **745** |
| Total | - | - | 856 | **856** |
| Other non-investment and non-cash assets | 134 | 58 | 570 | **762** |
| Investments of long-term business and other operations: | | | | |
| Investment properties | - | - | 14 | **14** |
| Financial investments: | | | | |
| Loans (note 1.4b) | 560 | 37 | 490 | **1,087** |
| Equity securities and portfolio holdings in unit trusts | 4,472 | 4,728 | 604 | **9,804** |
| Debt securities (see section 3 for analysis of credit quality) | 2,329 | 1,901 | 2,690 | **6,920** |
| Other investments | 13 | 6 | 23 | **42** |
| Deposits | 44 | 118 | 215 | **377** |
| Total investments | 7,418 | 6,790 | 4,036 | **18,244** |
| Cash and cash equivalents | 194 | 123 | 362 | **679** |
| **Total assets** | **7,746** | **6,971** | **5,824** | **20,541** |
| **Equity and liabilities** | | | | |
| ***Equity*** | | | | |
| Shareholders' equity | - | - | 1,369 | **1,369** |
| Minority interests | - | - | 7 | **7** |
| Total equity | - | - | 1,376 | **1,376** |
| ***Liabilities*** | | | | |
| Policyholder liabilities and unallocated surplus of with-profits funds: | | | | |
| Insurance contract liabilities | 6,280 | 6,971 | 3,661 | **16,912** |
| Investment contract liabilities with discretionary participation features | 84 | - | - | **84** |
| Investment contract liabilities without discretionary participation features | 37 | - | - | **37** |
| Unallocated surplus of with-profits funds (see note 1.2h in section 1.2) | 146 | - | - | **146** |
| Total | 6,547 | 6,971 | 3,661 | **17,179** |
| Other non-insurance liabilities | 1,199 | - | 787 | **1,986** |
| Total liabilities | 7,746 | 6,971 | 4,448 | **19,165** |
| **Total equity and liabilities** | **7,746** | **6,971** | **5,824** | **20,541** |

**Notes**

**1.4a** The balance sheet for with-profits business in this analysis comprises the with-profit assets and liabilities of the Hong Kong, Malaysia and Singapore with-profits operations. Assets and liabilities of other participating business is included in the column for 'other business'.

**1.4b** The loans of the Group's Asian insurance operations of £1,087 million comprise mortgage loans of £132 million, policy loans of £430 million and other loans of £525 million. Mortgage and policy loans are secured by properties and life insurance policies respectively. The majority of the other loans are commercial loans held by the Malaysian operation and which are all investment graded by two local rating agencies.

**1.5 Asset management operations**

| | M&G £m | US broker-dealer and asset management £m | Asia asset management £m | **Total 2007 £m** |
|---|---|---|---|---|
| **Assets** | | | | |
| Intangible assets: | | | | |
| Goodwill (note 1.5a) | 1,153 | 16 | 61 | **1,230** |
| Deferred acquisition costs | 6 | - | - | **6** |
| Total | 1,159 | 16 | 61 | **1,236** |
| Other non-investment and non-cash assets | 304 | 132 | 85 | **521** |
| Investment properties | - | - | - | **-** |
| Financial investments: | | | | |
| Loans (note 1.5b) | 2,334 | - | - | **2,334** |
| Equity securities and portfolio holdings in unit trusts | 11 | - | 6 | **17** |
| Debt securities (see section 3 for analysis of credit quality) | 857 | - | 25 | **882** |
| Other investments | 132 | 19 | 4 | **155** |
| Deposits | - | 15 | 11 | **26** |
| Total investments | 3,334 | 34 | 46 | **3,414** |
| Cash and cash equivalents (note 1.5c) | 1,751 | 33 | 56 | **1,840** |
| **Total assets** | 6,548 | 215 | 248 | **7,011** |
| **Equity and liabilities** | | | | |
| ***Equity*** | | | | |
| Shareholders' equity | 1,424 | 81 | 172 | **1,677** |
| Minority interests (note 1.5d) | 52 | - | - | **52** |
| Total equity | 1,476 | 81 | 172 | **1,729** |
| ***Liabilities*** | | | | |
| Intra-group debt of M&G represented by operational borrowings at Group level (note 1.5e) | 2,477 | - | - | **2,477** |
| Net asset value attributable to external unit holders of consolidated investment funds (note 1.5c) | 1,234 | - | - | **1,234** |
| Other non-insurance liabilities | 1,361 | 134 | 76 | **1,571** |
| Total liabilities | 5,072 | 134 | 76 | **5,282** |
| **Total equity and liabilities** | 6,548 | 215 | 248 | **7,011** |

**Notes**

**1.5a** The goodwill primarily relates to the acquisition of M&G in 1999. This and other acquired goodwill is held in the balance sheet at cost and is subject to annual impairment testing.

**1.5b** The loans of £2,334 million comprise £1,383 million of bridging loan finance assets and £951 million of loans receivable under a structured finance arrangement, both managed by Prudential Capital.

The bridging loan finance assets do not generally have external credit ratings. Internal ratings for these loans are prepared by M&G's credit analysis team as part of the risk management process. The internal ratings, applying the Company's assessment of a comparable basis to Standard & Poors, are £738 million rated BBB+ to BBB- and £645 million rated BB+ to BB-.

£826 million of the receivable under the structured finance arrangement was with counterparties rated AA by Standard & Poor's and £125 million AA-. In addition, an AAA rated credit default swap was held covering £400 million of the AA rated element of the loans.

The loans are accounted for at amortised cost and are subject to impairment testing.

**1.5c** The M&G balance sheet shown above includes investment funds which are managed on behalf of third parties and that are consolidated under IFRS in recognition of the control arrangements for the funds. The balance sheet includes cash and cash equivalents of £1,253 million, £19 million of other liabilities and the net asset value attributable to external unit holders of £1,234 million in respect of these funds which are non-recourse to M&G and the Group.

**1.5d** The minority interests reflect external parties in the structured finance arrangement referred to in note 1.5b above.

**1.5e** Operational borrowings for M&G are in respect of Prudential Capital's short-term fixed income security programme and comprise £2,422 million of commercial paper and £55 million of medium term notes.

**1.6 Defined benefit pension schemes**

Included in the Group's balance sheet shown in section 1.1 are surpluses and deficits on the IAS 19 economic basis as described in note 1.6b for the Group's defined benefits pension schemes. The assets and liabilities giving rise to the surpluses and deficits are as follows:

| | 2007 | | |
|---|---|---|---|
| | Prudential Staff Pension Scheme (PSPS) £m | Other schemes £m | Total £m |
| Equities | **1,278** | **265** | **1,543** |
| Bonds | **1,134** | **249** | **1,383** |
| Properties | **545** | **54** | **599** |
| Cash-like investments (note 1.6a) | **1,932** | **5** | **1,937** |
| Total value of assets (note 1.6b) | **4,889** | **573** | **5,462** |
| Present value of benefit obligations | **(4,361)** | **(654)** | **(5,015)** |
| Pre-tax surplus/(deficit) (as shown in section 4.5) | **528** | **(81)** | **447** |

**Notes**

**1.6a** The PSPS has entered into a derivatives based strategy to match the duration and inflation profile of its liabilities. This involved a reallocation from other investments to cash-like investments with an interest and inflation swap overlay. In broad terms, the Scheme is committed to making a series of payments related to LIBOR on a nominal amount and in return the Scheme receives a series of fixed and inflation-linked payments which match a proportion of its liabilities. As at 31 December 2007, the nominal value of the interest and inflation swaps amounted to £1.2 billion and £0.7 billion respectively.

**1.6b** To show the economic position on the schemes, the assets above include investment in Prudential policies. These assets, and the equivalent liabilities to the pension schemes of the Prudential life insurance subsidiaries, are eliminated on consolidation for the purposes of the Group financial statements.

## Section 2 - Valuation bases for Group assets

### 2.1 Summary of valuation bases applied

The accounting carrying values of the Group's assets reflect the requirements of IFRS. For financial investments the basis of valuation reflects the Group's application of IAS 39 ('Financial Instruments: Recognition and Measurement'). The basis applied for the assets section of the consolidated balance sheet at 31 December 2007 is summarised below.

| | At fair value | Cost / Amortised cost (note 2.1a) | **Total** |
|---|---|---|---|
| | £m | £m | **£m** |
| Intangible assets attributable to shareholders: | | | |
| Goodwill | - | 1,341 | **1,341** |
| Deferred acquisition costs and other intangible assets | - | 2,836 | **2,836** |
| Total | - | 4,177 | **4,177** |
| Intangible assets attributable to PAC with-profits fund: | | | |
| In respect of acquired subsidiaries for venture fund and other investment purposes | - | 192 | **192** |
| Deferred acquisition costs | - | 19 | **19** |
| Total | - | 211 | **211** |
| Total | - | 4,388 | **4,388** |
| Other non-investment and non-cash assets: | | | |
| Property, plant and equipment | - | 1,012 | **1,012** |
| Reinsurers' share of insurance contract liabilities | - | 783 | **783** |
| Deferred tax asset | - | 925 | **925** |
| Current tax recoverable | - | 285 | **285** |
| Accrued investment income | - | 2,023 | **2,023** |
| Other debtors | - | 1,297 | **1,297** |
| Total | - | 6,325 | **6,325** |
| Investments of long-term business, banking and other operations: | | | |
| Investment properties | 13,688 | - | **13,688** |
| Investments accounted for using the equity method | - | 12 | **12** |
| Financial investments: | | | |
| Loans | - | 7,924 | **7,924** |
| Equity securities and portfolio holdings in unit trusts (note 2.1b) | 86,157 | - | **86,157** |
| Debt securities (note 2.1b) | 83,984 | - | **83,984** |
| Other investments (note 2.1b) | 4,396 | - | **4,396** |
| Deposits | 7,889 | - | **7,889** |
| Total | 196,114 | 7,936 | **204,050** |
| Held for sale assets | 30 | - | **30** |
| Cash and cash equivalents | 4,951 | - | **4,951** |
| **Total assets** | 201,095 | 18,649 | **219,744** |
| Percentage of Group assets | 91% | 9% | **100%** |

**Notes**

**2.1a** Assets carried at cost or amortised cost are subject to impairment testing where appropriate under IFRS requirements.

**2.1b** These assets comprise financial instruments requiring fair valuation under IAS 39 with a value of £174,537 million. Six per cent have been valued using valuation techniques as described in section 2.2.

### 2.2 Determination of fair value

The fair values of financial instruments for which fair valuation is required under IFRS and which are in an active market 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. If the market for a financial investment of the Group is not active, the Group establishes fair value by using valuation techniques. The valuation techniques include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option adjusted spread models and, if applicable, enterprise valuation and may include a number of assumptions relating to variables such as credit risk and interest rates. Changes in assumptions relating to these variables could positively or negatively impact the reported fair value of these instruments.

The fair value estimates are made at a specific point in time, based upon available market information and judgements about the financial instruments, including estimates of the timing and amount of expected future cash flows and the credit standing of counterparties. Such estimates do not reflect any premium or discount that could result from offering for sale at one time the Group's entire holdings of a particular financial instrument, nor do they consider the tax impact of the realisation of unrealised gains or losses. 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 estimated fair value of derivative financial instruments reflects the estimated amount the Group would receive or pay in an arm's length transaction. This amount is determined using quotations from independent third parties or valued internally using standard market practices. In accordance with the Group's risk management framework, all internally generated valuations are subject to independent assessment against external counterparties' valuations.

### 2.3 Use of valuation techniques

The carrying value of investments on the balance sheet at 31 December 2007 of the Group which are not on active markets and therefore valued using valuation techniques as described above are as follows:

| | | Shareholder-backed business | | | |
|---|---|---|---|---|---|
| | UK with–profits funds £m | UK (PRIL) £m | US £m | Total shareholder-backed business £m | Total £m |
| Debt securities | **3,002** | **509** | **2,863** | **3,372** | **6,374** |
| Equity securities | **629** | **-** | **-** | **-** | **629** |
| Other investments | **2,108** | **-** | **743** | **743** | **2,851** |
| | **5,739** | **509** | **3,606** | **4,115** | **9,854** |

The majority of the financial investments valued using valuation techniques are debt securities. Of the debt securities valued using valuation techniques of £6,374 million, debt securities with a fair value of £3,511 million were held by UK operations. £3,002 million of this amount related to securities held by with-profits operations and £509 million related to securities held by the shareholder-backed UK annuity subsidiary Prudential Retirement Income Limited (PRIL). Debt securities valued using valuation techniques held by the US operations were £2,863 million.

These debt securities include private debt securities such as private placements, project finance, asset securitisations and local authority securities. The securities are mainly long-dated and not regularly traded and are valued internally using standard market practices. The majority of the debt securities shown above are valued using matrix pricing, which is based on assessing credit quality of the underlying borrower to derive a suitable discount rate relative to government securities. Under matrix pricing, the debt securities are priced by taking the credit spreads on comparable quoted public debt securities and applied to the equivalent debt instruments factoring in a specified liquidity premium. The majority of the parameters used in this valuation technique are readily observable in the market and, therefore, are not subject to interpretation.

For UK operations, in accordance with the Group’s Risk Management Framework, all internally generated calculations are subject to independent assessment by the Group’s Fair Value Committees which comprise members who are independent of the asset managers involved in the day-to-day trading in these assets.

In addition to private debt securities, debt securities of US operations valued using valuation techniques also included securities held by the Piedmont trust entity, an 80 per cent Jackson held static trust formed as a result of securitisation of asset-backed securities in 2003 that are accounted for on an available-for-sale basis. As at 31 December 2007, the fair value of these Piedmont assets valued using valuation techniques was £316 million. Significant estimates and judgements are also employed in valuing certain asset-backed and mortgage-backed securities held by the Piedmont trust entity. These valuations may impact reported shareholder profit and loss amounts through the determination of impairment and recovery amounts.

Whilst management believes that the estimates and assumptions employed in developing the fair value estimates are reasonable and present management’s best estimate of such values, a reasonable range of values exists with respect to most assumptions utilised in determining these values. As a result of the potentially significant variability in the estimates of the assumptions used in these models, the range of reasonable estimates of the fair value of these securities is significant.

Management has obtained broker bids on these Piedmont trust assets that represent the value at which the Group could sell the investments, if forced. These bids are not based on full knowledge and hence analysis of the investments, but represent the best estimate of the worst case decline in market value of these securities. The broker bids for these securities at 31 December 2007 totalled £260 million, a difference of £56 million from the fair value applied.

The equity securities and other investments which included property and other partnerships in investment pools, venture fund investments, and derivative assets as shown in the table above are valued using valuation techniques which apply less readily observable market factors and more non-observable factors than the matrix pricing technique as used for the majority of the debt securities for which a valuation technique is necessary. In addition to the investments shown above, there are some minor amounts valued using valuation techniques for Group's Asian operations.

The total amount of the change in fair value estimation using valuation techniques, including valuation techniques based on assumptions not wholly supported by observable market prices or rates, recognised in the income statement in 2007 was a gain of £101 million for the with-profits fund investments. Changes in values of assets of the with-profits funds are reflected in policyholder liabilities and unallocated surplus. Due to the liability accounting treatment of unallocated surplus, changes in values of securities held by with-profits funds have no direct effect on the profit or loss attributable to shareholders or shareholders’ equity.

The total amount of the change in fair value estimation using valuation techniques, including those based on assumptions not wholly supported by observable market prices or rates, recognised in the income statement in 2007 and which was attributable to shareholders, was a gain of £138 million for PRIL and US operations' investments.

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## Section 3 - Credit quality of Group's portfolios of debt securities at 31 December 2007

Debt securities are accounted for at fair value. The amounts included in the balance sheet are analysed as follows, with further information provided in the notes below.

| Summary | Section cross reference | Total £m |
|---|---|---|
| Insurance operations | | |
| Asia (note 3a) | 1.4 | **6,920** |
| US (note 3b) | 1.3 | **19,002** |
| UK (note 3c) | 1.2 | **57,180** |
| | | **83,102** |
| Asset management operations (note 3d) | 1.5 | **882** |
| Total (note 3e) | 1.1 | **83,984** |

In the tables shown below, Standard & Poor's (S&P) ratings have been used where available. For securities, where S&P ratings are not immediately available, those produced by Moody's and then Fitch have been used as an alternative.

**Notes**

**3a Asian insurance operations**

The following table summarises the credit quality of the debt securities of the Asian insurance operations by rating agency grading:

| | With-profits business £m | Unit-linked business £m | Other business £m | Total £m |
|---|---|---|---|---|
| S&P – AAA | 1,367 | 660 | 257 | **2,284** |
| S&P – AA+ to AA- | 242 | 153 | 1,599 | **1,994** |
| S&P – A+ to A- | 299 | 271 | 105 | **675** |
| S&P – BBB+ to BBB- | 142 | 34 | 17 | **193** |
| S&P – Other | 8 | 47 | 94 | **149** |
| | 2,058 | 1,165 | 2,072 | **5,295** |
| Moody's – Aaa | 16 | 185 | - | **201** |
| Moody's – Aa1 to Aa3 | 7 | 19 | 19 | **45** |
| Moody's – A1 to A3 | 11 | 16 | 1 | **28** |
| Moody's – Baa1 to Baa3 | 12 | 7 | - | **19** |
| Moody's – Other | 58 | - | - | **58** |
| | 104 | 227 | 20 | **351** |
| Other | 167 | 509 | 598 | **1,274** |
| Total debt securities | 2,329 | 1,901 | 2,690 | **6,920** |

Of the £598 million debt securities for other business which are not rated in the table above, £317 million are in respect of government bonds, £83 million corporate bonds rates as investment grade by local external ratings agencies, and £71 million structured deposits issued by banks which are themselves rated but where the specific deposits have not been.

**3b US insurance operations**

| | Total £m |
|---|---|
| Corporate security and commercial loans (note (ii)): | |
| Publicly traded and SEC Rule 144A traded | **10,345** |
| Non-SEC Rule 144A traded | **2,613** |
| Mortgage-backed securities (note (iii)) | **12,958** |
| Residential | **2,939** |
| Commercial | **1,532** |
| Other debt securities (note (iv)) | **1,573** |
| Total debt securities (note (i)) | **19,002** |

**Notes**

(i) Total debt securities by rating agency grading

The following table summarises the credit quality of the debt securities held by US insurance operations at 31 December 2007 by agency grading:

| | £m |
|---|---|
| S&P – AAA | **3,896** |
| S&P – AA+ to AA- | **1,187** |
| S&P – A+ to A- | **3,657** |
| S&P – BBB+ to BBB- | **5,415** |
| S&P – Other | **1,113** |
| | **15,268** |
| Moody's – Aaa | **549** |
| Moody's – Aa1 to Aa3 | **118** |
| Moody's – A1 to A3 | **47** |
| Moody's – Baa1 to Baa3 | **79** |
| Moody's – Other | **78** |
| | **871** |
| Fitch | **380** |
| Other (see below) | **2,483** |
| Total debt securities | **19,002** |

Other unrated US debt securities

The securities without S&P, Moody's or Fitch ratings have the following NAIC classification:

| NAIC designation | 2007 £m |
|---|---|
| 1 | **1,079** |
| 2 | **1,311** |
| 3-6 | **93** |
| | **2,483** |

(ii) Corporate security and commercial loans

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

The following table shows the quality of publicly traded and SEC Rule 144A traded debt securities held by the US operations as at 31 December 2007:

| | Carrying value £m | % of total |
|---|---|---|
| NAIC designation: | | |
| 1 | **4,338** | **42** |
| 2 | **5,194** | **50** |
| 3 | **542** | **5** |
| 4 | **231** | **2** |
| 5 | **40** | **1** |
| | **10,345** | **100** |

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

| | Carrying value £m | % of total |
|---|---|---|
| NAIC designation: | | |
| 1 | **1,011** | **39** |
| 2 | **1,351** | **52** |
| 3 | **206** | **8** |
| 4 | **45** | **1** |
| 5 | **–** | **–** |
| | **2,613** | **100** |

(iii) Mortgage-backed securities

The following table shows the quality of residential and commercial mortgage-backed securities:

| | £m (unless otherwise stated) |
|---|---|
| **Residential mortgage-backed securities** | |
| Total residential mortgage-backed securities | **2,939** |
| Residential mortgage-backed securities rated AAA or equivalent by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch): | |
| Amount | **2,542** |
| Percentage of total | **86.5%** |
| Residential mortgage-backed securities rated NAIC 1: | |
| Amount | **2,932** |
| Percentage of total | **99.8%** |
| **Commercial mortgage-backed securities** | |
| Total commercial mortgage-backed securities | **1,532** |
| Commercial mortgage-backed securities rated AAA or equivalent by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch): | |
| Amount | **1,351** |
| Percentage of total | **88.2%** |
| Commercial mortgage-backed securities rated NAIC 1: | |
| Amount | **1,462** |
| Percentage of total | **95.4%** |

(iv) Other debt securities

Included within other debt securities of £1,573 million in the summary shown above, are £944 million of asset backed securities held directly by Jackson, of which £817 million were NAIC designation 1 and £127 million NAIC designation 2. In addition, other debt securities includes £316 million in respect of securities held by the Piedmont trust entity (as discussed in section 2.3) and £313 million from the consolidation of investment funds managed by PPM America.

**3c UK insurance operations**

The following table summarises by rating the securities held by UK insurance operations as at 31 December 2007:

| | PAC with-profits sub-fund | | | | Other funds and subsidiaries | | | UK insurance operations |
|---|---|---|---|---|---|---|---|---|
| | Scottish Amicable Insurance fund £m | Excluding Prudential Annuities Limited £m | Prudential Annuities Limited £m | Total £m | Prudential Retirement Income Limited £m | Other non-profit unit-linked business £m | Other business £m | Total 2007 £m |
| S&P – AAA | 1,453 | 6,434 | 4,356 | 10,790 | 5,658 | 3,534 | 121 | **21,556** |
| S&P – AA+ to AA- | 436 | 1,978 | 1,518 | 3,496 | 1,541 | 680 | 20 | **6,173** |
| S&P – A+ to A- | 1,030 | 4,356 | 2,693 | 7,049 | 3,354 | 1,093 | 31 | **12,557** |
| S&P – BBB+ to BBB- | 652 | 2,780 | 920 | 3,700 | 781 | 267 | 9 | **5,409** |
| S&P – Other | 167 | 757 | 11 | 768 | 1 | 6 | - | **942** |
| | 3,738 | 16,305 | 9,498 | 25,803 | 11,335 | 5,580 | 181 | **46,637** |
| Moody's – Aaa | 138 | 550 | 177 | 727 | 125 | 22 | 9 | **1,021** |
| Moody's – Aa1 to Aa3 | 23 | 198 | 273 | 471 | 82 | 9 | 2 | **587** |
| Moody's – A1 to A3 | 74 | 321 | 284 | 605 | 243 | 19 | 3 | **944** |
| Moody's – Baa1 to Baa3 | 41 | 180 | 150 | 330 | 103 | 14 | 2 | **490** |
| Moody's – Other | 10 | 400 | - | 400 | - | - | - | **410** |
| | 286 | 1,649 | 884 | 2,533 | 553 | 64 | 16 | **3,452** |
| Fitch | 43 | 196 | 265 | 461 | 160 | 17 | 1 | **682** |
| Other | 528 | 2,233 | 2,428 | 4,661 | 1,125 | 90 | 5 | **6,409** |
| Total debt securities | 4,595 | 20,383 | 13,075 | 33,458 | 13,173 | 5,751 | 203 | **57,180** |

Where no external ratings are available internal ratings produced by the Group's asset management operations, which are prepared on the Company's assessment of a comparable basis to external ratings, are used where possible. Of the total debt securities held at 31 December 2007 which are not externally rated, £2,972 million were internally rated AAA to A-, £2,844 million were internally rated BBB to B- and £593 million were unrated. The majority of the unrated debt security investments were held in SAIF and the PAC with-profits fund and relate to convertible debt and other investments which are not covered by ratings analysts nor have an internal rating attributed to them.

**3d Asset management operations**

Of the £882 million of debt securities of asset management operations, as shown in the summary table at the front of this section, securities with a value of £841 million are held by M&G's Prudential Capital operation which were all AAA to A- rated where S&P rated or Aaa by Moody's.

**3e Group exposure to holdings in sub prime and Alt-A assets, monoline insurers and CDO funds**

Included in the total of debt securities of £83,984 million as shown in the summary of this section, are the following holdings:

(i) Sub-prime and Alt-A securities

| **Shareholder-backed business** | £m |
|---|---|
| US insurance operations - Sub-prime (AAA) | **237** |
| - Alt-A (77% AAA, 17% AA) | **660** |
| Asian insurance operations | **15** |
| | **912** |

| **With-profits operations** | **£m** |
|---|---|
| UK insurance operations - Sub-prime (AAA) | **129** |
| - Alt-A (96% AAA) | **100** |
| Asian insurance operations | **7** |
| | **236** |
| Total | **1,148** |

Further details on Jackson's sub-prime and Alt-A securities are given in notes 4.4c and 4.4d of section 4.

(ii) Direct holdings in monoline insurers

| | £m |
|---|---|
| Shareholder-backed operations: | |
| US insurance operations | **23** |
| Asian insurance operations | **4** |
| | **27** |
| With-profits operations: | |
| Asian insurance operations | **6** |
| | **33** |

(iii) Holdings in debt securities with a wrap guarantee from a monoline insurer

| | £m |
|---|---|
| **Shareholder-backed operations:** | |
| US insurance operations: | |
| Residential mortgage-backed securities: | |
| Sub-prime | **36** |
| Alt-A | **18** |
| Asset-backed securities | **79** |
| Private corporate issues | **22** |
| | **155** |
| UK insurance operations (98% held by PRIL) | **422** |
| | **577** |
| **With-profits operations:** | |
| Asian insurance operations | **9** |
| UK insurance operations (73% held by PAL) | **1,168** |
| | **1,177** |
| **Total** | **1,754** |

The holdings of UK insurance operations are primarily in PFI and utility stocks.

(iv) CDO funds (all without sub-prime exposure)

| **Shareholder-backed business** | £m |
|---|---|
| US insurance operations (65% AAA, 8% AA)* | **260** |
| Asian insurance operations (72% AAA, 28% AA-) | **62** |
| UK insurance operations - PRIL (AAA) | **36** |
| Other operations (AAA) | **19** |
| | **377** |

| **With-profits operations** | **£m** |
|---|---|
| UK insurance operations (79% AAA, 8% AA) | **240** |
| Asian insurance operations (AAA) | **59** |
| | **299** |
| Total | **676** |

* Including the Group's economic interest in Piedmont (as described in note 2.3 of section 2) and other consolidated CDO funds.

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## Section 4 - Impact of investment return on Group IFRS shareholders' results

### 4.1 Summary movement on Group IFRS shareholders' equity

| | 2007 £m | 2006 £m |
|---|---|---|
| Profit before tax attributable to shareholders (see section 4.2) | **1,166** | 1,372 |
| Tax attributable to shareholders' profits | **(382)** | (392) |
| Profit from continuing operations after tax | **784** | 980 |
| Discontinued operations (net of tax) | **241** | (105) |
| Profit for the year | **1,025** | 875 |
| Less: minority interests | **(3)** | (1) |
| Profit attributable to equity holders' of the Company | **1,022** | 874 |
| Items recognised directly in shareholders' equity: | | |
| Exchange translation movements | | |
| Gross | **11** | (224) |
| Related tax | **2** | (74) |
| Unrealised valuation movements on securities classified as available-for-sale for US insurance operations | | |
| Gross valuation movements (see section 4.4) | **(244)** | (201) |
| Related change in amortisation of deferred income and acquisition costs | **88** | 75 |
| Related tax | **53** | 50 |
| Other items recognised directly in shareholders' equity | **(4)** | 3 |
| Total of items of income and expense recognised directly in equity | **(94)** | (371) |
| Total income and expense for the year attributable to shareholders | **928** | 503 |
| Dividends | **(426)** | (399) |
| Acquisition of Egg minority interests | **-** | (167) |
| New share capital subscribed | **182** | 336 |
| Other movements | **29** | 21 |
| Net increase in shareholders' equity | **713** | 294 |
| Shareholders' equity at beginning of year | **5,488** | 5,194 |
| Shareholders' equity at end of year | **6,201** | 5,488 |

### 4.2 Supplementary analysis of profit from continuing operations before tax attributable to shareholders

| | 2007 £m | 2006 £m |
|---|---|---|
| **Asian operations** | | |
| Long-term business | **189** | 189 |
| Asset management | **72** | 50 |
| Development expenses | **(15)** | (15) |
| Total | **246** | 224 |
| **US operations** | | |
| Jackson | **444** | 398 |
| Broker-dealer and asset management | **13** | 18 |
| Curian | **(5)** | (8) |
| Total | **452** | 408 |
| **UK operations** | | |
| UK insurance operations | **528** | 500 |
| M&G | **254** | 204 |
| Total | **782** | 704 |
| **Other income and expenditure** | | |
| Investment return and other income | **86** | 58 |
| Interest payable on core structural borrowings | **(168)** | (177) |
| Corporate expenditure | | |
| Group Head Office | **(117)** | (83) |
| Asia Regional Head Office | **(38)** | (36) |
| Charge for share-based payments for Prudential schemes | **(11)** | (10) |
| Total | **(248)** | (248) |
| Restructuring costs | **(19)** | (38) |
| Operating profit from continuing operations based on longer-term investment returns | **1,213** | 1,050 |
| Short-term fluctuations in investment returns on shareholder-backed business (note 4.3) | **(137)** | 155 |
| Shareholders' share of actuarial gains and losses on defined benefit pension schemes | **90** | 167 |
| Profit from continuing operations before tax attributable to shareholders | **1,166** | 1,372 |

### 4.3 Short-term fluctuations in investment returns on shareholder-backed business

| | 2007 £m | 2006 £m |
|---|---|---|
| Asian operations (note 4.3b) | **(71)** | 134 |
| Jackson (note 4.4b on section 4) | **(18)** | 53 |
| UK insurance operations (note 4.3c) | **(47)** | (43) |
| Other | **(1)** | 11 |
| Total (note 4.3a) | **(137)** | 155 |

**Notes**

**4.3a General**

The short-term fluctuations in investment returns for 2007 primarily reflect temporary market value movements on the portfolio of investments held by the Group's shareholder-backed operations. There were no default losses on debt securities in 2007.

**4.3b Asian operations**

The fluctuations for Asian operations in 2007 primarily reflect value movements in Taiwan on the value of debt securities arising from increases in interest rates and a £30 million reduction in the value of an investment in a CDO fund, partially offset by the effects of strong equity market movements in Vietnam. For 2006, the £134 million of short-term fluctuations mainly arose in Vietnam due to strong equity returns.

**4.3c UK insurance operations**

The fluctuations for the UK insurance operations, arose primarily in Prudential Retirement Income Limited, which writes the most significant element of the shareholder-backed annuity business in the UK. The fluctuations principally reflect the impact of widened credit spreads on the corporate bond securities backing the shareholders' equity of the business.

**4.4 US insurance operations results**

| | 2007 £m | 2006 £m |
|---|---|---|
| Operating profits based on longer-term investment returns (note 4.4a) | **444** | 398 |
| Short-term fluctuations in investment returns (note 4.4b) | **(18)** | 53 |
| Profit before shareholder tax | **426** | 451 |
| Tax | **(126)** | (150) |
| Profit for the year | **300** | 301 |

| | 2007 £m | 2006 £m |
|---|---|---|
| Profit for the year (as above) | **300** | 301 |
| Items recognised directly in equity: | | |
| Exchange movements | **(42)** | (377) |
| Unrealised valuation movements on securities classified as held-for-sale: | | |
| Unrealised holding losses arising during the year | **(231)** | (208) |
| Less (gains) losses included in the income statement | **(13)** | 7 |
| | **(244)** | (201) |
| Related change in amortisation of deferred income and acquisition costs | **88** | 75 |
| Related tax | **54** | 50 |
| Total items of income and expense recognised directly in equity | **(144)** | (453) |
| Total income and expense for the year | **156** | (152) |
| Transfers to central companies | **(122)** | (91) |
| Net increase (decrease) in equity | **34** | (243) |
| Shareholders' equity at beginning of year | **2,656** | 2,899 |
| **Shareholders' equity at end of year** | **2,690** | 2,656 |

**Notes**

**4.4a Operating profits based on longer-term investment returns**

IFRS basis operating profits include the following amounts so as to derive longer-term investment returns.

| | 2007 £m | 2006 £m |
|---|---|---|
| Debt securities: | | |
| Amortisation of interest related realised gains and losses* (note 4.4b) | **31** | 38 |
| Risk margin reserve charge for longer-term credit related losses* (note 4.4b) | **(37)** | (44) |
| Equity type investments: | | |
| Longer-term returns | **47** | 45 |

* net of related change in amortisation of deferred acquisition costs

The risk margin (RMR) charge for longer-term impairment losses for 2007 is based on an average annual RMR charge of 21 basis points (2006: 23 basis points) on a book value of US$42.7 billion (2006: US$43.9 billion).

Market value movements on equity-based derivatives and embedded derivatives are also recorded within operating profits based on longer-term investment returns so as to be consistent with the market related effects on fees and reserve movements for equity based products. Market value movements on other derivatives are excluded from operating profit, and are included in short-term fluctuations in investment returns as shown below in note 4.4b.

**4.4b Short-term fluctuations in investment returns**

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

| | 2007 £m | 2006 £m |
|---|---|---|
| Debt securities | | |
| Credit related | | |
| Losses in the year | | |
| Bond write downs | **(35)** | (32) |
| Losses on sales of impaired and deteriorating bonds | **(51)** | (3) |
| Recoveries/ reversals | **8** | 10 |
| | **(78)** | (25) |
| Risk margin charge to operating profit based on longer-term investment returns (note 4.4a) | **48** | 54 |
| Short-term fluctuation | **(30)** | 29 |
| Interest related realised gains and losses | | |
| Gains (losses) in year | **31** | (15) |
| Amortisation of current and prior year interest related realised gains and losses to operating profit based on longer-term investment returns (note 4.4a) | **(37)** | (45) |
| Short-term fluctuation | **(6)** | (60) |
| Related change to amortisation of deferred acquisition costs | **9** | 6 |
| Total short-term fluctuation related to debt securities | **(27)** | (25) |
| Derivatives (other than equity related, as explained in note 4.4a): market value movement | **(19)** | 34 |
| Equity type investments: actual less longer-term return | **42** | 21 |
| Other items | **(14)** | 23 |
| Total | **(18)** | 53 |

**4.4c Unrealised valuation movements on securities classified as available-for-sale**

In addition, for Jackson, included within the statement of changes in equity is a net reduction in the value of Jackson's debt securities classified as 'available-for-sale' under IAS 39 of £244 million. This reduction reflects the effects of widened credit spreads in the US bond market partially offset by the effect of reduced US interest rates and a steepening yield curve. These movements do not reflect defaults or permanent impairments.

With the exception of debt securities for US insurance operations classified as 'available-for-sale' under IAS 39, unrealised value movements on the Group's investments are booked within the income statement. For with-profits operations such value movements are reflected in changes to asset share liabilities to policyholders and the liability for unallocated surplus. For shareholder-backed operations the unrealised value movements form part of the total return for the year booked in the profit before tax attributable to shareholders, which in the Company's supplementary IFRS information, is then analysed between operating profit based on longer-term investment return and short-term fluctuations in investment returns.

However, for debt securities classified as 'available-for-sale', unless impaired, fair value movements are recorded as a movement in shareholder reserves direct to equity. Impairments are recorded in the income statement as shown in note 4.4b.

In general, the debt securities of the Group's US insurance operations are purchased with the intention and the ability to hold them for the longer-term. In 2007, there was a movement in the balance sheet value for these debt securities classified as available-for-sale from a net unrealised gain of £110 million to a net unrealised loss of £136 million. During 2007, US interest rates fell and the yield curve steepened. Offsetting this movement were market price effects resulting from increasing credit spreads and global credit concerns. As a result of these factors, the gross unrealised gain in the balance sheet decreased from £366 million at 31 December 2006 to £303 million at 31 December 2007 while the gross unrealised loss increased from £256 million at 31 December 2006 to £439 million at 31 December 2007. Details of the securities in an unrealised loss position are shown in note 4.4d below.

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

| | 31 Dec 2007 £m | Change in unrealised appreciation £m | 31 Dec 2006 £m |
|---|---|---|---|
| Assets fair valued at below book value | | | |
| Book value | **10,730** | | 11,258 |
| Unrealised loss | **(439)** | (183) | (256) |
| Fair value (as included in balance sheet) | **10,291** | | 11,002 |
| Assets fair valued at or above book value | | | |
| Book value | **8,041** | | 8,208 |
| Unrealised gain | **303** | (63) | 366 |
| Fair value (as included in the balance sheet) | **8,344** | | 8,574 |
| Total | | | |
| Book value | **18,771** | | 19,466 |
| Net unrealised (loss) gain | **(136)** | (246) | 110 |
| Fair value (as included in balance sheet)* | **18,635** | | 19,576 |
| Reflected as part of items recognised directly in shareholders' equity: | | | |
| Movement in unrealised appreciation (as shown in summary movement in note 4.1a) | | (244) | |
| Exchange movements | | (2) | |
| | | (246) | |

* Debt securities for US operations as included in the balance sheet of £19,002 million comprise £18,635 million in respect of securities classified as available-for-sale as shown above and £367 million for securities of consolidated investment funds classified as fair value through profit and loss.

Included within the movement in unrealised losses for the debt securities of Jackson of £244 million as shown above was a value reduction of £55 million relating to the sub-prime and Alt-A securities as referred to in note 3e of section 3.

**4.4d Debt securities in an unrealised loss position**

The unrealised losses in the Jackson balance sheet on unimpaired securities are £(439) million (2006: £(256) million). This reflects assets with fair market value and book value of £10,291 million and £10,730 million respectively.

The following tables show some key attributes of those securities that are in an unrealised loss position at 31 December 2007:

| (i) Fair value of securities as a percentage of book value | Fair value 2007 £m | Unrealised loss 2007 £m | Fair value 2006 £m | Unrealised loss 2006 £m |
|---|---|---|---|---|
| Between 90% and 100% | **9,370** | **(274)** | 10,941 | (248) |
| Between 80% and 90% | **784** | **(122)** | 61 | (8) |
| Below 80% | **137** | **(43)** | - | - |
| | **10,291** | **(439)** | 11,002 | (256) |

Included within the table above are amounts relating to sub-prime and Alt-A securities at 31 December 2007 of:

| | Fair value £m | Unrealised loss £m |
|---|---|---|
| Between 90% and 100% | **572** | **(24)** |
| Between 80% and 90% | **132** | **(22)** |
| Below 80% | **28** | **(10)** |
| | **732** | **(56)** |

| (ii) Aged analysis of unrealised losses for the time periods indicated | 2007 Not rated £m | 2007 Non-investment grade £m | 2007 Investment grade £m | 2007 Total £m | 2006 Not rated £m | 2006 Non-investment grade £m | 2006 Investment grade £m | 2006 Total £m |
|---|---|---|---|---|---|---|---|---|
| Less than 6 months | **(7)** | **(8)** | **(52)** | **(67)** | (1) | (1) | (14) | (16) |
| 6 months to 1 year | **(10)** | **(21)** | **(105)** | **(136)** | (3) | (1) | (10) | (14) |
| 1 year to 2 years | **(5)** | **(2)** | **(16)** | **(23)** | (24) | (10) | (135) | (169) |
| 2 years to 3 years | **(24)** | **(10)** | **(140)** | **(174)** | (5) | - | (9) | (14) |
| More than 3 years | **(7)** | **(3)** | **(29)** | **(39)** | (7) | (1) | (35) | (43) |
| | **(53)** | **(44)** | **(342)** | **(439)** | (40) | (13) | (203) | (256) |

At 31 December 2007, the gross unrealised losses in the balance sheet for the sub-prime and Alt-A securities in an unrealised loss position, as shown in note (i) above, were £56 million. £37 million of these losses relate to securities that have been in an unrealised loss position for less than one year and £19 million securities that have been in an unrealised position for more than one year.

| (iii) By maturity of security | 2007 £m | 2006 £m |
|---|---|---|
| Less than 1 year | **(1)** | (1) |
| 1 year to 5 years | **(54)** | (29) |
| 5 years to 10 years | **(164)** | (113) |
| More than 10 years | **(60)** | (51) |
| Mortgage-backed and other debt securities | **(160)** | (62) |
| Total | **(439)** | (256) |

**4.5 Actuarial gains and losses on defined benefit pension schemes**

The movement on the IAS 19 basis financial position including the actuarial gains of £90 million recognised in the shareholder profit for the year are as follows:

| | Deficit in schemes at 1 Jan 2007 | (Charge) credit to income statement: Operating results (based on longer term investment returns) | (Charge) credit to income statement: Actuarial gains and losses (note 4.5c) | Contributions paid | Surplus (deficit) in schemes at 31 Dec 2007 |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| Prudential Staff Pension Scheme (PSPS) | 141 | | | | 528 |
| Other defined benefit schemes (note 4.5b) | (76) | | | | (81) |
| Total Group surplus (deficit) (as shown in section 1.6) | 65 | (14) | 295 | 101 | 447 |
| Less: amount attributable to PAC with-profits fund | (73) | (9) | (205) | (51) | (338) |
| Shareholders' share: | | | | | |
| Pre-tax (deficit) surplus | (8) | (23) | 90 | 50 | 109 |
| Related tax | 0 | 6 | (25) | (14) | (33) |
| Net of shareholders' tax | (8) | (17) | 65 | 36 | 76 |

**Notes**

**4.5a** The table reflects the financial position of the defined benefit schemes on an 'economic basis'. This is the IAS 19 basis adjusted to include scheme assets invested in Prudential Group insurance policies. At 31 December 2007, M&G Pension Scheme and Prudential Staff Pension Scheme (PSPS) had invested £172 million and £140 million respectively, in Prudential Group insurance policies.

**4.5b** The principal defined benefit pension scheme is PSPS. In the UK there are two smaller schemes, the Scottish Amicable Pension Scheme and the M&G Pension Scheme, with a combined deficit at 31 December 2007 of £71 million gross of tax. There is also a small scheme in Taiwan, which at 31 December 2007 had a deficit gross of tax of £10 million.

**4.5c** The components of the credit for actuarial gains and losses (gross of allocation of the share attributable to the PAC with-profits fund) are as follows:

| | £m |
|---|---|
| Actual less expected return on scheme assets | (8) |
| Gains on changes of assumptions for scheme liabilities | 317 |
| Experience losses on scheme liabilities | (14) |
| Total credit | 295 |

The credit for actuarial gains and losses is recorded within the income statement but, within the supplementary analysis of profit, it is excluded from operating profit based on longer-term investment returns.

The gains on changes of assumptions for plan liabilities reflect gains due to changes in economic assumptions of £509 million which more than offset the actuarial losses of £192 million from the effect of strengthened mortality assumptions for the UK pension schemes.

**4.5d** The actuarial assumptions applied to the UK schemes are as follows:

| | 1 January 2007 % | 31 December 2007 % |
|---|---|---|
| Discount rate | 5.2 | 5.9 |
| Rate of increase in salaries | 5.0 | 5.3 |
| Price inflation | 3.0 | 3.3 |
| Rate of increase of pensions in payment for inflation: | | |
| Guaranteed (maximum 5 per cent) | 3.0 | 3.3 |
| Guaranteed (maximum 2.5 per cent)* | 2.5 | 2.5 |
| Discretionary* | 2.5 | 2.5 |
| Expected return on plan assets | 5.9 | 6.2 |

* The rates of 2.5 percent shown are those for PSPS. Assumed rates of increase of pensions in payment for inflation for all other schemese are 3.3 per cent in 2007 (2006: 3.0 per cent).

The current mortality assumptions are as follows:

Male: 100 per cent PMA92 with CMIR17 improvements to the valuation date and medium cohort improvements subject to a floor of 1.75 per cent up to the age of 90, decreasing linearly to zero by the age of 120.

Female: 100 per cent PFA92 with CMIR17 improvements to the valuation date and 75 per cent medium cohort improvements subject to a floor of 1.0 per cent up to the age of 90, decreasing linearly to zero by the age of 120.

## Section 5 - Sensitivity of shareholder results to market and other risks

### 5.1 Group Overview

Background

The financial assets and liabilities attaching to the Group’s life assurance business are, to varying degrees, subject to market and insurance risk and other changes of experience assumptions that may have a material effect on IFRS basis profit or loss and equity.

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

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

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

In addition, the profitability of the Group life assurance businesses and fund management business, is indirectly affected by the performance of the assets covering policyholder liabilities and related capital.

Key points

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

IFRS shareholder results-key exposures for market and other risk

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

For Jackson at the level of operating profit based on longer-term investment returns, the results are sensitive to market conditions to the extent of income earned on spread based products and equity based exposure to the extent not covered by the equity derivative programmes. However, the main effect is on Jackson IFRS total profit and equity. IFRS profit or loss and equity arise from the accounting rather than economic effect of market value movements on assets and derivatives attaching to fixed annuity, term and institutional business.

Jackson’s derivative programme is used to substantially mitigate equity market risk attaching to its equity based products and interest rate risk associated with its spread based products. Combined with the spread based nature of Jackson’s other products and the US GAAP basis of measuring liabilities to policyholders, Jackson’s risk exposure at the level operating profit based on longer-term investment returns, is relatively less significant than for other parts of the Group.

However, movements in interest rates and credit spreads materially affect the carrying value of derivatives which are used to manage the liabilities to policyholders and backing investment assets of fixed annuity and other general account business. Combined with the use of US GAAP measurement for the insurance contracts attaching to these types of business, which is largely insensitive to current period market movements the Jackson total profit (i.e. including short-term fluctuation in investment returns) is very sensitive to market movements. In addition to these effects the Jackson IFRS equity is volatile for the impact of interest rate and credit spread movements on the value of fixed income securities. Movements in unrealised appreciation on these securities are included as movement in equity (i.e. outside the income statement).

For Asian operations, other than possibly for the impact of any alteration to assumed long-term interest rates in Taiwan, at the level of operating profit based on longer-term investment returns it is mainly affected by the impact of market levels on unit-linked business persistency, and other insurance risk.

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

M&G profits are affected primarily by movements in the growth in funds under management and investment performance and the effect of any impairment on the loan book of Prudential Capital.

The most significant items for which the IFRS basis profit or loss and equity for the businesses is sensitive to market, insurance and lapse risk is as shown below. The distinction between direct and indirect exposure is not intended to indicate the relative size of the sensitivity.

| | Market and credit risk | | | Insurance and lapse risk (notes 5.1e) |
|---|---|---|---|---|
| **Type of business** | **Investments / Derivatives** | **Liabilities / unallocated surplus** | **Indirect exposure** | |
| **UK insurance operations (note 5.1a)** | | | | |
| With-profits business (including Prudential Annuities Limited) | Net neutral direct exposure (indirect exposure only) | | Investment performance subject to smoothing through declared bonuses | Persistency risk to future shareholder transfers |
| SAIF sub-fund | Net neutral direct exposure (indirect exposure only) | | Asset management fees earned by M&G | |
| Unit-linked business | Net neutral direct exposure (indirect exposure only) | | Investment performance through asset management fees | Persistency risk |
| Shareholder-backed annuity business | Asset / liability mismatch risk | | | Mortality experience and assumptions for longevity |
| | Credit risk<br>Interest rate risk for assets in excess of liabilities i.e. representing shareholder capital | | | |
| **US insurance operations (note 5.1b)** | | | | |
| All business | Currency risk | | | Persistency risk |
| Variable annuity business | Net effect of market risk arising from incidence of guarantee features and variability of asset management fees offset by derivative hedging programme | | Investment performance through asset management fees | |
| Fixed indexed annuity business | Derivative hedge programme to the extent not fully hedged against liability and fund performance | Incidence of equity participation features | Spread difference between earned rate and rate credited to policyholders | Lapse risk but the effects of extreme events are mitigated by the use of swaption contracts |
| Fixed annuity business / GIC business | Credit risk<br>Interest rate risk<br>These risks are reflected in volatile profit or loss for derivative value movements and impairment losses and, in addition, for shareholders' equity for value movements on fixed income securities classified as 'available-for-sale' under IAS 39 | | | |
| **Asian insurance operations (note 5.1c)** | | | | |
| All business | Currency risk | | | Persistency risk |
| With-profits business | Net neutral direct exposure (indirect exposure only) | | Investment performance subject to smoothing through declared bonuses | |
| Unit-linked business | Net neutral direct exposure (indirect exposure only) | | Investment performance through asset management fees | |
| Non-participating business | | | | |
| Taiwan | Interest rate and price risk | Long-term interest rates | | |
| Other non-participating business | Interest rate and price risk | | | |
| **Asset management operations (note 5.1d)** | | | | |
| M&G | Credit risk on Prudential Capital loan book | | Investment performance through asset management fees | |
| US broker-dealer and asset management | | | | |
| Asian asset management | | | | |

Additional notes on these operations follow.

**5.1a UK insurance operations**

With-profits business

• With-profits business

Shareholder results of UK with-profits business are sensitive to market risk only through the indirect effect of investment performance on the smoothing of declared policyholder bonuses.

The investment assets of the PAC with-profits fund are subject to market risk. However, changes in their carrying value, net of related changes to asset-share liabilities of with-profits contracts, affect the level of unallocated surplus of the fund. As unallocated surplus is accounted for as a liability under IFRS, movements in its value do not affect shareholders' profit or equity.

The shareholder results of the UK with-profits fund corresponds to the shareholders' share of the cost of bonuses declared on the with-profits business. This currently corresponds to one-ninth of the cost of bonuses declared.

Investment performance is a key driver of bonuses, and hence the shareholders' share of the cost of bonuses. However, due to the 'smoothed' basis of bonus declaration the sensitivity to investment performance in a single year is low. However, over multiple periods it is important.

• Prudential Annuities Limited (PAL)

PAL's business is not with-profit; it writes annuity business, However, as PAL is owned by the PAC with-profits sub-fund, changes in the carrying value of PAL's assets and liabilities are reflected in the liability for unallocated surplus and do not affect shareholder results.

• Scottish Amicable Insurance Fund (SAIF)

SAIF is a ring-fenced fund in which, apart from investment management fees, shareholders have no interest. Accordingly, the Group's IFRS profit and equity are insensitive to the direct effects of market risk attaching to SAIF's assets and liabilities.

Shareholder-backed business

The factors that may significantly affect the IFRS results of UK shareholder-backed business are the mortality experience and assumptions and credit risk attaching to the annuity business and market risk attaching to the assets that represent the capital of PRIL and the PAC non-profit sub-fund that write this business.

• Prudential Retirement Income Limited (PRIL)

The assets covering PRIL's liabilities are principally debt securities and other investments that are held to match the expected duration and payment characteristics of the policyholder liabilities. These liabilities are valued for IFRS reporting purposes by applying discount rates that reflect the market rates of return attaching to the covering assets.

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

The main market risk sensitivity for PRIL arises from interest rate risk on the debt securities which represent IFRS equity. This equity comprises the net assets held within the long-term fund of the company that cover regulatory basis liabilities that are not recognised for IFRS reporting purposes, for example contingency reserves, and shareholder capital held outside the long-term fund.

The principal items affecting the IFRS results for PRIL are mortality experience and assumptions and credit risk.

• PAC non-profit sub-fund

The PAC non-profit sub-fund principally comprises annuity business previously written by Scottish Amicable Life, credit life, unit-linked and other non-participating business.

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

• Other shareholder-backed unit-linked business

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

Additional information on the sensitivity of the results of UK insurance operations is shown in Section 5.2.

**5.1b US insurance operations**

The IFRS basis results of Jackson are highly sensitive to market risk on the assets covering liabilities for fixed annuity, term, institutional and other variable annuity business not segregated in the seperate accounts..

Invested assets covering liabilities for these types of business and related capital comprise principally debt securities classified as available-for-sale. Value movements for these securities are reflected as movements in shareholders' equity. Other invested assets and derivatives are carried at fair value with the value movements reflected in the income statement.

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

These differences in carrying value give rise to potentially significant volatility in the IFRS income statement and shareholders' equity. As for other shareholder-backed business the profit or loss for Jackson is presented in the Group's supplementary basis of reporting as shown in section 4.2 and 4.4, by distinguishing the result for the year between an operating result based on longer-term fluctuation in investment returns. In this way the most significant direct effect of market changes that have taken place on the Jackson result are separately categorised.

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

• Variable Annuity business for the net effect of market risk arising from incidence of guarantee features and variability of fund management fees offset by derivative hedging performance.

• Fixed Annuity business for the spread differential between the earned rate the rate credited to policyholders; and

• Fixed Index Annuity business for the spread differential between the earned rate and the rate credited to policyholders and incidence of equity index participation features.

Additional information on the sensitivity of the results of US insurance operations is shown in Section 5.3.

**5.1c Asian operations**

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

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

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

In addition to these features, the overriding factor that affects IFRS basis results for Asian non-participating business is the return on the assets covering the Taiwan whole of life policies. This factor directly affects the actual return in any given reporting period. In addition though, the measurement of the liabilities to policyholders and the carrying value of deferred acquisition costs for this business is dependent upon an assessment of longer-term interest rates.

Additional information on the sensitivity of the results of Asian operations is shown in Section 5.4.

**5.1d Asset management operations**

The principal financial risks of the asset management operations are for credit risk on the bridging loan portfolio (as described in note 1.5) of M&G's Prudential Capital operation and the indirect effect of changes to market values of funds under management on fees.

**5.1e Insurance and lapse risk**

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

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

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

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

**5.1f Impact of diversification on risk exposure**

There is a significant impact from diversification benefit across the Group. This arises because not all risk scenarios will happen at the same time and across all geographic regions. The Group tests the sensitivities of results to different correlation factors such as:

Correlation across geographic regions

– Financial risk factors
– Non-financial risk factors

Correlation across risk factors

– Longevity risk
– Expenses
– Persistency
– Other risks

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

**5.2 Sensitivity of results to market and other risks: UK insurance operations**

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

**5.2a With-profits business**

**SAIF**

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

**With-profits sub-fund business**

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

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

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

The level of unallocated surplus is particularly sensitive to the level of investment returns on the portion of the life fund assets that represents the surplus.

**5.2b Shareholder-backed annuity business**

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

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

A decrease in assumed mortality rates of 1 per cent would decrease gross profits by approximately £35 million (2006: £34 million). A decrease in credit default assumptions of 5 basis points would increase gross profits by £72 million (2006: £64 million). A decrease in renewal expenses (excluding investment management expenses) of 5 per cent would increase gross profits by £13 million (2006: £14 million). The effect on profits would be approximately symmetrical for changes in assumptions that are directionally opposite to those explained above.

**5.2c Unit-linked and other business**

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

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

**5.2d Shareholder exposure to interest rate risk and other market risk**

By virtue of the fund structure, product features and basis of accounting, the policyholder liabilities of the UK insurance operations are, except for pension annuity business, not generally exposed to interest rate risk. For pension annuity business, liabilities are exposed to fair value interest rate risk. However, the net exposure to the PAC WPSF (for PAL) and shareholders (for liabilities of PRIL and the non-profit sub-fund) is very substantially mitigated by virtue of the close matching of assets with appropriate duration.

The close matching by the Group of assets of appropriate duration to annuity liabilities is based on maintaining economic and regulatory capital. The measurement of liabilities under capital reporting requirements and IFRS is not consistent with contingency reserves and margins for prudence within the assumptions required under the FSA regulatory solvency basis not being recognised as liabilities for IFRS reporting purposes. As a result IFRS equity is higher than regulatory capital and therefore more sensitive to interest rate risk.

The estimated sensitivity of the UK non-linked shareholder backed business (principally pension annuities business) to a movement in interest rates of 1 per cent as at 31 December 2007 and 2006 is as follows:

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **Decrease of 1%** | **Increase of 1%** | Decrease of 1% | Increase of 1% |
| | **£m** | **£m** | £m | £m |
| Carrying value of debt securities and derivatives | **1,930** | **(1,634)** | 1,802 | (1,529) |
| Policyholder liabilities | **(1,777)** | **1,467** | (1,671) | 1,374 |
| Related deferred tax effects | **(43)** | **47** | (40) | 47 |
| Net sensitivity of profit and equity | **110** | **(120)** | 91 | (108) |

In addition, the shareholder-backed portfolio of UK non-linked insurance operations covering liabilities and shareholders' equity includes equity securities and investment property. Excluding any second order effect on the measurement of the liability for future cash flows to policyholders, a 10 per cent fall in their value would have given rise to a £86 million and £42 million reduction in pre-tax profit for 2007 and 2006. After related deferred tax there would have been a £62 million and £29 million reduction in shareholders' equity at 31 December 2007 and 2006 respectively.

The market risk sensitivity shown above reflects the impact of temporary market movements and, therefore, the primary effect of such movements would, in the Company's supplementary analysis of profit, be included within short-term fluctuations in investment returns rather than operating profit based on longer-term investment returns.

**5.3 Sensitivity of results to market and other risks: US insurance operations**

**5.3a Currency fluctuations**

Consistent with the Group's accounting policies, the profits of the Group's US operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2007, the rates were US$2.00 (2006: US$1.84) and US$1.99 (2006: US$1.96) to £1 sterling, respectively. A 10 per cent increase or decrease in these rates would reduce or increase profit before tax attributable to shareholders, profit for the year and shareholders' equity attributable to US insurance operations respectively as follows:

| | **A 10% increase in exchange rates** | | **A 10% decrease in exchange rates** | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| Profit before tax attributable to shareholders | **(39)** | (42) | **48** | 51 |
| Profit for the year | **(29)** | (29) | **35** | 35 |
| Shareholders' equity attributable to US insurance operations | **(242)** | (247) | **296** | 293 |

**5.3b Other sensitivities**

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

- growth in the size of assets under management covering the liabilities for the contracts in force;
- incidence of guarantees; and
- spread returns for the difference between investment returns and rates credited to policyholders.

For the purpose of determining longer-term returns, adjustment is necessary for the normalisation of investment returns to remove the effects of short-term volatility in investment returns.

- amortisation of deferred acquisition costs.

For term business, acquisition costs are deferred and amortised in line with expected premiums. For annuity business, acquisition costs are deferred and amortised in line with expected gross profits on the relevant contracts. For interest-sensitive business, the key assumption is the expected long-term spread between the earned rate and the rate credited to policyholders, which is based on an annual spread analysis. In addition, expected gross profits depend on mortality assumptions, assumed unit costs and terminations other than deaths (including the related charges) all of which are based on a combination of actual experience of Jackson, industry experience and future expectations. A detailed analysis of actual experience is measured by internally developed mortality and persistency studies. For variable annuity business, the key assumption is the expected long-term level of equity market returns, which for 2007 and 2006 was 8.4 per cent per annum implemented using a mean reversion methodology. These returns affect the level of future expected profits through their effects on the fee income and the required level of provision for guaranteed minimum death benefit claims.

• variations in fees and other income, offset by variations in market value adjustment payments and, where necessary, strengthening of liabilities.

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

**5.3c Exposure to equity risk**

Jackson is exposed to equity risk through the options embedded in the fixed indexed liabilities and GMDB and GMWB guarantees included in certain variable annuity benefits. This risk is managed using a comprehensive equity hedging programme to minimise the risk of a significant economic impact as a result of increases or decreases in equity market levels while taking advantage of naturally offsetting exposures in Jackson's operations. Jackson purchases external futures and options that hedge the risks inherent in these products, while also considering the impact of rising and falling separate account fees. As a result of this hedging programme, if the equity markets were to increase, Jackson's free-standing derivatives would decrease in value. However, over time, this movement would be broadly offset by increased separate account fees and reserve decreases, net of the related changes to amortisation of deferred acquisition costs.

Due to the nature of the free-standing and embedded derivatives, this hedge, while highly effective on an economic basis, may not completely mitigate the immediate impact of the market movements as the free-standing derivatives reset immediately while the hedged liabilities reset more slowly and fees are recognised prospectively. It is estimated that an immediate increase in the equity markets of 10 per cent would result in an accounting charge, net of related DAC amortisation, before tax of up to £30 million (2006: £20 million), excluding the impact on future separate account fees. After related deferred tax there would have been an estimated reduction in shareholders' equity at 31 December 2007 of up to £20 million (2006: £13 million). An immediate decrease in the equity markets of 10 per cent would result in an approximately equal and opposite estimated effect on profit and shareholders' equity. The actual impact on financial results would vary contingent upon the volume of new product sales and lapses, changes to the derivative portfolio, correlation of market returns and various other factors including volatility, interest rates and elapsed time.

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

A 10 per cent decrease in their value would have given rise to an estimated £76 million (2006: £66 million) reduction in pre-tax profit, net of related changes in amortisation of DAC, for 2007. After related deferred tax there would have been an estimated £50 million (2006: £43 million) reduction in shareholder's equity at 31 December 2007. A 10 per cent increase in their value would have an approximately equal and opposite effect on profit and shareholders' equity.

**5.3d Exposure to interest rate risk**

Notwithstanding the market risk exposure, except in the circumstances of interest rate scenarios where the guarantee rates included in contract terms are higher than crediting rates that can be supported from assets held to cover liabilities, the accounting measurement of liabilities of Jackson products is not generally sensitive to interest rate risk. This position derives from the nature of the products and the US GAAP basis of measurement.

However, the debt securities and related derivatives are marked to market value. Value movements on derivatives, again net of related changes to amortisation of DAC and deferred tax, are recorded within profit and loss. Market value movements on debt securities, net of related changes to amortisation of DAC and deferred tax, are recorded within the statement of changes in equity. The estimated sensitivity of these items and policyholder liabilities to a 1% decrease and increase in interest rates at 31 December 2007 and 2006 is as follows:

| | A 1% decrease in interest rate | | A 1% increase in interest rates | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| Profit and loss: | | | | |
| Direct effect | | | | |
| Derivatives value change | **(116)** | (95) | **163** | 109 |
| Policyholder liabilities | **(38)** | (7) | **29** | 3 |
| Related effect on amortisation of DAC | **52** | 29 | **(58)** | (30) |
| Pre-tax profit effect | | | | |
| Operating profit based on longer-term investment returns | **(15)** | (2) | **11** | 1 |
| Short-term fluctuations in investment returns | **(87)** | (71) | **123** | 81 |
| | **(102)** | (73) | **134** | 82 |
| Related effect on charge for deferred tax | **36** | 26 | **(47)** | (29) |
| Net profit effect | **(66)** | (47) | **87** | 53 |
| Statement of changes in equity: | | | | |
| Direct effect on carrying value of debt securities | **848** | 858 | **(848)** | (858) |
| Related effect on amortisation of DAC | **(212)** | (214) | **212** | 214 |
| Related effect on movement in deferred tax | **(223)** | (225) | **223** | 225 |
| Net effect | **413** | 419 | **(413)** | (419) |
| Total net effect on IFRS equity | **347** | 372 | **(326)** | (366) |

## 5.4 Sensitivity of results to market and other risks: Asian insurance operations

### 5.4a Currency translation

Consistent with the Group's accounting policies, the profits of the Asian operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period.

A 10 per cent increase or decrease in these rates and those of other Asian operations would have reduced or increased profit before tax attributable to shareholders, profit for the year and shareholders' equity, excluding goodwill, attributable to Asian operations respectively as follows:

| | A 10% increase in exchange rates | | A 10% decrease in exchange rates | |
|---|---|---|---|---|
| | **2007** | 2006 | **2007** | 2006 |
| | **£m** | £m | **£m** | £m |
| Profit before tax attributable to shareholders | **(16)** | (33) | **20** | 34 |
| Profit for the year | **(10)** | (21) | **13** | 25 |
| Shareholders' equity, excluding goodwill, attributable to Asian operations | **(124)** | (116) | **151** | 143 |

### 5.4b Other market risks

*(i) With-profits business*

Similar principles to those explained for UK with-profits business apply to profit emergence for the Asian with-profits business. Correspondingly, the profit emergence reflects bonus declaration and is relatively insensitive to period by period fluctuations in insurance risk or interest rate movements.

*(ii) Unit-linked business*

As for the UK insurance operations, the profits and shareholders' equity related to the Asian operations are primarily driven by charges related to invested funds. For the Asian operations, substantially all of the contracts are classified as insurance contracts under IFRS 4, i.e. containing significant insurance risk. The sensitivity of profits and equity to changes in insurance risk is minor and, to interest rate risk, not material.

*(iii) Other business*

**Taiwan whole of life business – interest rate risk on deferred acquisition costs and policyholders' liabilities**

The principal other business of Asian operations is the traditional whole of life business written in Taiwan.

The in-force business of the Taiwan life operation includes traditional whole of life policies where the premium rates have been set by the regulator at different points for the industry as a whole. Premium rates were set to give a guaranteed minimum sum assured on death and a guaranteed surrender value on early surrender based on prevailing interest rates at the time of policy issue. Premium rates also included allowance for mortality and expenses. The required rates of guarantee have fallen over time as interest rates have reduced from a high of 8 per cent to current levels of around 2.5 per cent. The current low level of bond rates in Taiwan gives rise to a negative spread for the majority of these policies. The current cash cost of funding in force negative spread in Taiwan is around £45 million a year.

The profits attaching to these contracts are particularly affected by the rates of return earned, and estimated to be earned, on the assets held to cover liabilities and on future investment income and contract cash flows. Under IFRS, the insurance contract liabilities of the Taiwan business are determined on the US GAAP basis as applied previously under UK GAAP. Under this basis, the policy liabilities are calculated on sets of assumptions, which are locked in at the point of policy inception, and a deferred acquisition cost is held in the balance sheet.

The adequacy of the insurance contract liabilities is tested by reference to best estimates of expected investment returns on policy cash flows and reinvested income. The assumed earned rates are used to discount the future cash flows. The assumed earned rates consist of a long-term best estimate determined by consideration of long-term market conditions and rates assumed to be earned in the trending period. For 2007 and 2006, it has been projected that rates of return for Taiwanese bond yields will trend from the then current levels of some 2.5 per cent (2.0 per cent) to 5.5 per cent by 31 December 2013.

The liability adequacy test results are sensitive to the attainment of the trended rates during the trending period. Based on the current asset mix, margins in other contracts that are used in the assessment of the liability adequacy tests and currently assumed future rates of return, if interest rates were to remain at current levels in 2008 and 2009 and the target date for attainment of the long-term bond yield deferred to 31 December 2015, the premium reserve, net of deferred acquisition costs, would be sufficient. If interest rates were to remain at current levels beyond the end of 2009 with the date of the attainment of the long-term rate further delayed, the margin within the net GAAP reserve will reduce further.

However, the need to write off deferred acquisition costs or increase the liabilities, and by how much, would be affected by the impact of new business written between 31 December 2007 and the future reporting dates to the extent that the business is taken into account as part of the liability adequacy testing calculations for the portfolio of contracts.

The adequacy of the liability is also sensitive to the level of the projected long-term rate on bonds. The current long-term assumption of 5.5 per cent has been determined on a prudent best estimate basis by reference to detailed assessments of the financial dynamics of the Taiwanese economy. In the event that the rate applied was altered, the carrying value of the deferred acquisition costs and policyholder liabilities would potentially be affected.

At 31 December 2007, if the assumed long-term bond yield applied had been reduced by 0.5 per cent from 5.5 per cent to 5.0 per cent and continued to apply the same progression period to 31 December 2013, by assuming bond yields increase from current levels in equal annual instalments to the long-term rate, the premium reserve, net of deferred acquisition costs, would have been sufficient. The impact of reducing the long-term rate by a further 0.5 per cent to 4.5 per cent would have been such that the net GAAP reserve would have met the liability adequacy test but with no margin available to cover further deterioration. An additional 0.5 per cent reduction in the assumed long-term rate from 4.5 per cent to 4.0 per cent would lead to a charge of some £200 million.

The adequacy of the Taiwan insurance contract liabilities is also sensitive to movements in short-term movements in market interest rates. This is because a reduction in the current interest rates would alter the progression to the long-term rate and the assumed timing of attainment of the rate may be insufficient and therefore have been deferred. If the interest rates at 31 December 2006 of circa 2 per cent had been lower by 0.5 per cent and the date for the attainment of the long-term rate deferred by one year to 2014, the effect of the net premium reserve would have been a charge of approximately £60 million.

If the interest rate at 31 December 2007 of circa 2.5 per cent had been lower by 0.5 per cent with the same progression period and long-term rate, the net premium reserve would have been adequate and no charge would have been necessary.

Whole of life contracts with floor levels of policyholder benefits that accrue at rates set at inception are also written in the Korean life operations, though to a much less significant extent than in Taiwan. The Korean business has non-linked liabilities and linked liabilities at 31 December 2007 of £261 million and £728 million respectively (2006: £226 million and £316 million respectively). The business is much less sensitive to returns than Taiwan with the higher proportion of linked and health business.

The other area of note in respect of guarantees is the Japanese business where pricing rates are higher than current bond yields. Lapse risk is a feature in that policyholders could potentially surrender their policies on guaranteed terms if interest rates increased leaving the potential for losses if bond values had depreciated significantly. However, the business is matched to a relatively short realistic liability duration.

For the Korean and Japanese life business exposures the results are comparatively unaffected by changes of assumption. The accounts basis value of liabilities for both operations are of a similar order of magnitude to those that apply for the purposes of Group solvency calculations under the Insurance Groups Directive (IGD).

**Interest rate risk for other business excluding Taiwan**

In addition to the sensitivity of the Taiwan results to the impact of current period and longer-term interest rates on liability adequacy tests, as described above, the other business and solvency capital of Asian operations are also sensitive to the vagaries of routine movements in interest rates.

Asian operations offer a range of insurance and investment products, predominantly with-profits and non-participating term, whole life endowment and unit-linked business.

Excluding with-profits and unit-linked business along with Taiwan, which is detailed above, 76 per cent (2006: 78 per cent) of the bond portfolio for other business of Asian operations at 31 December 2007 was held in Japan, Singapore and Vietnam with corporate bond rates varying from territory to territory and ranging from 1.5 per cent to 9.1 per cent at 31 December 2007 (1.7 per cent to 8.8 per cent at 31 December 2006) for these three countries. An analysis of movements in bond rates during previous periods and its impact on IFRS basis profit or loss and shareholders' equity has been undertaken, with reasonably possible movements for these countries being considered to be 0.25 per cent for Japan, 0.5 per cent for Singapore and 1.0 per cent for Vietnam.

Based on these movements, plus indicative changes for bonds held in other Asian operations within the region, the impact on IFRS basis profit or loss and shareholders' equity from a reasonably possible change in interest rates for Asian operations excluding Taiwan at 31 December 2007 has been assessed, with rate movements ranging from 0.25 per cent to 1.0 per cent (2006: 0.25 per cent to 1.0 per cent) dependent on country. Looking at the region in aggregate and noting that interest rates are unlikely to move consistently by the same degree from period to period, the range of movements considered to be reasonably possible would result in a change in IFRS profit or loss of plus or minus £30 million (2006: £32 million). These amounts, if they arose, would be recorded within the category short-term fluctuations in investment returns in the Group's supplementary analysis of profit before tax. After adjusting for deferred tax the reasonably possible effect on shareholders' equity is plus or minus £22 million (2006: £24 million).

**Equity price risk**

The principal holders of equity securities are the Taiwan, Singapore and Vietnam businesses. For the Taiwan and Singapore operations market changes have a direct effect on profit and loss with no matching effect on the carrying value of policyholder liabilities. This is also true for the Vietnam business. However, to the extent that equity investment appreciation is realised through sales of securities then policyholders' liabilities are adjusted to the extent that policyholders' participate.

The impact of a 10 per cent change in equity prices for shareholder backed Asian other business, which would be reflected in the short-term fluctuations component of the Group's supplementary analysis of profit before tax, would be as follows:

| | **2007** | | 2006 | |
|---|---|---|---|---|
| | **10% increase £m** | **10% decrease £m** | 10% increase £m | 10% decrease £m |
| Pre-tax | **73** | **(73)** | 67 | (67) |
| Related deferred tax (where applicable) | **(5)** | **5** | (8) | 8 |
| Net effect on profit and equity | **68** | **(68)** | 59 | (59) |

## Section 6 - Accounting policies

### 6.1 Financial instruments (other than long-term business contracts classified as financial instruments under IFRS 4)

**Investment classification**

Upon initial recognition, financial investments are measured at fair value. Subsequently, the Group is permitted under IAS 39, 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 Group holds financial investments on the following bases:

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

(ii) Financial investments on an available-for-sale basis – this comprises assets that are designated by management and/or do not fall into any of the other categories. These investments are carried at fair value. Interest income is recognised on an effective interest basis in the income statement. Except for foreign exchange gains and losses on debt securities, not in functional currency, which are included in the income statement, unrealised gains and losses are recognised in equity. Upon disposal or impairment, accumulated unrealised gains and losses are transferred from equity to the income statement as realised gains or losses.

(iii) 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 collateralised by mortgages, deposits, loans to policyholders and other unsecured loans and receivables. These investments are carried at amortised cost using the effective interest method.

The Group has designated certain financial assets as fair value through profit and loss as these assets are managed and their performance is evaluated on a fair value basis. These assets represent all of the Group's financial assets except all loans and receivables and debt securities held by Jackson and Egg prior to its sale in May 2007. Debt securities held by Jackson and Egg (prior to its sale) are accounted for on an available-for-sale basis. The use of the fair value option is consistent with the Group's risk management and investment strategies.

The Group uses the trade date method to account for regular purchases and sales of financial assets with the exception of Egg's loans and advances to customers which were on a settlement day basis.

**Use of fair values**

The Group uses current bid prices to value its quoted 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 Group applies an appropriate valuation technique such as a discounted cash flow technique.

**Impairments**

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

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

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

**Derivatives and hedge accounting**

Derivative financial instruments are used to reduce or manage investment, interest rate and currency exposures, to facilitate efficient portfolio management and for investment purposes. The Group's policy is that amounts at risk through derivative transactions are covered by cash or by corresponding assets.

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

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

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

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

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

The primary areas of the Group's continuing operations where derivative instruments are held are the UK with-profits funds and annuity business, and Jackson National Life. In addition, for 2006 and during 2007 to the date of disposal, the Group also entered into significant derivative transactions for its discontinued banking operations.

For the Group's continuing operations, hedge accounting under IAS 39 is not usually applied.

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

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

For Jackson an extensive derivative programme is maintained. Value movements on the derivatives held can be very significant in their effect on shareholder results. The Group has chosen to not generally seek to construct the Jackson derivative programme so as to facilitate hedge accounting where theoretically possible, under IAS 39.

**Embedded derivatives**

Embedded derivatives are held by various Group companies including Jackson and Egg prior to its sale. They are embedded within other non-derivative host financial instruments to create hybrid instruments. Where economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risks of the host instrument, and where the hybrid instrument is not measured at fair value with the changes in fair value recognised in the income statement, the embedded derivative is bifurcated and carried at fair value as a derivative in accordance with IAS 39.

**6.2 Investment properties**

Investments in leasehold and freehold properties not for occupation by the Group are carried at fair value, with changes in fair value included in the income statement. Properties are valued annually either by the Group's qualified surveyors or professional external valuers using the Royal Institution of Chartered Surveyors (RICS) guidelines. The RICS guidelines apply separate assumptions to the value of the land, buildings and tenancy associated with each property. Each property is externally valued at least once every three years. The cost of additions and renovations is capitalised and considered when estimating fair value.

**6.3 Supplementary analysis of results attributable to shareholders**

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

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

**Operating profit based on longer-term investment returns**

The Group continues to use operating profit based on longer-term investment returns as a supplemental measure of its results. For the purpose of measuring operating profit, investment returns on shareholder-financed business are based on the expected longer-term rates of return. Except as discussed below, in determining profit on this basis the following key elements are applied to the results of the Group's shareholder-financed operations.

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

(ii) Derivative value movements
Value movements for Jackson's equity-based derivatives and variable annuity product embedded derivatives are included in operating profits based on longer-term investment returns. The inclusion of these movements is so as to broadly match with the results on the Jackson variable annuity book that pertain to equity market movements.

Other derivative value movements are excluded from operating results based on longer-term investment returns. These derivatives are primarily held by Jackson as part of a broadly-based hedging programme for features of Jackson's bond portfolio (for which value movements are booked directly to shareholders' equity rather than income statement) and product liabilities (for which US GAAP accounting does not reflect the economic features being hedged).

These key elements are of most importance in determining the operating results based on longer-term investment returns of Jackson.

There are three exceptions to the basis described above for determining operating results based on longer-term investment returns. These are for:

• Unit-linked and US variable annuity business
For such business the policyholder liabilities are directly reflective of the asset value movements. Accordingly all asset value movements are recorded in the operating results based on longer-term investment returns.

• Assets covering non-participating business liabilities that are interest rate sensitive
For UK annuity business policyholder liabilities are determined by reference to current interest rates. The value movements of the assets covering liabilities are closely correlated with the related change in liabilities. Accordingly asset value movements are recorded within the operating results based on longer-term investment returns. Policyholder liabilities include a margin for asset defaults which, if they occur, are recorded as a component of short-term fluctuations in investment returns.

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

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

**Items excluded from operating profit based on longer-term investment returns**

Items excluded from operating profit based on longer-term investment returns but included in profit before tax attributable to shareholders of continuing operations, include short-term fluctuations in investment returns (i.e. actual less longer-term returns), actuarial gains and losses on defined benefit pension schemes and exceptional items.

With the exception of derivatives used for managing equity exposure of Jackson and other derivatives where value movements match other items in operating results based on longer-term investment returns, value movements on derivatives held by Jackson are included within short-term fluctuations. For the purposes of distinguishing actuarial gains and losses on defined benefit pension schemes in this analysis, plan assets include Prudential policies held by the schemes.

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

Under IAS 39, derivatives are required to be carried at fair value. Unless hedge accounting is applied, value movements on derivatives are recognised in the income statement. Except in respect of variable annuity business, the value movements on these derivatives are separately identified within the short-term fluctuations in investment returns identified as part of the Group's supplementary analysis of results described in section 6.3 and in section 4.2. Derivative value movements in respect of variable annuity business are included within the operating profit based on longer-term investment returns.

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

• IAS 39 hedging criteria has been designed primarily in the context of hedging and hedging instruments that are assessable as financial instruments that are either stand-alone or separable from host contracts, rather than, for example, duration characteristics of insurance contracts;

• the high hurdle levels under IAS 39 of ensuring hedge effectiveness at the level of individual hedge transactions for specific transactions;

• the difficulties in applying the macro hedge provisions under IAS 39 (which are more suited to banking arrangements) to Jackson's derivative book;

• the complexity of asset and liability matching of US life insurers such as those with Jackson's product range; and finally

• whether it is possible or desirable, without an unacceptable level of costs and restraint on commercial activity, to achieve the accounting hedge effectiveness required under IAS 39.

In this regard, the issues surrounding the IAS 39 application are very similar to those considered by other US life insurers when the US financial reporting standard FAS 133 was first applied for US GAAP reporting. Taking account of these considerations the Group has decided that, except for certain minor categories of derivatives, it is not appropriate to seek to achieve hedge accounting under IAS 39 by completely reconfiguring the structure of Jackson's derivative book. As a result of this decision the total income statement results are more volatile as the movements in the value of Jackson's derivatives are reflected within it.

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

**Report to Prudential plc (the Company) on information included in the Group Investments: IFRS Disclosures from the 2007 Annual Report document (the Disclosures Document) to be published alongside the Company's preliminary announcement for the year ended 31 December 2007 (the Prelim)**

In accordance with agreed terms of engagement, we have performed the procedure set out below on the information included in the Disclosures Document.

This report has been prepared solely for the Company and solely for the purpose of reporting our findings to the Company in connection with the preparation by the Company of the Disclosures Document. We permit the publication of this report with the Company's Prelim, to enable readers of the Prelim to verify that a report on performance of the procedures set out below has been commissioned by the Company and issued by us. Our report was designed to meet the agreed requirements of the Company determined by the Company's needs at the time. Our report should not therefore be regarded as suitable to be used or relied on by any party wishing to acquire rights against us other than the Company for any purpose or in any context. Any party other than the Company who obtains access to our report or a copy and chooses to rely on our report (or any part of it) will do so at its own risk. To the fullest extent permitted by law, KPMG Audit Plc will accept no responsibility or liability in respect of our report to any other party.

We performed the following procedure that was agreed with the Company:

- Compare the financial information in sections 1 to 6 in the Disclosures Document with the audited group financial statements and related notes of the Company and its subsidiaries for the year ended 31 December 2007 to confirm that it has been properly extracted from those financial statements.

The agreed procedure, which has limited scope, does not constitute an audit or a review and, as such, no assurance is expressed.

The financial information set out in the Disclosures Document is the responsibility of the Company's directors. Our responsibility is to report our findings based on our work.

**Findings**

Based on the procedure performed, we confirm that:

- the financial information in sections 1 to 6 in the Disclosures Document has been properly extracted from the audited group financial statements and related notes of the Company and its subsidiaries for the year ended 31 December 2007.

Our findings relate only to the Disclosures Document and do not extend or apply to the rest of the Prelim, nor to any financial statements of the Company or its subsidiaries which have been audited on a statutory basis and for a different purpose, as stated in the respective audit reports.

**KPMG Audit Plc**
Chartered Accountants
London
13 March 2008