

Notes on the Group financial statements

A: Background and accounting policies

A1: Nature of operations

Prudential plc (the Company) together with its subsidiaries (collectively, the Group or Prudential) is an international financial services group with its principal operations in the UK, the US and Asia. The Group operates in the UK through its subsidiaries, primarily The Prudential Assurance Company Limited (PAC), Prudential Annuities Limited (PAL), Prudential Retirement Income Limited (PRIL) and M&G Investment Management Limited.

In the US, the Group's principal subsidiary is Jackson National Life Insurance Company (Jackson). The Group also has operations in Hong Kong, Malaysia, Singapore, Taiwan and other Asian countries. On 20 February 2009, the Company announced that it had entered into agreement, subject to regulatory approval to sell the assets and liabilities of its agency distribution business and its agency force in Taiwan. See note I10 for further details.

Prudential offers a wide range of retail financial products and services and asset management services throughout these territories. The retail financial products and services principally include life insurance, pensions and annuities as well as collective investment services.

Long-term business products written in the UK and Asia are principally with-profits deposit administration, other conventional and unithised with-profits policies and non-participating pension annuities in the course of payment. Long-term business also includes linked business written in the UK and Asia. The principal products written by Jackson are interest-sensitive deferred annuities and whole-life policies, variable annuities, guaranteed investment contracts, fixed index deferred annuities and term life insurance.

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

Laurence Pountney Hill
London
EC4R 0HH
Registered number: 1397169

A2: Basis of preparation

The consolidated financial statements consolidate the Group and the Group's interest in associates and jointly-controlled entities. The parent company financial statements present information about the Company as a separate entity and not about the Group.

The consolidated financial statements have been prepared and approved by the directors in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU). The Company has elected to prepare its parent company financial statements in accordance with UK Generally Accepted Accounting Practice (GAAP). These are presented on pages 306 to 315.

As part of its response to the global financial crisis, in 2008, the International Accounting Standards Board (IASB) has issued amendments to IAS 39, 'Financial Instruments: Recognition and Measurement' and IFRS 7, 'Financial Instruments: Disclosures'. 'Reclassification of Financial Assets: Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures' was issued in October 2008 permitting the reclassification of non-derivative financial assets into the 'loans and receivables' category under which assets are carried at amortised cost if specific conditions are met. The Group has not made any such reclassification of financial assets as permitted by the amendments.

The Group has applied all IFRS standards and interpretations adopted by the EU and effective at 31 December 2008. In addition, the Group has early adopted IFRIC 14 'The Limit on a Defined Benefit Asset, Minimum Funding Requirement and their Interaction'. Further details on the impact of the adoption of this interpretation are provided in notes A5 and I1.

A3: Critical accounting policies, estimates and judgements

a Critical accounting policies

Prudential's discussion and analysis of its financial condition and results of operations are based upon Prudential's consolidated financial statements, which have been prepared in accordance with IFRS adopted for use in the EU. Were the Group to apply IFRS as published by the IASB, as opposed to EU-adopted IFRS, no additional adjustments would be required.

The preparation of these financial statements requires Prudential to make estimates and judgements that affect the reported amounts of assets, liabilities, and revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, Prudential evaluates its estimates, including those related to long-term business provisioning, the fair value of assets and the declaration of bonus rates. Prudential bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgements about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgements and uncertainties, and potentially give rise to different results under different assumptions and conditions. Prudential believes that its critical accounting policies are limited to those described below.

Notes on the Group financial statements

A: Background and accounting policies

continued

A3: Critical accounting policies, estimates and judgements continued

The critical accounting policies in respect of the items discussed below are critical for the Group's results insofar as they relate to the Group's shareholder-financed business. In particular this applies for Jackson which is the largest shareholder-backed business in the Group. The policies are not critical in respect of the Group's with-profits business. Accordingly, explanation is provided in this note and cross-referenced notes as to why the distinction between with-profits business and shareholder-backed business is relevant.

The items discussed below and in cross-referenced notes explain the effect of changes in estimates and the effect of reasonably likely changes in the key assumptions underlying these estimates as of the latest balance sheet date so as to provide analysis that recognises the different accounting effects on profit and loss or equity. In order to provide relevant analysis that is appropriate to the circumstances applicable to the Group's businesses, the explanations refer to types of business, fund structure, the relationship between asset and policyholder liability measurement, and the differences in the method of accounting permitted under IFRS 4 for accounting for insurance contract assets, policyholder liabilities and unallocated surplus of the Group's with-profits funds.

Insurance contract accounting

With the exception of certain contracts described in note D1, the Group's life assurance contracts are classified as insurance contracts and investment contracts with discretionary participating features. As permitted by IFRS 4, assets and liabilities of these contracts (see below) are accounted for under previously applied GAAP. Accordingly, except as described below, the modified statutory basis (MSB) of reporting as set out in the revised Statement of Recommended Practice (SORP) issued by the Association of British Insurers (ABI) in November 2003 has been applied.

In 2005 the Group chose to improve its IFRS accounting for UK regulated with-profits funds by the voluntary application of the UK accounting standard FRS 27, 'Life Assurance'. Under this standard, the main accounting changes that were required for UK with-profits funds were:

- Derecognition of deferred acquisition costs and related deferred tax; and
- replacement of MSB liabilities with adjusted realistic basis liabilities.

The results shown for 2008 and 2007 reflect this basis.

Unallocated surplus represents the excess of assets over policyholder liabilities for the Group's with-profits funds that have yet to be appropriated between policyholders and shareholders. The Group has opted to account for unallocated surplus wholly as a liability with no allocation to equity. This treatment reflects the fact that shareholders' participation in the cost of bonuses arises only on distribution. Shareholder profits on with-profits business reflect one-ninth of the cost of declared bonus.

For Jackson, applying the MSB as applicable to overseas operations, the assets and liabilities of insurance contracts are accounted for under insurance accounting prescribed by US GAAP. For the assets and liabilities of insurance contracts of Asian operations, the local GAAP is applied with adjustments, where necessary, to comply with UK GAAP. For the operations in Taiwan, Vietnam and Japan, countries where local GAAP is not appropriate in the context of the previously applied MSB, accounting for insurance contracts is based on US GAAP. For participating business the liabilities include provisions for the policyholders' interest in realised investment gains and other surpluses that, where appropriate, and in particular for Vietnam, have yet to be declared as bonuses.

The usage of these bases of accounting has varying effects on the way in which product options and guarantees are measured. For UK regulated with-profits funds, for the 2008 and 2007 results, options and guarantees are valued on a market consistent basis. The basis is described in note D2(g)(ii). For other operations a market consistent basis is not applied under the accounting basis described in note A4. Details of the guarantees, basis of setting assumptions, and sensitivity to altered assumptions are described in notes D3 and D4.

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 net investment 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 derivatives held by Jackson are separately identified within the short-term fluctuations in investment returns identified as part of the Group's supplementary analysis of results described below and in note B1. 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 have been designed primarily in the context of hedging and hedging instruments that are assessable as financial instruments that are either stand-alone or separable from host contracts, rather than, for example, duration characteristics of insurance contracts;

- the high hurdle levels under IAS 39 of ensuring hedge effectiveness at the level of individual hedge transactions;
- the difficulties in applying the macro hedge provisions under IAS 39 (which are more suited to banking arrangements) to Jackson's derivative book;
- the complexity of asset and liability matching of US life insurers such as those with Jackson's product range; and finally
- whether it is possible or desirable, without an unacceptable level of costs and constraint on commercial activity, to achieve the accounting hedge effectiveness required under IAS 39.

In this regard, the issues surrounding 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. 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, unless impaired, being recorded as movements within shareholders' equity. Impairments are recorded in the income statement.

Presentation of results before tax

The total tax charge for the Group reflects tax that in addition to relating to shareholders' profits is also attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies. This is explained in more detail in note F5. However, pre-tax profits are determined after transfers to or from unallocated surplus of with-profits funds. These transfers are in turn determined after taking account of tax borne by with-profits funds. Consequently reported profit before the total tax charge is not representative of pre-tax profits attributable to shareholders. In order to provide a measure of pre-tax profits attributable to shareholders the Group has chosen to adopt an income statement presentation of the tax charge and pre-tax results that distinguishes between policyholder and shareholder components.

Supplementary analysis of results and earnings attributable to shareholders

The Group uses operating profit based on longer-term investment returns as a supplemental measure of its results. The basis of calculation is disclosed in note A4(d).

For shareholder-backed business, with the exception of debt securities held by Jackson 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) the 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.

b Critical accounting estimates and judgements

Investments

Determining the fair value of financial investments when the markets are not active

The Group holds certain financial investments for which the markets are not active. These include financial investments which are not quoted on active markets and financial investments for which markets are no longer active as a result of market conditions e.g. market illiquidity. When the markets are not active, there is generally no or limited observable market data for the financial investments. The determination of whether an active market exists for a financial investment requires management's judgement.

If the market for a financial investment of the Group is not active, the fair value is determined in full or in part by using valuation techniques. The Group establishes fair value for these financial investments by using quotations from independent third-parties, such as brokers or pricing services or by using internally developed pricing models. Priority is given to publicly available prices from independent sources, when available but overall, the source of pricing and/or the valuation technique is chosen with the objective of arriving at a fair value measurement which reflects the price at which an orderly transaction would take place between market participants on the measurement date. The valuation techniques include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option adjusted spread models and, if applicable, enterprise valuation and may include a number of assumptions relating to variables such as credit risk and interest rates. Changes in assumptions relating to these variables could positively or negatively impact the reported fair value of these instruments.

Notes on the Group financial statements

A: Background and accounting policies

continued

A3: Critical accounting policies, estimates and judgements continued

The fair values of financial investments, net of derivative liabilities, valued using a valuation technique either internally by the Group or by independent third-parties at 31 December 2008 was £40,252 million (2007: £33,822 million). Of these amounts, financial investments net of derivative liabilities with a fair value of £24,833 million (2007: £19,748 million) were held by the US operations. Financial investments valued using valuation techniques held by UK operations were £15,399 million (2007: £14,139 million) and of this amount £14,695 million (2007: £13,580 million) related to securities held by with-profits operations and £704 million (2007: £559 million) related to securities held by the UK shareholder-backed business. Debt securities of US insurance operations valued internally using valuation techniques in 2008 include certain asset-backed securities which had previously been valued using prices provided by a pricing service or brokers in the context of active markets. The current market dislocations have caused a reassessment of the valuation process for these asset-backed securities. In particular, beginning the end of the third quarter of 2008, the external prices obtained for certain asset-backed securities were deemed to be inappropriate in the current market conditions. For the valuations at 31 December 2008, the US operations have therefore utilised internal valuation models, provided by PPM America, to derive fair values for all non-agency residential mortgage-backed securities and asset-backed securities and certain commercial mortgage-backed securities. The techniques used by PPM America include cash flow models based on spreads and, when available, market indices. Additional details are explained in note G1.

Determining impairments relating to financial assets

Available-for-sale securities

Financial investments carried on an available-for-sale basis are represented by Jackson's debt securities portfolio. The consideration of evidence of impairment requires management's judgement. In making this determination the factors considered include, for example, whether the decline is substantial, the ability and intent to retain the investment long enough to allow for an estimated full recovery in value, the duration and extent to which the amortised cost exceeds fair value, the financial condition and prospects of the issuer, or any other objectively observable conditions that indicate that the investment may be impaired.

For Jackson's residential mortgage-backed securities, the model used to analyse cash flows, begins with the current delinquency experience of the underlying collateral pool for the structure, by applying assumptions about how much of the currently delinquent loans will eventually default, and multiplying this by an assumed loss severity. Additional factors are applied to anticipate ageing effect. After applying a cash flow simulation an indication is obtained as to whether or not the security has suffered a principal payment shortfall. If a shortfall applies an impairment charge is generally recorded.

Unrealised losses that are considered to be primarily the result of market conditions, such as interest rates movements, unusual market volatility, or industry-related events, and where the Group also believes there is a reasonable expectation for recovery and, furthermore, it has the intent and ability to hold the investment until maturity or the market recovers, are usually determined to be temporary. The Group's review of fair value involves several criteria, including economic conditions, credit loss experience, other issuer-specific developments and future cash flows. These assessments are based on the best available information at the time. Factors such as market liquidity, the widening of bid/ask spreads and a change in cash flow assumptions can contribute to future price volatility. If actual experience differs negatively from the assumptions and other considerations used in the consolidated financial statements, unrealised losses currently in equity may be recognised in the income statement in future periods. The preceding note in this section provides explanation on how fair value is determined when the markets for the financial investments are not active. Further, additional details on the impairments of the available-for-sale securities of Jackson are described in notes D3 and G5.

Assets held at amortised cost

Financial assets classified as loans and receivables under IAS 39 are carried at amortised cost using the effective interest rate method. The loans and receivables include loans collateralised by mortgages, deposits and loans to policyholders. In estimating future cash flows, the Group looks at the expected cash flows of the assets and applies historical loss experience of assets with similar credit risks that has been adjusted for conditions in the historical loss experience which no longer exist or for conditions that are expected to arise. The estimated future cash flows are discounted using the financial asset's original or variable effective interest rate and exclude credit losses that have not yet been incurred.

The risks inherent in reviewing the impairment of any investment include the risk that market results may differ from expectations; facts and circumstances may change in the future and differ from estimates and assumptions; or the Group may later decide to sell the asset as a result of changed circumstances.

Changes in the estimates of credit risk in any reporting period could result in a change in the allowance for losses on the loans and advances.

Insurance contracts

Product classification

IFRS 4 requires contracts written by insurers to be classified as either 'insurance contracts' or 'investment contracts' depending on the level of insurance risk transferred. Insurance risk is risk, other than financial risk, transferred from the contract holder to the contract issuer. If significant insurance risk is transferred by the contract then it is classified as an insurance contract. Contracts that transfer financial risk but not significant insurance risk are termed investment contracts. Furthermore, some contracts, both insurance and investment, contain discretionary participating features representing the contractual right to receive additional benefits as a supplement to guaranteed benefits:

- a that are likely to be a significant portion of the total contract benefits;
- b whose amount or timing is contractually at the discretion of the insurer; and
- c that are contractually based on asset or fund performance, as discussed in IFRS 4.

Accordingly, insurers must perform a product classification exercise across their portfolio of contracts issued to determine the allocation to these various categories. IFRS 4 permits the continued usage of previously applied GAAP for insurance contracts and investment contracts with discretionary participating features. Except for UK regulated with-profits funds, as described subsequently, this basis has been applied by the Group.

For investment contracts that do not contain discretionary participating features, IAS 39 and, where the contract includes an investment management element, IAS 18, apply measurement principles to assets and liabilities attaching to the contract.

Valuation assumptions

i Contracts of with-profits funds

The Group's insurance contracts and investment contracts with discretionary participating features are primarily with-profits and other protection type policies. For UK regulated with-profits funds, the contract liabilities are valued by reference to the UK Financial Services Authority's (FSA) realistic basis. In aggregate, this basis has the effect of placing a value on the liabilities of UK with-profits contracts, which reflects the amounts expected to be paid based on the current value of investments held by the with-profits funds and current circumstances.

The basis of determining liabilities for the Group's with-profits business has little or no effect on the results attributable to shareholders. This is because movements on liabilities of the with-profits funds are absorbed by the unallocated surplus. Except through indirect effects, or in remote circumstances as described below, changes to liability assumptions are therefore reflected in the carrying value of the unallocated surplus, which is accounted for as a liability rather than shareholders' equity.

A detailed explanation of the basis of liability measurement is contained in note D2(g)(ii).

The Group's other with-profits contracts are written in with-profits funds that operate in some of the Group's Asian operations. The liabilities for these contracts and those of Prudential Annuities Limited, which is a subsidiary company of the PAC with-profits funds, are determined differently. For these contracts the liabilities are estimated using actuarial methods based on assumptions relating to premiums, interest rates, investment returns, expenses, mortality and surrenders. The assumptions to which the estimation of these reserves is particularly sensitive are the interest rate used to discount the provision and the assumed future mortality experience of policyholders.

For liabilities determined using the basis described above for UK regulated with-profits funds, and the other liabilities described in the preceding paragraph, changes in estimates arising from the likely range of possible changes in underlying key assumptions have no direct impact on the reported profit.

This lack of sensitivity reflects the with-profits fund structure, basis of distribution, and the application of previous GAAP to the unallocated surplus of with-profits funds as permitted by IFRS 4. Changes in liabilities of these contracts that are caused by altered estimates are absorbed by the unallocated surplus of the with-profits funds with no direct effect on shareholders' equity. The Company's obligations and more detail on such circumstances are described in note H14.

ii Other contracts

Contracts, other than those of with-profits funds, are written in shareholder-backed operations of the Group. The significant shareholder-backed product groupings and the factors that may significantly affect IFRS results due to experience against assumptions or changes of assumptions vary significantly between business units. For some types of business the effect of changes in assumptions may be significant, whilst for others, due to the nature of the product, assumption setting may be of less significance. The nature of the products and the significance of assumptions are discussed in notes D2, D3 and D4. From the perspective of shareholder results the key sensitivities relate to assumptions for allowance for credit risk for UK annuity business and assumed future investment returns for the Taiwan life operation.

Notes on the Group financial statements

A: Background and accounting policies

continued

A3: Critical accounting policies, estimates and judgements continued

Jackson

Jackson offers individual fixed annuities, fixed index annuities, immediate annuities, variable annuities, individual and variable life insurance and institutional products. With the exception of institutional products and an incidental amount of business for annuity certain contracts, which are accounted for as investment contracts under IAS 39, all of Jackson's contracts are accounted for under IFRS 4 as insurance contracts by applying US GAAP, the previous GAAP used before IFRS adoption. Under US GAAP the requirements of SFAS 60 'Accounting and Reporting for Insurance Enterprises' and SFAS 97 'Accounting and Reporting by Insurance Enterprises for certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments' apply to these contracts. The accounting requirements under these standards and the effect of changes in valuation assumptions are considered below for fixed annuity, variable annuity and traditional life insurance contracts.

Fixed annuity contracts, which are investment contracts under US GAAP terminology, are accounted for by applying in the first instance a retrospective deposit method to determine the liability for policyholder benefits. This is then augmented by potentially three additional amounts, namely deferred income, any amounts previously assessed against policyholders that are refundable on termination of the contract, and any premium deficiency, i.e., any probable future loss on the contract. These types of contract contain considerable interest rate guarantee features. Notwithstanding the accompanying market risk exposure, except in the circumstances of interest rate scenarios where the guarantee rates included in contract terms are higher than crediting rates that can be supported from assets held to cover liabilities, the accounting measurement of Jackson's fixed annuity products is not generally sensitive to interest rate risk. This position derives from the nature of the products and the US GAAP basis of measurement.

Variable annuity contracts written by Jackson may provide for guaranteed minimum death, income, or withdrawal benefit features. In general terms, liabilities for these benefits are accounted for under US GAAP by using estimates of future benefits and fees under best estimate assumptions. For variable annuity business the key assumption is the expected long-term level of equity market returns, which for 2008 and 2007 was 8.4 per cent per annum (net of fund management fees) determined using a mean reversion methodology. This rate reflects a long-term assumption applied from year to year that is appropriate in the context of 'grandfathered' US GAAP under IFRS 4 for accounting for Jackson's insurance assets and liabilities. Under the mean reversion methodology, projected returns over the next five years are flexed (subject to capping) so that, combined with the actual rates of return for the current and the previous two years the 8.4 per cent rate is maintained. The projected rates of return are capped at no more than 15 per cent for each of the next five years. Further details are explained in note D3(i).

These returns affect the level of future expected profits through their effects on the fee income with consequential impact on the amortisation of deferred acquisition costs as described below and the required level of provision for guaranteed minimum death benefit claims.

For traditional life insurance contracts, provisions for future policy benefits are determined under SFAS 60 using the net level premium method and assumptions as of the issue date as to mortality, interest, policy lapses and expenses plus provisions for adverse deviation.

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

Asian operations

The insurance products written in the Group's Asian operations principally cover with-profits business, unit-linked business, and other non-participating business. The results of with-profits business are relatively insensitive to changes in estimates and assumptions that affect the measurement of policyholder liabilities. As for the UK business, this feature arises because unallocated surplus is accounted for by the Group as a liability. The results of Asian unit-linked business are also relatively insensitive to changes in estimates or assumptions.

The principal non-participating business in the Group's Asian operations, for which changes in estimates and assumptions are important from year to year, is the traditional whole-life business written in Taiwan. The premiums for the in-force business for these contracts 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 an allowance for mortality and expenses. The required rates of guarantee have fallen over time as interest rates have reduced from a high of eight per cent to current levels of around 1.4 per cent. The current low bond rates in Taiwan gives rise to a negative spread against the majority of these policies. The current cash costs of funding in-force negative spread in Taiwan is around £50 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 asset 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. In determining the long-term estimate, external advice of expert macroeconomic consultants has been obtained. At 31 December 2008 it has been assumed that the longer-term bond rate of 5.5 per cent will be attained by 31 December 2018 (2007: 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 and the level of the projected long-term rate.

Details of this sensitivity are shown in note D4(j)(iii).

Deferred acquisition costs

Significant costs are incurred in connection with acquiring new insurance business. Except for acquisition costs of with-profits contracts of the UK regulated with-profits funds, which are accounted for under the realistic FSA regime as described in note A4, these costs, which vary with, and are primarily related to, the production of new business, are capitalised and amortised against margins in future revenues on the related insurance policies. The recoverability of the asset is measured and the asset is deemed impaired if the projected future margins are less than the carrying value of the asset. To the extent that the future margins differ from those anticipated, then an adjustment to the carrying value of the deferred acquisition cost asset will be necessary.

The deferral and amortisation of acquisition costs is of most relevance to the Group's results for shareholder-financed long-term business of Jackson and Asian operations. The majority of the UK shareholder-backed operations is for individual and group annuity business where the incidence of acquisition costs is negligible.

Jackson

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 long-term spread between the earned rate and the rate credited to policyholders, which is based on the 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 the Jackson companies, industry experience and future expectations. A detailed analysis of actual experience is measured by internally developed mortality studies.

For variable annuity business, the key assumption is the expected long-term level of equity market returns as described above.

The level of acquisition costs carried in the balance sheet is also sensitive to unrealised valuation movements on debt securities held to back the liabilities and solvency capital. Further details are explained in notes D3(i) and H1.

Asian operations

The key shareholder-backed Asian operation is the Taiwan life business.

In 2008, a number of changes have been made to the basis of estimating the level of deferred acquisition costs, as described in note D4(i)(b).

The carrying value of the deferred acquisition costs of the Taiwan operation are potentially sensitive to changes in current assumed future interest rates as described above.

Pensions

The Group applies the requirements of IAS 19, 'Employee benefits', to its defined benefit pension schemes. Due to the inclusion of actuarial gains and losses in the income statement rather than being recognised directly in equity, the results of the Group are affected by changes in interest rates for corporate bonds that affect the rate applied to discount projected pension payments and changes in mortality assumptions.

The economic participation in the surplus or deficits attaching to the main Prudential Staff Pension Scheme (PSPS) and the smaller Scottish Amicable Pensions Scheme (SAPS) are shared between the PAC with-profits sub-fund (WPSF) and shareholder operations. The economic interest reflects the source of contributions over the scheme life, which in turn reflects the activity of the members during their employment.

In the case of PSPS, movements in the apportionment of the surplus or deficit for PSPS between the WPSF and shareholders' funds in 2008 reflect the 70/30 ratio applied to the base deficit position as at 31 December 2005 but with service cost and contributions for ongoing service apportioned by reference to the cost allocation for activity of current employees. For SAPS the ratio is estimated to be 50/50 between the WPSF and shareholders' funds.

On 1 January 2008, the Group adopted IFRIC 14 'IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'. IFRIC 14 provides guidance on the recognition of IAS 19 surpluses in, and funding obligations for, defined benefit pension schemes. As a result of the adoption of this interpretation, in respect of the position at 31 December 2008, the Group has not recognised the underlying PSPS pension surplus of £728 million (£615 million net of deferred tax), reflecting the difference between the market value of the scheme assets and the discounted value of the liabilities, which would have otherwise been recognised as an asset on its balance sheet under the previous policy. In addition, the Group has recognised a liability for deficit funding to 5 April 2010 of £65 million (£55 million net of deferred tax) in respect of PSPS. Of these, the amounts attributable to shareholders are £223 million (£160 million net of deferred tax) for the surplus not recognised as an asset and £20 million (£15 million net of deferred tax) for the additional liability for deficit funding. In total the impact on shareholders' equity at 31 December 2008 is a reduction of £175 million.

Notes on the Group financial statements

A: Background and accounting policies

continued

A3: Critical accounting policies, estimates and judgements continued

Deferred tax

Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all the available evidence, it can be regarded as more likely than not that there will be suitable taxable profits against which the losses can be relieved. The UK taxation regime applies separate rules to trading and capital profits and losses. The distinction between temporary differences that arise from items of either a capital or trading nature may affect the recognition of deferred tax assets. The judgements made, and uncertainties considered, in arriving at deferred tax balances in the financial statements are discussed in note H4.

Goodwill

Goodwill impairment testing requires the exercise of judgement by management as to prospective future cash flows. Further information is disclosed in note H1.

A4: Significant accounting policies

a 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. 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. Debt securities held by Jackson 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.

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. Additional details are provided in note G1.

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.

For the Group's continuing operations, hedge accounting under IAS 39 is not usually applied. The exceptions, where hedge accounting has been applied in 2008 and 2007, are summarised in note G3.

For UK with-profits funds the derivative programme is undertaken as part of the efficient management of the portfolio as a whole. As noted in section D2 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 generally not to seek to construct the Jackson derivative programme so as to facilitate hedge accounting where theoretically possible, under IAS 39. Further details on this aspect of the Group's financial reporting are described in note A3.

Embedded derivatives

Embedded derivatives are held by various Group companies including Jackson. 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.

In Jackson, for 2008 and subsequently, the embedded derivative liabilities for Guaranteed Minimum Withdrawal Benefit (GMWB), Guaranteed Minimum Income Benefit (GMIB) reinsurance, and Fixed Index Annuity business are valued by reference to AA corporate bond rates. Previously, the liabilities had been measured by reference to swap rates. The reason for the change is the anomalous swap curves applying in the current dislocated credit markets. Further details are provided in note D3 (g).

Securities lending including repurchase agreements

The Group is party to various securities lending agreements under which securities are loaned to third-parties on a short-term basis. The loaned securities are not derecognised; rather, they continue to be recognised within the appropriate investment classification. The Group's policy is that collateral in excess of 100 per cent of the fair value of securities loaned is required from all securities borrowers and typically consists of cash, debt securities, equity securities or letters of credit.

Notes on the Group financial statements

A: Background and accounting policies

continued

A4: Significant accounting policies continued

In cases where the Group takes possession of the collateral under its securities lending programme, the collateral, and corresponding obligation to return such collateral, are recognised in the consolidated balance sheet. To further minimise credit risk, the financial condition of counterparties is monitored on a regular basis.

Derecognition of financial assets and liabilities

The Group's policy is to derecognise financial assets when it is deemed that substantially all the risks and rewards of ownership have been transferred. The Group also derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire. Where the Group neither transfers nor retains substantially all the risks and rewards of ownership, the Group will derecognise the financial asset where it is deemed that the Group has not retained control of the financial asset.

Where the transfer does not result in the Group transferring the right to receive the cash flows of the financial assets, but does result in the Group assuming a corresponding obligation to pay the cash flows to another recipient, the financial assets are also accordingly derecognised providing all of the following conditions are met:

- The Group has no obligation to pay amounts to the eventual recipients unless it collects the equivalent amounts from the original asset;
- the Group is prohibited by the terms of the transfer contract from selling or pledging the original asset; and
- the Group has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.

The Group derecognises financial liabilities only when the obligation specified in the contract is discharged, cancelled or has expired.

Borrowings

Although initially recognised at fair value, net of transaction costs, borrowings, excluding liabilities of consolidated collateralised debt obligations, are subsequently accounted for on an amortised cost basis using the effective interest method. Under the effective interest method, the difference between the redemption value of the borrowing and the initial proceeds (net of related issue costs) is amortised through the income statement to the date of maturity.

Financial liabilities designated at fair value through profit and loss

Consistent with the Group's risk management and investment strategy and the nature of the products concerned, the Group has designated under IAS 39 classification certain financial liabilities at fair value through profit and loss as these instruments are managed and their performance evaluated on a fair value basis. These instruments include liabilities related to consolidated collateralised debt obligations and net assets attributable to unit holders of consolidated unit trusts and similar funds.

b Long-term business contracts

Income statement treatment

Premiums and claims

Premium and annuity considerations for conventional with-profits policies and other protection type insurance policies are recognised when due. Premiums and annuity considerations for linked policies, unitised with-profits and other investment type policies are recognised when received or, in the case of unitised or unit-linked policies, when units are issued. These amounts exclude any taxes or duties assessed based on premiums.

Policy fees charged on linked and unitised with-profits policies for mortality, asset management and policy administration are recognised as revenue when related services are provided.

Claims paid include maturities, annuities, surrenders and deaths. Maturity claims are recorded on the policy maturity date. Annuity claims are recorded when the annuity becomes due for payment. Surrenders are recorded when paid and death claims are recorded when notified.

For investment contracts which do not contain discretionary participating features, the accounting reflects the deposit nature of the arrangement, with premiums and claims reflected as deposits and withdrawals and taken directly to the balance sheet.

Acquisition costs

Costs of acquiring new insurance business, principally commissions, marketing and advertising costs and certain other costs associated with policy issuance and underwriting that are not reimbursed by policy charges, are specifically identified and capitalised as part of deferred acquisition costs (DAC), which are included as an asset in the balance sheet. The DAC asset in respect of insurance contracts is amortised against margins in future revenues on the related insurance policies, to the extent that the amounts are recoverable out of the margins. Recoverability of the unamortised DAC asset is assessed at the time of policy issue and reviewed if profit margins have declined.

Under IFRS, investment contracts (excluding those with discretionary participation features) are required to be accounted for as financial liabilities in accordance with IAS 39 and, where relevant, the provisions of IAS 18 in respect of the attaching

investment management features of the contracts. The Group's investment contracts primarily comprise certain unit-linked savings contracts in the UK and Asia and contracts with fixed and guaranteed terms in the US (such as guaranteed investment contracts and annuity-certain).

Incremental, directly attributable acquisition costs relating to the investment management element of these contracts are capitalised and amortised in line with the related revenue. If the contracts involve up-front charges, this income is also deferred and amortised through the income statement in line with contractual service provision.

UK regulated with-profits funds

Prudential's long-term business written in the UK comprises predominantly life insurance policies 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.

Annual bonuses are declared and credited each year to with-profits policies. The annual bonuses increase policy benefits and, once credited, become guaranteed. Annual bonuses are charged to the profit and loss account in the year declared. Final bonuses are declared each year and accrued for all policies scheduled to mature and for death benefits expected to be paid during the next financial year. Final bonuses are not guaranteed and are only paid on policies that result from claims through the death of the policyholder or maturity of the policy within the period of declaration or by concession on surrender. No policyholder benefit provisions are recorded for future annual or final bonus declarations.

The policyholders' liabilities of the regulated with-profits funds are accounted for under FRS 27. FRS 27 is underpinned by the FSA's Peak 2 basis of reporting. This Peak 2 basis requires the value of liabilities to be calculated as:

- A with-profits benefits reserve (WPBR); plus
- future policy related liabilities (FPRL); plus
- the realistic current liabilities of the fund.

The WPBR is primarily based on the retrospective calculation of accumulated asset shares but is adjusted to reflect future policyholder benefits and other outgoings.

The FPRL must include a market consistent valuation of costs of guarantees, options and smoothing, less any related charges, and this amount is determined using either a stochastic approach, hedging costs or a series of deterministic projections with attributed probabilities.

The assumptions used in the stochastic models are calibrated to produce risk-free returns on each asset class. Volatilities of, and correlations between, investment returns from different asset classes are as determined by the Group's Portfolio Management Group but are also market consistent.

The cost of guarantees, options and smoothing is very sensitive to the bonus, market value reduction (MVR) and investment policies the Group employs and therefore the stochastic modelling incorporates a range of management actions that would help to protect the fund in adverse scenarios. Substantial flexibility has been included in the modelled management actions in order to reflect the discretion that the Group retains in adverse investment conditions, thereby avoiding the creation of unreasonable minimum capital requirements. The management actions assumed are consistent with management's policy for with-profits funds and the disclosures made in the publicly available Principles and Practices of Financial Management.

Under FRS 27 for the UK with-profits funds:

- No deferred acquisition costs and related deferred tax are recognised; and
- adjusted realistic basis liabilities instead of MSB liabilities are recognised.

Adjusted realistic basis liabilities represent the Peak 2 basis realistic liabilities for with-profits business included in Form 19 of the FSA regulatory returns, but after excluding the element for the shareholders' share of the future bonuses. This latter item is recognised as a liability for the purposes of regulatory returns but, for accounting purposes under FRS 27, consistent with the current basis of financial reporting, shareholder transfers are recognised only on declaration.

Notes on the Group financial statements

A: Background and accounting policies

continued

A4: Significant accounting policies continued

Unallocated surplus

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

Other insurance contracts (i.e. contracts which contain significant insurance risk as defined under IFRS 4)

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

Other UK insurance contracts

Other UK insurance contracts that contain significant insurance risk include unit-linked, annuity and other non-profit business. For the purposes of local regulations, segregated accounts are established for linked business for which policyholder benefits are wholly or partly determined by reference to specific investments or to an investment-related index. The interest rates used in establishing policyholder benefit provisions for pension annuities in the course of payment are adjusted each year. Mortality rates used in establishing policyholder benefit provisions were based on published mortality tables adjusted to reflect actual experience.

Overseas subsidiaries

The assets and liabilities of insurance contracts of overseas subsidiaries are determined initially using local GAAP bases of accounting with subsequent adjustments where necessary to comply with the Group's accounting policies.

Jackson

The future policyholder benefit provisions for Jackson's conventional protection-type policies are determined using the net level premium method under US GAAP principles and assumptions as of the issue date as to mortality, interest, policy lapses and expenses plus provisions for adverse deviations. For non-conventional protection-type policies, the policyholder benefit provision included within policyholder liabilities in the consolidated balance sheet is the policyholder account balance.

For the business of Jackson, the determination of the expected emergence of margins, against which the amortisation profile of the DAC asset is established, is dependent on certain key assumptions. For single premium deferred annuity business, the key assumption is the expected long-term spread between the earned rate and the rate credited to policyholders. For variable annuity business, the key assumption is the expected long-term level of equity market returns which, for 2008 and 2007, 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 fee income and the required level of provision for guaranteed minimum death benefit claims.

Jackson accounts for the majority of its investment portfolio on an available-for-sale basis (see investment policies above) whereby unrealised gains and losses are recognised directly in equity. As permitted by IFRS 4, Jackson has used shadow accounting. Under shadow accounting, to the extent that recognition of unrealised gains or losses on available-for-sale securities causes adjustments to the carrying value and amortisation patterns of DAC and deferred income, these adjustments are recognised directly in equity to be consistent with the treatment of the gains or losses on the securities.

Asian operations

Except for the operations in Taiwan, Vietnam and Japan, the future policyholder benefit provisions for Asian businesses are determined in accordance with methods prescribed by local GAAP adjusted to comply, where necessary, with UK GAAP. For the Hong Kong business, which is a branch of the PAC, and the Singapore and Malaysian operations the valuation principles and sensitivities to changes of assumptions of conventional with-profits and other protection-type policies are similar to those described above for equivalent products written by the UK operations.

For the operations in Taiwan, Vietnam and Japan, countries where local GAAP is not appropriate in the context of the previously applied MSB, accounting for insurance contracts is based on US GAAP. For these three operations the business written is primarily non-participating and linked business. The future policyholder benefit provisions for non-linked business are determined using the net level premium method, with an allowance for surrenders, maintenance and claim expenses. Rates of interest used in establishing the policyholder benefit provisions vary by operation depending on the circumstances attaching to each block of business. Where appropriate, liabilities for participating business for these three operations include provisions for the policyholders' interest in realised investment gains and other surpluses that have yet to be declared as bonuses.

Although the basis of valuation of Prudential's overseas operations is in accordance with the requirements of the Companies Act 1985 and ABI SORP, the valuation of policyholder benefit provisions for these businesses may differ from that determined on a UK MSB for UK operations with the same features.

Liability adequacy

The Group performs liability adequacy testing on its insurance provisions to ensure that the carrying amounts of provisions (less related DAC and present value of in-force business – see policy on business acquisitions and disposals) is sufficient to cover current estimates of future cash flows. When performing the liability adequacy test, the Group discounts all contractual cash flows and compares this amount to the carrying value of the liability. Any deficiency is immediately charged to the income statement.

Reinsurance

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

Gains arising on the purchase of reinsurance contracts by Jackson are deferred and amortised over the contract duration. Any loss is recognised in the income statement immediately.

Investment contracts (contracts which do not contain significant insurance risk as defined under IFRS 4)

For investment contracts with discretionary participation features, the accounting basis is consistent with the accounting for similar with-profits insurance contracts. Other investment contracts are accounted for on a basis that reflects the hybrid nature of the arrangements whereby part is accounted for as a financial instrument under IAS 39 and the investment management service component is accounted for under IAS 18.

For those investment contracts in the US with fixed and guaranteed terms, the Group uses the amortised cost model to measure the liability. On contract inception, the liability is measured at fair value less incremental, directly attributable acquisition costs. Remeasurement at future reporting dates is on an amortised cost basis utilising an effective interest rate methodology whereby the interest rate utilised discounts to the net carrying amount of the financial liability.

Those investment contracts without fixed and guaranteed terms are designated at fair value through profit and loss. Fair value is based upon the fair value of the underlying assets of the fund. Where the contract includes a surrender option its carrying value is subject to a minimum carrying value equal to its surrender value.

c Other assets, liabilities, income and expenditure

Basis of consolidation

The Group consolidates those entities it is deemed to control. The degree of control is determined by the ability of the Group to govern the financial and operating policies of an entity in order to obtain benefits. Consideration is given to other factors such as potential voting rights.

The Group has consolidated some special purpose entities (SPEs), such as funds holding collateralised debt obligations (CDOs), where equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. These SPEs are consolidated because the Group is deemed to control them under IFRS.

The Group holds investments in internally and externally managed open-ended investment companies (OEICs) and unit trusts. The Group's percentage ownership levels in these entities can fluctuate from day to day according to changes in the Group's and third-party participation in the funds. In instances where the Group's ownership of internally managed funds declines marginally below 50 per cent and, based on historical analysis and future expectations the decline in ownership is expected to be temporary, the funds continue to be consolidated as subsidiaries under IAS 27.

Where the Group exercises significant influence or has the power to exercise significant influence over an entity, generally through ownership of 20 per cent or more of the entity's voting rights, but does not control the entity, then this is considered to be an investment in an associate. With the exception of those referred to below, the Group's investments in associates are recorded at the Group's share of the associates' net assets. The carrying value of investments in associates is adjusted each year for the Group's share of the entities' profit or loss. This does not apply to investments in associates held by the Group's insurance or investment funds including the venture capital business or mutual funds and unit trusts, which are carried at fair value through profit and loss.

The Group's investments in joint ventures are recognised using proportional consolidation whereby the Group's share of an entity's individual balances are combined line-by-line with similar items into the Group financial statements.

Other interests in entities, where significant influence is not exercised, are carried as investments at fair value through profit and loss.

The consolidated financial statements of the Group include the assets, liabilities and results of the Company and subsidiary undertakings in which Prudential has a controlling interest, using accounts drawn up to 31 December 2008 except where entities have non-coterminous year ends. In such cases, the information consolidated is based on the accounting period of these entities and is adjusted for material changes up to 31 December. Accordingly, the information consolidated is deemed to cover the same period for all entities throughout the Group. The results of subsidiaries are included in the financial statements from the date acquired to the effective date of disposal. All inter-company transactions are eliminated on consolidation. Results of asset management activities include those for managing internal funds.

Notes on the Group financial statements

A: Background and accounting policies

continued

A4: Significant accounting policies continued

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. Fair value is based on active market prices, adjusted, if necessary, for any difference in the nature, location or condition of the specific property. If this information is not available, the Group uses alternative valuation methods such as discounted cash flow projections or recent prices in less active markets.

Leases of investment property where the Group has substantially all the risks and rewards of ownership are classified as finance leases (leasehold property). Finance leases are capitalised at the lease's inception at the lower of the fair value of the leased property and the present value of the minimum lease payments. Where a lease has a contingent rent element, the rent is calculated in accordance with individual lease terms and charged as an expense as incurred.

Pension schemes

The Group operates a number of pension schemes around the world. The largest of these schemes is the PSPS, a defined benefit scheme. The Group also operates defined contribution schemes. Defined contribution schemes are schemes where the Company pays contributions into a fund and the Company has no legal or constructive obligation to pay further contributions should the assets of that fund be insufficient to pay the employee benefits relating to employee service in both current and prior periods. Defined benefit schemes are post-employment benefit plans that are not defined contribution schemes.

For the Group's defined benefit schemes, if the present value of the defined benefit obligation exceeds the fair value of the scheme assets, then a liability is recorded in the Group's balance sheet. By contrast, if the fair value of the assets exceeds the present value of the defined benefit obligation then the surplus will only be recognised if the nature of the arrangements under the Trust deed, and funding arrangements between the Trustee and the Company support the availability of refunds or recoverability through agreed reductions in future contributions. In addition, if there is a constructive obligation for the Company to pay deficit funding, this is also recognised.

The Group utilises the projected unit credit method to calculate the defined benefit obligation. Estimated future cash flows are then discounted at a high-quality corporate bond rate, adjusted to allow for the difference in duration between the bond index and the pension liabilities where appropriate, to determine its present value. These calculations are performed by independent actuaries.

The plan assets of the Group's pension schemes exclude several insurance contracts that have been issued by the Group. These assets are excluded from plan assets in determining the pension obligation recognised in the consolidated balance sheet.

The aggregate of the actuarially determined service costs of the currently employed personnel and the unwind of discount on liabilities at the start of the period, less the expected investment return on scheme assets at the start of the period, is charged to the income statement. Actuarial gains and losses as a result of changes in assumptions or experience variances are also charged or credited to the income statement.

Contributions to the Group's defined contribution schemes are expensed when due. Once paid, the Group has no further payment obligations. Any prepayments are reflected as an asset on the balance sheet.

Share-based payments

The Group offers share award and option plans for certain key employees and a Save As You Earn (SAYE) plan for all UK and certain overseas employees. The arrangements for distribution to employees of shares held in trust relating to share award plans and for entitlement to dividends depend upon the particular terms of each plan. Shares held in trust relating to these plans are conditionally gifted to employees.

The compensation expense charged to the income statement is primarily based upon the fair value of the options granted, the vesting period and the vesting conditions. The Group revises its estimate of the number of options likely to be exercised at each balance sheet date and adjusts the charge to the income statement accordingly. Where the share-based payment depends upon vesting outcomes attaching to market-based performance conditions, additional modelling is performed to estimate the fair value of the awards. No subsequent adjustment is then made to the fair value charge for awards that do not vest on account of these performance conditions not being met.

The Company has established trusts to facilitate the delivery of Prudential plc shares under employee incentive plans and savings-related share option schemes. None of the trusts that hold shares for employee incentive and savings plans continue to hold these shares once they are issued to employees. The cost to the Company of acquiring these treasury shares held in trusts is shown as a deduction from shareholders' equity.

Tax

The Group's UK subsidiaries each file separate tax returns. Jackson and other foreign subsidiaries, where permitted, file consolidated income tax returns. In accordance with UK tax legislation, where one domestic UK company is a 75 per cent owned subsidiary of another UK company or both are 75 per cent owned subsidiaries of a common parent, the companies are considered to be within the same UK tax group. For companies within the same tax group, trading profits and losses arising in the same accounting period may be offset for purposes of determining current and deferred taxes.

Current tax expense is charged or credited to operations based upon amounts estimated to be payable or recoverable as a result of taxable operations for the current year. To the extent that losses of an individual UK company are not offset in any one year, they can be carried back for one year or carried forward indefinitely to be offset against profits arising from the same company.

Deferred taxes are provided under the liability method for all relevant temporary differences, being the difference between the carrying amount of an asset or liability in the balance sheet and its value for tax purposes. IAS 12, 'Income Taxes' does not require all temporary differences to be provided for, in particular, the Group does not provide for deferred tax on undistributed earnings of subsidiaries where the Group is able to control the timing of the distribution and the temporary difference created is not expected to reverse in the foreseeable future. The tax effects of losses available for carry forward are recognised as an asset. Deferred tax assets are only recognised when it is probable that future taxable profits will be available against which these losses can be utilised. Deferred tax related to charges or credits taken directly to equity is also credited or charged directly to equity and is subsequently recognised in the income statement together with the deferred gain or loss.

The tax charge for long-term business includes tax expense on with-profits funds attributable to both the policyholders and the shareholders. Different tax rules apply under UK law depending upon whether the business is life insurance or pension business. Tax on the life insurance business is based on investment returns less expenses attributable to that business. Tax on the pension business is based on the shareholders' profits or losses attributable to that business. The shareholders' portion of the long-term business is taxed at the shareholders' rate with the remaining portion taxed at rates applicable to the policyholders.

Basis of presentation of tax charges

Tax charges in the income statement reflect the aggregate of the shareholder tax on the long-term business result and on the Group's other results.

Under UK Listing Authority rules, profit before tax is required to be presented. This requirement, coupled with the fact that IFRS does not contemplate tax charges which are attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies, necessitates the reporting of total tax charges within the presented results. The result before all taxes (i.e. 'profit before tax' as shown in the income statement) represents income net of post-tax transfers to unallocated surplus of with-profits funds, before tax attributable to policyholders and unallocated surplus of with-profits funds, unit-linked policies and shareholders. Separately within the income statement, 'profit before tax attributable to shareholders' is shown after deduction of taxes attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies. Tax charges on this measure of profit reflect the tax charges attributable to shareholders. In determining the tax charges attributable to shareholders, the Group has applied a methodology consistent with that previously applied under UK GAAP reflecting the broad principles underlying the tax legislation of life assurance companies.

Property, plant and equipment

All property, plant and equipment such as owner occupied property, computer equipment and furniture and fixtures, are carried at depreciated cost. Costs including expenditure directly attributable to the acquisition of the assets are capitalised. Depreciation is calculated and charged on a straight-line basis over an asset's estimated useful life. The residual values and useful lives are reviewed at each balance sheet date. If the carrying amount of an asset is greater than its recoverable amount then its carrying value is written down to that recoverable amount.

Leasehold improvements to owner occupied property are depreciated over the life of the lease. Assets held under finance leases are capitalised at their fair value.

Business acquisitions and disposals

Business acquisitions are accounted for by applying the purchase method of accounting, which adjusts the net assets of the acquired company to fair value at the date of purchase. The excess of the costs of acquisition over the fair value of the assets and liabilities of the acquired entity is recorded as goodwill. Should the fair value of the identifiable assets and liabilities of the entity exceed the cost of acquisition then this amount is recognised immediately in the income statement. Income and expenses of acquired entities are included in the income statement from the date of acquisition. Revenues and expenses of entities sold during the period are included in the income statement up to the date of disposal. The gain or loss on disposal is calculated as the difference between sale proceeds, net of selling costs, less the net assets of the entity at the date of disposal.

For life insurance company acquisitions, the adjusted net assets include an identifiable intangible asset for the present value of in-force business which represents the profits that are expected to emerge from the acquired insurance business. The present value of in-force business is calculated using best estimate actuarial assumptions for interest, mortality, persistency and expenses and is amortised over the anticipated lives of the related contracts in the portfolio. An intangible asset may also be recognised in respect of acquired investment management contracts representing the fair value of contractual rights acquired under these contracts.

Notes on the Group financial statements

A: Background and accounting policies

continued

A4: Significant accounting policies continued

The Company uses the economic entity method to purchase minority interests. Under the economic entity method any difference between consideration and the share of net assets acquired is recorded directly in equity.

Goodwill

Goodwill arising on acquisitions of subsidiaries and businesses is capitalised and carried on the Group balance sheet as an intangible asset at initial value less any accumulated impairment losses. Goodwill impairment testing is conducted annually and when there is an indication of impairment. For the purposes of impairment testing, goodwill is allocated to cash generating units. These cash generating units reflect the smallest group of assets that includes the goodwill and generates cash flows that are largely independent of the cash inflows from other groups of assets. If the carrying amount of the cash generating unit exceeds its recoverable amount then the goodwill is considered impaired. Impairment losses are recognised immediately in the income statement and may not be reversed in future periods.

Acquired intangible assets

Intangible assets acquired on the purchase of a subsidiary or portfolio of contracts are valued at acquisition and carried at cost less amortisation and any accumulated impairment losses. Amortisation calculated is charged on a straight-line basis over the estimated useful life of the assets. The residual values and useful lives are reviewed at each balance sheet date.

Cash and cash equivalents

Cash and cash equivalents consist of cash at bank and in hand, deposits held at call with banks, treasury bills and other short-term highly liquid investments with less than 90 days maturity from the date of acquisition.

Rights of offset

Assets and liabilities in the consolidated financial statements are only reported on a net basis when there is a legally enforceable right to offset and there is an intention to settle on a net basis.

Segments

In accordance with IAS 14, 'Segment Reporting' the Group reports its results and certain other financial information by primary and secondary segments. The Group's primary segments are its business segments, namely, insurance operations and asset management. The Group's secondary segments are its geographical segments, namely, UK, US and Asia.

Shareholders' dividends

Dividends to shareholders are recognised as a liability in the period in which they are declared. Where scrip dividends are issued, the value of such shares, measured as the amount of the cash dividend alternative, is credited to reserves and the amount in excess of the nominal value of the shares issued is transferred from the share premium account to retained earnings.

Share capital

Where there is no obligation to transfer assets, shares are classified as equity. The difference between the proceeds received on issue of the shares, net of share issue costs, and the nominal value of the shares issued, is credited to share premium. Where the Company purchases shares for the purposes of employee incentive plans, the consideration paid, net of issue costs, is deducted from retained earnings. Upon issue or sale any consideration received is credited to retained earnings net of related costs.

Foreign exchange

The Group's consolidated financial statements are presented in pounds sterling, the Group's presentation currency. Accordingly, the results and financial position of foreign subsidiaries must be translated into the presentation currency of the Group from their functional currencies, i.e. the currency of the primary economic environment in which the entity operates. All assets and liabilities of foreign subsidiaries are converted at year end exchange rates whilst all income and expenses are converted at average exchange rates where this is a reasonable approximation of the rates prevailing on transaction dates. The impact of these currency translations is recorded as a separate component of equity.

Foreign currency borrowings that have been used to provide a hedge against Group equity investments in overseas subsidiaries are translated at year end exchange rates and movements taken directly to shareholders' equity. Other foreign currency monetary items are translated at year end exchange rates with changes recognised in the income statement. Foreign currency transactions are translated at the spot rate prevailing at the time.

d Presentation of supplementary analysis of profit before tax attributable to shareholders

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 purposes of measuring operating profit, investment returns on shareholder-financed business are based on the expected longer-term rates of return. This reflects the particular features of long-term insurance business where assets and liabilities are held for the long term and for which the accounting basis for insurance liabilities under current IFRS is not generally conducive to demonstrating trends in underlying performance for life businesses exclusive of changes in market conditions. In determining profit on this basis the following key elements are applied to the results of the Group's shareholder-financed operations.

i Debt 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 (RMR) 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. The shareholder-backed operation for which the risk margin reserve charge is most significant is Jackson National Life. The RMR charge for Jackson is based on long-term average default and recovery data as published by Moody's. Note B1 provides further detail.

Longer-term equity returns comprise aggregate long-term income and capital returns.

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 two 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.

iii Liabilities to policyholders and embedded derivatives for product guarantees

Under IFRS, the degree to which the carrying values of liabilities to policyholders are sensitive to current market conditions varies between territories depending upon the nature of the 'grandfathered' measurement basis. In general, in those instances where the liabilities are particularly sensitive to routine changes in market conditions, the accounting basis is such that the impact of market movements on the assets and liabilities are broadly equivalent in the income statement, and operating profit based on longer-term investment returns is not distorted. In these circumstances there is no need for the movement in the liability to be bifurcated between the element that relates to longer-term market conditions and short-term effects.

However, some types of business movements in liabilities do require bifurcation to ensure that at the net level (i.e. after allocated investment returns and change for policyholder benefits) the operating result reflects longer-term market returns.

Examples where such bifurcation is necessary are:

a Asia

Vietnamese participating business

For the participating business in Vietnam the liabilities include policyholders' interest in investment appreciation and other surplus. 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

Notes on the Group financial statements

A: Background and accounting policies

continued

A4: Significant accounting policies continued

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.

Non-participating business

Bifurcation for the effect of determining the movement in the carrying value of liabilities to be included in operating results based on longer-term investment returns, and the residual element for the effect of using year end rates in the balance sheet.

Guaranteed Minimum Death Benefit (GMDB) product features

For unhedged GMDB liabilities accounted for under IFRS using 'grandfathered' US GAAP, such as in the Japanese business, the change in carrying value is determined under SOP 03-01, which partially reflects changes in market conditions. Under the company's supplementary basis of reporting the operating profit reflects the change in liability based on longer-term market conditions with the difference between the charge to the operating result and the movement reflected in the total result included in short-term fluctuations in investment returns.

b US operations – embedded derivatives for variable annuity guarantee features

Under IFRS, the Guaranteed Minimum Withdrawal Benefit (GMWB) and Guaranteed Minimum Income Benefit (GMIB) reinsurance are required to be fair valued as embedded derivatives. The movements in carrying values are affected by changes in the level of observed implied equity volatility and changes to the discount rate applied from period to period. For these embedded derivatives, as described in note D3(i), the discount rate applied reflects AA corporate bond curve rates. For the purposes of determining operating profit based on longer-term investment returns the charge for these features is determined using historical longer-term equity volatility levels and long-term average AA corporate bond rate curves.

c UK shareholder-backed annuity business

With one exception, the operating result based on longer-term investment returns reflects the impact of all value movements on policyholder liabilities for annuity business in PRIL and the PAC non-profit sub-fund.

The exception is for the impact on credit risk provisioning of actual downgrades during the year. As this feature arises due to short-term market conditions the effect on the altered valuation rate of interest is included in the category of short-term fluctuations in investment returns as shown in note B1.

The effects of other changes to credit risk provisioning including the introduction of the short-term allowance for credit risk described in note D2(g) and D2(i) are included in the operating result, as in the net effect of changes to the valuation rate of interest applied to portfolio rebalancing to align more closely with management benchmark.

iv Fund management and other non-insurance businesses

For these businesses, where the business model is more conventional than for life assurance, it is inappropriate to include returns in the operating result on the basis described above. Instead it is appropriate to generally include realised gains and losses (including impairments) in the operating result with unrealised gains and losses being included in short-term fluctuations. In some instances it may also be appropriate to amortise realised gains and losses on derivatives and other financial instruments to operating results over a time period that reflects the underlying substance of the arrangements.

A5: New accounting pronouncements

The following standards, interpretations and amendments have either been effective and adopted in 2008 or have been issued but are not yet effective in 2008, including those which have not yet been adopted in the EU. This is not intended to be a complete list as only those standards, interpretations and amendments that are anticipated to have an impact upon the Group's financial statements have been discussed.

Accounting pronouncements adopted in 2008

IFRIC 14, IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'

IFRIC 14 provides guidance on assessing the limit in IAS 19 on the amount of the surplus that can be recognised as an asset and clarifies the impact of minimum funding requirements on such assets. It also addresses when a minimum funding requirement might give rise to a liability. IFRIC 14 was adopted by the EU in December 2008 and is effective for accounting periods beginning after 31 December 2008.

The Group early adopted IFRIC 14 for its accounting period ended 31 December 2008. As a result of the adoption of this interpretation, in respect of the position at 31 December 2008, the Group has not recognised the underlying PSPS pension surplus, reflecting the difference between the market value of the scheme assets and the discounted value of the liabilities, which would have otherwise been recognised as an asset on its balance sheet under the previous policy. In addition, the Group has recognised a liability for deficit funding to 5 April 2010 in respect of PSPS.

Further details on the impact of adoption are provided in note I1. The 2007 comparatives have been adjusted accordingly for the adoption of IFRIC 14.

Reclassification of Financial Assets: Amendments to IAS 39, 'Financial Instruments: Recognition and Measurement' and IFRS 7, 'Financial Instruments: Disclosures'

In October 2008, the IASB issued these amendments to IAS 39 and IFRS 7. The amendments to IAS 39 permit the reclassification of certain 'held for trading' (at fair value through profit and loss but not those voluntarily designated as at fair value through profit and loss under the fair value option) and 'available-for-sale' financial assets into the 'loans and receivables' category carried at amortised cost if specific conditions are met as follows:

- 'Held for trading' financial assets are permitted to be reclassified into the 'loans and receivables' category in only rare circumstances or where the 'held for trading' financial assets would have met the definition of 'loans and receivables' if they had not been required to be classified as 'held for trading' at initial recognition and the entity has the intent and ability to hold it for the foreseeable future or until maturity;
- 'Available-for-sale' financial assets are permitted to be reclassified into the 'loans and receivables' category if they would have met the definition of 'loans and receivables' if they had not been designated as 'available-for-sale' and the entity has the intent and ability to hold the asset for the foreseeable future or until maturity; and
- 'Fair value through profit and loss' financial assets are permitted to be reclassified into the 'available-for-sale' category.

The amendments to IFRS 7 result in additional disclosures in accordance with the amendments to IAS 39.

The amendments to IAS 39 and IFRS 7 are effective 1 July 2008 applied on a prospective basis from the date of reclassification. Any reclassification made on or after 1 November 2008 takes effect from the date of the reclassification. Any reclassification made before 1 November 2008 can take effect from 1 July 2008 or a subsequent date.

The adoption of these amendments did not have an impact on the financial statements of the Group as the Group has not reclassified any non-derivative financial assets as permitted by the amendments.

Accounting pronouncements not yet effective

IFRS 8, 'Operating Segments'

IFRS 8 requires entities to adopt the 'management approach' to reporting the financial performance of its operating segments similar to the requirements under the US standard SFAS 131, 'Disclosures about Segments of an Enterprise and Related Information'. The amount of each operating segment item to be reported is the measure reported to the chief operating decision maker, which in some instances will be non-GAAP. IFRS 8 will require the Group to provide an explanation of the basis on which the segment information is prepared and a reconciliation to the amount recognised in the Group's consolidated financial statements. This standard is effective for accounting periods beginning on or after 1 January 2009. The Group is currently assessing the impact of these amendments on its financial statements.

Amendments to IAS 1, 'Presentation of Financial Statements: A Revised Presentation'

The revised version of IAS 1 is aimed at improving users' ability to analyse and compare the information given in the financial statements.

The changes require information in financial statements to be aggregated on the basis of shared characteristics and introduce a statement of comprehensive income. The revisions also include changes to the titles of some of the financial statements to reflect their functions more clearly: for example the balance sheet is renamed a statement of financial position, though the new titles are not mandatory. This revised standard is effective for IASB compliant financial statements for accounting periods beginning on or after 1 January 2009. The Group is currently assessing the impact of these amendments on its financial statements.

Amendment to IFRS 2, 'Share-based Payment: Vesting Conditions and Cancellations'

The amendment to IFRS 2 clarifies that vesting conditions are service conditions and performance conditions only. Other features of a share-based payment are not vesting conditions. It also specifies that all cancellations, whether by the entity or by other parties, should receive the same accounting treatment. This amendment is effective for accounting periods beginning on or after 1 January 2009. The Group is currently assessing the impact of this amendment but it is not expected to have a material impact on the financial statements of the Group.

Notes on the Group financial statements

A: Background and accounting policies

continued

A5: New accounting pronouncements continued

Revised IFRS 3, 'Business Combinations' and Amendments to IAS 27, 'Consolidated and Separate Financial Statements'

The revised IFRS 3 and amended IAS 27 are the outcomes of the second phase of the IASB's and the US Financial Accounting Standards Board's (FASB) joint business combination project. The more significant changes from the revised IFRS 3 include:

- The immediate expensing of acquisition-related costs rather than inclusion in goodwill; and
- recognition and measurement at fair value of contingent consideration at acquisition date with subsequent changes to income.

The amendments to IAS 27 reflect changes to the accounting for non-controlling (minority) interests.

The revised IFRS 3 and amended IAS 27 are effective for business combinations occurring in the accounting period beginning on or after 1 July 2009.

Amendments to IAS 32, 'Financial instruments: Presentation' and IAS 1, 'Presentation of financial statements' - Puttable Financial Instruments and Obligations Arising on Liquidation

The amendments to IAS 32 and IAS 1 requires entities to classify puttable financial instruments and instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation as equity, provided the financial instruments have particular features and meet specific conditions. The amendments may have the effect of altering the accounting for external fund holder investments in consolidated funds from minority interests to liabilities. These amendments also have consequential amendments to IFRS 7 and IAS 39.

These amendments are effective for IASB compliant financial statements for accounting periods beginning on or after 1 January 2009. The Group is currently assessing the impact of these amendments on its financial statements.

Amendment to IAS 39, 'Financial instruments: Recognition and Measurement' - Eligible Hedged Items

This amendment to IAS 39 clarifies how the principles that determine whether a hedged risk or portion of cash flows is eligible for designation should be applied in particular situations. This amendment is effective for IASB compliant financial statements for accounting periods beginning on or after 1 July 2009. The Group is currently assessing the impact of this amendment but it is not expected to have a material impact on the financial statements of the Group.

Improvements to IFRSs

In May 2008, the IASB published amendments to a number of standards as part of its annual improvements projects. These amendments are effective for accounting periods beginning on or after 1 January 2009. The Group is currently assessing the impact of these improvements to its financial statements.

IFRIC 16, 'Hedges of a net investment in a foreign operation'

This interpretation clarifies the accounting treatment in respect of net investment hedging. This includes the fact that net investment hedging relates to differences in functional currency not presentation currency, and hedging instruments may be held anywhere in the Group. This interpretation is effective for IASB compliant financial statements for accounting periods beginning on or after 1 October 2008.

The Group is currently assessing the impact of this interpretation but it is not expected to have a material impact on the financial statements of the Group.

Improving Disclosures about Financial Instruments (Amendments to IFRS 7)

On 5 March 2009, the IASB issued amendments to IFRS 7 which require enhanced disclosures about fair value measurements and liquidity risk. The amendments include the introduction of a three-level hierarchy for fair value measurement disclosures and require additional disclosures about the relative reliability of fair value measurements.

These amendments are effective for accounting periods beginning on or after 1 January 2009. However, an entity will not be required to provide comparative disclosures in the first year of application. The Group is currently assessing the impact of these amendments on the financial statements of the Group.

Apart from IFRS 8, the Amendments to IAS 1 and the Amendment to IFRS 2, all of the other aforementioned pronouncements have not been adopted for use in the EU at 31 December 2008. Subsequent to the 31 December 2008, the improvements to IFRSs and the amendments to IAS 32 and IAS 1 have also been adopted for use in the EU.

B: Summary of results

B1: Supplementary analysis of profit from continuing operations before tax attributable to shareholders

This information is provided as supplementary information under the Group's accounting policies. It is not required by IFRS standards.

	2008 £m	2007 £m
Asian operations		
Insurance operations ^{note ii}	321	189
Asset management	52	72
Development expenses	(26)	(15)
Total	347	246
US operations		
Jackson ^{notes ii,iii}	406	444
Broker dealer and asset management (including Curian losses of £3m (2007: £5m))	7	8
Total	413	452
UK operations		
UK insurance operations: ^{note ii}		
Long-term business	545	524
General insurance commission	44	4
Total	589	528
M&G	286	254
Total	875	782
Other income and expenditure		
Investment return and other income	89	86
Interest payable on core structural borrowings	(172)	(168)
Corporate expenditure:		
Group Head Office	(130)	(129)
Asia Regional Head Office	(41)	(38)
Charge for share-based payments for Prudential schemes ^{note vi}	(6)	(11)
Total	(260)	(260)
Restructuring costs ^{note vii}	(28)	(19)
Operating profit from continuing operations based on longer-term investment returns ^{note i}	1,347	1,201
Short-term fluctuations in investment returns on shareholder-backed business ^{note iv}	(1,783)	(137)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes ^{note v}	(14)	(1)
(Loss) profit from continuing operations before tax attributable to shareholders	(450)	1,063

Notes

- i Operating profit based on longer-term investment returns
Operating profit based on longer-term investment returns is a supplemental measure of results. For the purposes of measuring operating profit, investment returns on shareholder-financed business and movements in policyholders' liabilities are based on expected long-term rates of return as discussed in note A4. The expected long-term rates of return are intended to reflect historical real rates of return and, where appropriate, current inflation expectations adjusted for consensus economic and investment forecasts. The significant operations that require adjustment for the difference between actual and long-term investment returns are Jackson and certain businesses of the Group's Asian operations. The amounts included in operating results for long-term capital returns for debt securities comprise two components. 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 gains and losses for operating results based on longer-term results to the date when sold bonds would otherwise have matured.
- ii Effect of changes to assumptions, estimates and bases of determining life assurance liabilities
The results of the Group's long-term business operations are affected by changes of assumptions and bases of preparation. These are described in notes D2(i), D3(i) and D4(i).

Notes on the Group financial statements

B: Summary of results

continued

B1: Supplementary analysis of profit from continuing operations before tax attributable to shareholders continued

Notes continued

- iii Jackson operating results based on longer-term investment returns.
IFRS basis operating profits for US operations include the following amounts (net of related change in amortisation of deferred acquisition costs, where applicable) so as to derive longer-term investment returns.

	2008 £m	2007 £m
Debt securities:		
Amortisation of interest related realised gains and losses	24	31
Risk margin reserve charge for longer-term credit related losses	(41)	(37)
Equity type investments:		
Longer-term returns	62	47

The risk margin reserve (RMR) charge for longer-term credit related losses for 2008 is based on an average annual RMR of 23 basis points (2007: 22 basis points) on average book values for the year as shown below.

Moody's rating category	2008				2007			
	Average book value (US \$m)	RMR (bps)	Annual expected losses		Average book value (US \$m)	RMR (bps)	Annual expected losses	
			US \$m	£m			US \$m	£m
A3 or higher	21,098	0.03	(6)	(3)	20,231	0.03	(6)	(3)
Baa1, 2, 3	20,145	0.23	(46)	(25)	20,306	0.22	(46)	(23)
Ba1, 2, 3	1,635	1.11	(18)	(10)	1,687	1.13	(19)	(9)
B1, 2, 3	514	2.80	(14)	(8)	530	2.88	(15)	(7)
Below B3	373	3.98	(15)	(8)	240	4.00	(10)	(5)
Total	43,765	0.23	(99)	(54)	42,994	0.22	(96)	(47)
Related change to amortisation of deferred acquisition costs			23	13			20	10
Risk margin reserve charge for longer-term credit related losses			(76)	(41)			(76)	(37)

The longer-term rates of return for equity-type interests ranged from 6.3 per cent to 8.4 per cent for 2008 and 8.1 per cent to 10.1 per cent for 2007 depending on the type of investments. These rates are currently based on spreads over 10 year US treasury rates of 400 to 600 basis points.

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.

- iv Short-term fluctuations in investment returns on shareholder-backed business.

	2008 £m	2007 £m
Insurance operations:		
Asia	(200)	(71)
US	(1,058)	(18)
UK	(212)	(47)
Other operations	(313)	(1)
	(1,783)	(137)

General

The short-term fluctuations in investment returns for 2008 primarily reflect temporary market value movements on the portfolio of investments held by the Group's shareholder-backed operations. Default losses were incurred during 2008 in respect of Lehman Brothers and Washington Mutual, with total losses (including losses on sale) for these in respect of the Group's shareholder-backed business operations being £110 million and £91 million respectively of which the majority was incurred in Jackson. Excluding Lehman Brothers and Washington Mutual there was only one other default in 2008 which resulted in a loss of £5 million. There were no default losses in 2007.

Asian insurance operations

The fluctuations for Asian operations in 2008 primarily relates to £(81) million for Vietnam, reflecting a significant fall in the Vietnamese bond and equity markets, and £(65) million for Taiwan, which reflects the decrease in Taiwanese equity markets and a £(40) million reduction in the value of an investment in a CDO fund. For 2007, the £(71) million of short-term fluctuations primarily reflect value movements in Taiwan on the value of debt securities arising from increases in interest rates and a £(30) million reduction of the investment in a CDO fund, partially offset by strong equity market movements in Vietnam.

US insurance operations

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

	2008 £m	2007 £m
Short-term fluctuations related to debt securities		
Charges in the year*		
Defaults	(78)	0
Losses on sale of impaired and deteriorating bonds	(130)	(51)
Bond writedowns	(419)	(35)
Recoveries/reversals	3	8
	(624)	(78)
Less: risk margin charge included in operating profit based on longer-term investment returns	54	48
	(570)	(30)
Interest related gains (losses)		
Arising in the year	(25)	31
Less: amortisation gains and losses arising in current and prior years to operating profit based on longer-term investment returns	(28)	(37)
	(53)	(6)
Related change to amortisation of deferred acquisition costs	88	9
Total short-term fluctuations related to debt securities	(535)	(27)
Derivatives (other than equity related): market value movements (net of related change to amortisation of deferred acquisition costs)†	(369)	(19)
Equity type investments: actual less longer-term return (net of related change to amortisation of deferred acquisition costs)	(69)	42
Other items (net of related change to amortisation of deferred acquisition costs)‡	(85)	(14)
Total	(1,058)	(18)

* The charges on debt securities incurred in 2008 of £624 million comprise the following:

	Defaults £m	Bond write downs £m	Losses on sale of impaired and deteriorating bonds £m	Recoveries/ reversals £m	Total £m
Residential mortgage-backed securities					
Prime	–	25	–	–	25
Alt-A	–	138	–	–	138
Sub-prime	–	4	–	–	4
Total residential mortgage-backed securities	–	167	–	–	167
Public fixed income	78	233	130	–	441
Other	–	19	–	(3)	16
Total	78	419	130	(3)	624

Further details on the impairment losses for Jackson are described in note D3(a).

† The £369 million value movement is for freestanding derivatives held to manage the fixed annuity and other general account business. Under IAS 39, 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 derivatives held by Jackson are separately identified within short-term fluctuations in investment returns.

Derivative value movements in respect of variable annuity business are included within the operating profit based on longer-term investment returns to broadly match with the commercial effect to which the variable annuity derivative programme relates.

For the derivatives programme attaching to the fixed annuity and other general account business the Group has continued its approach of not seeking to apply hedge accounting under IAS 39. This decision reflects the inherent constraints for hedge accounting investments and life assurance assets and liabilities under 'grandfathered' US GAAP under IFRS 4.

‡ The £85 million charge for 2008 for other items shown above comprises £70 million for the difference between the charge for embedded derivatives included in the operating result and the charge to the total result, and £15 million of other items. For embedded derivatives the operating result reflects the application of 10-year average AA corporate bond rate curves and a static historical equity volatility assumption. The total result reflects the application of year end AA corporate bond rate curves and current equity volatility levels. Additional details are explained in note D3(i).

In addition, for US insurance operations, included within the statement of changes in equity, is a net reduction (translated at the 2008 year-end exchange rate of 1.44) in the value of debt securities classified as available-for-sale of £2,710 million (2007: £244 million). This reduction reflects the effect of widened credit spreads and global credit concerns partially offset by the effect of reductions in US interest rates and a steepening yield curve. These temporary market value movements do not reflect defaults or impairments. Additional details on the movement in the value of the Jackson portfolio are included in note D3.

Notes on the Group financial statements

B: Summary of results

continued

B1: Supplementary analysis of profit from continuing operations before tax attributable to shareholders continued

Notes continued

UK insurance operations

The short-term fluctuations charge for UK insurance operations of £212 million for 2008 reflects £170 million for asset value movements, principally for shareholder-backed annuity business, and £42 million for the effect of credit downgrades on the calculation of liabilities for shareholder-backed annuity business in PRIL and the PAC non-profit sub-fund, as discussed in note D2(g)(iii). The short-term fluctuation charge for 2007 arose mostly in PRIL. The fluctuation principally reflected the impact of widened credit spreads on the corporate bond securities backing the shareholders' equity of the business.

Other

The charge of £313 million for short-term fluctuations of other operations in 2008 arises from:

	2008 £m
Sale of investment in India Mutual fund in May 2008 giving rise to a transfer to operating profit of £47 million for the crystallised gain, and value reduction in the period, prior to sale, of £24 million	(71)
Unrealised value movements on swaps held centrally to manage Group assets and liabilities	(38)
Unrealised value movements on Prudential Capital's bond portfolio	(190)
Unrealised value movements on centrally held investments	(14)
	(313)

v Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes

	2008 £m	2007 £m
Actuarial gains and losses		
Actual less expected return on scheme assets	(97)	4
Experience gains (losses) on scheme liabilities	18	(4)
Gains (losses) on changes of assumptions for scheme liabilities	71	(7)
	(8)	(7)
Less: amount attributable to the PAC with-profits sub-fund	(2)	6
	(10)	(1)
Other gains and losses		
Movement in the provision for deficit funding of PSPS	(13)	–
Less: amount attributable to the PAC with-profits sub-fund	9	–
	(4)	–
Total	(14)	(1)

The 2008 and 2007 actuarial gains and losses shown in the table above related to the Scottish Amicable, M&G and the small Taiwan defined benefit pension schemes. The amounts did not include actuarial gains and losses for the Prudential Staff Pension Scheme (PSPS). Following the Group's adoption of IFRIC 14 for pension schemes in 2008, PSPS pension surplus was not recognised in the Group's financial statements with the 2007 comparatives adjusted accordingly. In addition, as a result of the adoption of IFRIC 14, the Group has recognised a liability for deficit funding to 5 April 2010 in respect of PSPS. The change in the period in relation to this liability is recognised above as other gains and losses on defined benefit pension schemes.

The gains of £71 million on change of assumptions comprises the effect of an increase in the risk discount rate combined with the effect of decreases in inflation rates.

Further details on the Group's defined benefit pension schemes and the effect of the accounting policy change are shown in note I1.

vi Share-based payments

The charge for share-based payments for Prudential schemes is for the SAYE and Group performance-related schemes.

vii Restructuring costs are allocated as follows:

	2008 £m	2007 £m
UK insurance operations	10	7
Unallocated corporate	18	12
	28	19

B2: Earnings per share

Basic earnings per share is calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year, excluding those held in employee share trusts, which are treated as cancelled.

For diluted earnings per share, the weighted average number of shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares. The Group's only class of dilutive potential ordinary shares are those share options granted to employees where the exercise price is less than the average market price of the Company's ordinary shares during the year.

	2008					
	Before tax note B1 £m	Tax note F5 £m	Minority interests £m	Net of tax and minority interests £m	Basic earnings per share Pence	Diluted earnings per share Pence
Based on operating profit based on longer-term investment returns	1,347	(292)	(4)	1,051	42.5p	42.5p
Short-term fluctuations in investment returns on shareholder-backed business	(1,783)	348	(1)	(1,436)	(58.1)p	(58.1)p
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	(14)	3	–	(11)	(0.4)p	(0.4)p
Based on loss for the year from continuing operations	(450)	59	(5)	(396)	(16.0)p	(16.0)p

There were no earnings from discontinued operations in 2008

	2007					
	Before tax note B1 £m	Tax note F5 £m	Minority interests £m	Net of tax and minority interests £m	Basic earnings per share Pence	Diluted earnings per share Pence
Based on operating profit based on longer-term investment returns	1,201	(381)	(4)	816	33.3p	33.3p
Short-term fluctuations in investment returns on shareholder-backed business	(137)	26	1	(110)	(4.5)p	(4.5)p
Shareholders' share of actuarial gains and losses on defined benefit pension schemes	(1)	1	–	0	0.0p	0.0p
Based on profit for the year from continuing operations	1,063	(354)	(3)	706	28.8p	28.8p
Adjustment for post-tax results of discontinued operations*	222	19	–	241	9.9p	9.8p
Based on profit for the year	1,285	(335)	(3)	947	38.7p	38.6p

* Discontinued operations in 2007 related entirely to UK Banking operations following the sale on 1 May 2007 of Egg Banking plc to Citi. Note I9 provides details of the sale of Egg.

Notes on the Group financial statements

B: Summary of results

continued

B2: Earnings per share continued

Number of shares

A reconciliation of the weighted average number of ordinary shares used for calculating basic and diluted earnings per share is set out as below:

	2008 m	2007 m
Weighted average shares for calculation of basic earnings per share	2,472	2,445
Shares under option at end of year	7	9
Number of shares that would have been issued at fair value on assumed option exercise	(6)	(6)
Weighted average shares for calculation of diluted earnings per share	2,473	2,448

B3: Dividends

	2008 £m	2007 £m
Dividends declared and paid in reporting period		
Parent company:		
Interim dividend (2008: 5.99p, 2007: 5.70p per share)	149	140
Final dividend for prior period (2008: 12.30p, 2007: 11.72p per share)	304	286
Subsidiary company payments to minority interests	2	5
Total	455	431

As a result of shares issued in lieu of dividends of £157 million (2007: £176 million), dividends paid in cash, as set out in the consolidated cash flow statement, were £297 million (2007: £255 million).

	2008 £m	2007 £m
Parent company dividends relating to reporting period:		
Interim dividend (2008: 5.99p, 2007: 5.70p per share)	149	140
Final dividend (2008: 12.91p, 2007: 12.30p per share)	322	304
Total	471	444

A final dividend of 12.91 pence per share was proposed by the directors on 18 March 2009. Subject to shareholders' approval, the dividend will be paid on 22 May 2009 to shareholders on the register at the close of business on 14 April 2009. The dividend will absorb an estimated £322 million of shareholders' funds. A scrip dividend alternative will be offered to shareholders.

B4: Exchange translation

Exchange movement recorded directly in equity

	2008 £m	2007 £m
Asian operations	456	16
US operations	821	(43)
Unallocated to a segment (central funds)	(646)	38
	631	11

The movements for Asian and US operations reflect the application of year end exchange rates to the assets and liabilities and average exchange rates to the income statement on translation of these operations into the presentation currency of the Group. The movement unallocated to a segment mainly reflects the translation of currency borrowings and forward contracts which have been designated as a net investment hedge against the currency risk of the net investment in Jackson.

The exchange rates applied were:

Local currency: £	Closing rate at 31 Dec 2008	Average for 2008	Closing rate at 31 Dec 2007	Average for 2007	Opening rate at 1 Jan 2007
Hong Kong	11.14	14.42	15.52	15.62	15.22
Japan	130.33	192.09	222.38	235.64	233.20
Malaysia	5.02	6.15	6.58	6.88	6.90
Singapore	2.07	2.61	2.87	3.02	3.00
Taiwan	47.28	58.24	64.56	65.75	63.77
US	1.44	1.85	1.99	2.00	1.96

B5: New business

Insurance products and investment products (note i)

	Insurance products gross premiums		Investment products gross inflows <small>note ii</small>		Total	
	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m
Asian operations	2,673	2,901	46,957	38,954	49,630	41,855
US operations	6,941	6,534	36	60	6,977	6,594
UK operations	7,183	6,879	16,154	14,745	23,337	21,624
Group total	16,797	16,314	63,147	53,759	79,944	70,073

Notes on the Group financial statements

B: Summary of results

continued

B5: New business continued

Insurance products - new business premiums and contributions (note i)

	Single		Regular		Annual premium and contribution equivalents	
	2008 £m	2007 £m	2008 £m	2007 £m	2008 £m	2007 £m
Asian operations						
China ^{note iv}	63	45	32	24	38	29
Hong Kong	507	501	154	117	205	167
India (Group's 26% interest)	60	26	202	177	208	180
Indonesia	94	118	167	109	176	121
Japan	115	122	30	22	42	34
Korea	78	179	211	241	219	259
Malaysia	28	41	99	78	102	82
Singapore	341	593	78	67	112	126
Taiwan	153	132	189	218	204	231
Other ^{note vii}	18	36	54	55	56	58
Total Asian operations	1,457	1,793	1,216	1,108	1,362	1,287
US operations						
Fixed annuities	1,724	573	–	–	172	57
Fixed index annuities	501	446	–	–	50	45
Variable annuities	3,491	4,554	–	–	349	455
Life	7	7	24	19	25	20
Guaranteed investment contracts	857	408	–	–	86	41
GIC – Medium Term Notes	337	527	–	–	34	53
Total US operations	6,917	6,515	24	19	716	671
UK operations						
Product summary						
Internal vesting annuities	1,600	1,399	–	–	160	140
Direct and partnership annuities	703	842	–	–	70	84
Intermediated annuities ^{note v}	497	555	–	–	50	56
Total individual annuities	2,800	2,796	–	–	280	280
Income drawdown ^{note v}	75	34	–	–	8	3
Equity release	242	156	–	–	24	16
Individual pensions	115	38	3	1	14	5
Corporate pensions	221	283	88	84	110	112
Unit-linked bonds	109	243	–	–	11	24
With-profits bonds	869	297	–	–	87	30
Protection	–	–	6	5	6	5
Offshore products	551	434	4	4	59	47
PruHealth ^{note vi}	–	–	16	13	16	13
Total retail retirement	4,982	4,281	117	107	615	535
Corporate pensions	227	198	116	115	139	135
Other products	132	190	21	25	34	44
DWP rebates	153	143	–	–	15	14
Total mature life and pensions	512	531	137	140	188	193
Total retail	5,494	4,812	254	247	803	728
Wholesale annuities ^{note iii}	1,417	1,799	–	–	142	180
Credit life	18	21	–	–	2	2
Total UK operations	6,929	6,632	254	247	947	910
Channel summary						
Direct and partnership	2,352	2,385	215	212	450	451
Intermediated	2,990	2,284	39	35	338	263
Wholesale ^{note iii}	1,434	1,820	–	–	144	182
Sub-total	6,776	6,489	254	247	932	896
DWP rebates	153	143	–	–	15	14
Total UK operations	6,929	6,632	254	247	947	910
Group total	15,303	14,940	1,494	1,374	3,025	2,868

Investment products - funds under management (note ii)

	2008 £m				31 Dec 2008
	1 Jan 2008	Market gross inflows	Redemptions	Market and other movements	
Asian operations	17,393	46,957	(46,102)	(3,016)	15,232
US operations	55	36	(32)	(9)	50
UK operations	51,221	16,154	(12,747)	(7,631)	46,997
Group total	68,669	63,147	(58,881)	(10,656)	62,279

	2007 £m				31 Dec 2007
	1 Jan 2007	Market gross inflows	Redemptions	Market and other movements	
Asian operations	12,253	38,954	(35,993)	2,179	17,393
US operations	–	60	(4)	(1)	55
UK operations	44,946	14,745	(9,787)	1,317	51,221
Group total	57,199	53,759	(45,784)	3,495	68,669

Notes

- i The tables shown above are provided as an indicative volume measure of transactions undertaken in the reporting period that have the potential to generate profits for shareholders. The amounts shown are not, and not intended to be, reflective of premium income recorded in the IFRS income statement.
APEs are calculated as the aggregate of regular new business amounts and one-tenth of single new business amounts. New business premiums for regular premium products are shown on an annualised basis. Department of Work and Pensions (DWP) rebate business is classified as single recurrent business. Internal vesting business is classified as new business where the contracts include an open market option.
The format of the tables shown above is consistent with the distinction between insurance and investment products as applied for previous financial reporting periods. With the exception of some US institutional business, products categorised as 'insurance' refer to those classified as contracts of long-term insurance business for regulatory reporting purposes, i.e. falling within one of the classes of insurance specified in part II of Schedule 1 to the Regulated Activities Order under FSA regulations.
The details shown above for insurance products include contributions for contracts that are classified under IFRS 4 'Insurance Contracts' as not containing significant insurance risk. These products are described as investment contracts or other financial instruments under IFRS. Contracts included in this category are primarily certain unit-linked and similar contracts written in UK insurance operations and Guaranteed Investment Contracts and similar funding agreements written in US operations.
- ii Investment products referred to in the table for funds under management above are unit trust, mutual funds and similar types of retail fund management arrangements. These are unrelated to insurance products that are classified as 'investment contracts' under IFRS 4, as described in the preceding paragraph, although similar IFRS recognition and measurement principles apply to the acquisition costs and fees attaching to this type of business.
- iii The tables for 2007 above include the transfer of 62,000 with-profits annuity policies from Equitable Life on 31 December 2007 with assets of approximately £1.7 billion. The transfer represented APE of £174 million.
- iv Subsequent to 29 September 2007 following expiry of the previous management agreement CITIC–Prudential Life Insurance Company Ltd (CITIC–Prudential), the Group's life operation in China, has been accounted for as a 50 per cent joint venture. Prior to this date CITIC–Prudential was consolidated as a subsidiary undertaking. All premiums for CITIC–Prudential are shown at 50 per cent on a like for like basis, reflecting the constant economic interest before and after the management changes in line with the original agreement with CITIC.
- v Income drawdown has been reallocated from the intermediated annuities product line. The APE sales are £8 million for 2008 and £3 million for 2007.
- vi Sales for PruHealth are included in UK sales. Comparative figures have been restated accordingly. The APE sales are £16 million for 2008 and £13 million for 2007.
- vii Other operations include Thailand, the Philippines and Vietnam.

Notes on the Group financial statements

B: Summary of results

continued

B6: Group balance sheet

The Group's primary reporting segments are insurance operations, asset management and, prior to disposal, banking. The Group's secondary reporting segments are geographical, namely the UK, the US and Asia. Details of disclosures in accordance with the requirements of IAS 14 for segment assets and liabilities are shown below.

Details of the primary reporting segments are as follows:

Insurance operations

This segment comprises long-term products that contain both significant and insignificant elements of insurance risk. The products are managed together and not classified in this way other than for accounting purposes. This segment also includes activity of the PAC with-profits funds' venture investments and other investment subsidiaries held for the purpose of supporting the Group's insurance operations.

Asset management

The asset management segment is comprised of both internal and third-party asset management services, inclusive of portfolio and mutual fund management, where the Group acts as an adviser, and broker-dealer activities. The nature of the products and the managing of the business differ from the risks inherent in the other business segments, and the regulatory environment of the asset management industry differs from that of the other business segments.

	2008 £m				Total
	Insurance operations	Asset management	Unallocated to a segment	Intra-group eliminations	
Consolidated total assets	210,694	6,306	4,150	(5,608)	215,542
Consolidated total liabilities	(205,120)	(4,663)	(6,254)	5,608	(210,429)
Segment assets by geographical segment					
UK					140,110
US					54,431
Asia					26,609
Intra-group eliminations					(5,608)
Total assets per balance sheet					215,542

	2007 £m				Total
	Insurance operations	Asset management	Unallocated to a segment	Intra-group eliminations	
Consolidated total assets	213,105	7,011	4,765	(5,499)	219,382
Consolidated total liabilities	(207,632)	(5,282)	(5,803)	5,499	(213,218)
Segment assets by geographical segment					
UK					161,334
US					42,758
Asia					20,789
Intra-group eliminations					(5,499)
Total assets per balance sheet					219,382

To explain more comprehensively the assets, liabilities and capital of the Group's businesses it is appropriate to provide an analysis of the Group's balance sheet by a mixture of primary and secondary segments.

This analysis is shown below for the Group balance sheet by business segment at 31 December 2008.

By business segment	2008 £m							
	Insurance operations			Total insurance operations	Asset management	Unallocated to a segment (central operations)	Intra-group eliminations	Group total
	UK D2	US D3	Asia D4					
Assets								
Intangible assets attributable to shareholders:								
Goodwill	–	–	111	111	1,230	–	–	1,341
Deferred acquisition costs and other intangible assets	134	3,962	1,247	5,343	6	–	–	5,349
Total ^{H1}	134	3,962	1,358	5,454	1,236	–	–	6,690
Intangible assets attributable to with-profits funds:								
In respect of acquired subsidiaries for venture fund and other investment purposes	174	–	–	174	–	–	–	174
Deferred acquisition costs and other intangible assets	13	–	113	126	–	–	–	126
Total ^{H2}	187	–	113	300	–	–	–	300
Total	321	3,962	1,471	5,754	1,236	–	–	6,990
Deferred tax assets ^{H4}	513	1,969	101	2,583	160	143	–	2,886
Other non-investment and non-cash assets ^{H3-H6}	4,962	1,819	1,416	8,197	135	3,553	(5,608)	6,277
Investment of long-term business and other operations:								
Investment properties	11,959	13	20	11,992	–	–	–	11,992
Investments accounted for using the equity method	–	–	–	–	–	10	–	10
Loans	1,902	5,121	1,705	8,728	1,763	–	–	10,491
Equity securities and portfolio holdings in unit trusts	38,880	15,142	8,077	62,099	23	–	–	62,122
Debt securities	58,871	24,249	11,113	94,233	991	–	–	95,224
Other investments	4,160	1,256	144	5,560	462	279	–	6,301
Deposits	6,090	390	750	7,230	64	–	–	7,294
Total investments ^{note a, G1, H7, H8}	121,862	46,171	21,809	189,842	3,303	289	–	193,434
Held for sale assets ^{H9}	–	–	–	–	–	–	–	–
Cash and cash equivalents ^{H10}	2,571	246	1,501	4,318	1,472	165	–	5,955
Total assets	130,229	54,167	26,298	210,694	6,306	4,150	(5,608)	215,542

Notes on the Group financial statements

B: Summary of results

continued

B6: Group balance sheet continued

	2008 £m							Group total
	Insurance operations			Total insurance operations	Asset management E2	Unallocated to a segment (central operations)	Intra-group eliminations	
	UK D2	US D3	Asia D4					
By business segment								
Equity and liabilities								
Equity								
Shareholders' equity ^{H11}	1,655	1,698	2,167	5,520	1,642	(2,104)	–	5,058
Minority interests	47	–	7	54	1	–	–	55
Total equity	1,702	1,698	2,174	5,574	1,643	(2,104)	–	5,113
Liabilities								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Insurance contract liabilities ^{H12}	72,756	42,476	20,798	136,030	–	–	–	136,030
Investment contract liabilities with discretionary participation features ^{G1}	23,367	–	79	23,446	–	–	–	23,446
Investment contract liabilities without discretionary participation features ^{G1}	11,584	2,885	32	14,501	–	–	–	14,501
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds) ^{D2ei,H12}	8,254	–	160	8,414	–	–	–	8,414
Total policyholder liabilities and unallocated surplus of with-profits funds ^{note b}	115,961	45,361	21,069	182,391	–	–	–	182,391
Core structural borrowings of shareholder-financed operations: ^{H13}								
Subordinated debt	–	–	–	–	–	1,987	–	1,987
Other	–	173	–	173	–	798	–	971
Total	–	173	–	173	–	2,785	–	2,958
Operational borrowings attributable to shareholder-financed operations ^{G1,H13}	54	511	130	695	4	1,278	–	1,977
Borrowings attributable to with-profits funds ^{G1,H13}	1,308	–	–	1,308	–	–	–	1,308
Other non-insurance liabilities: ^{G1,H4,H9,H14,H15}								
Obligations under funding, securities lending and sale and repurchase agreements	2,251	3,321	–	5,572	–	–	–	5,572
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	1,536	88	1,154	2,778	1,065	–	–	3,843
Current tax liabilities	127	–	76	203	40	599	–	842
Deferred tax liabilities	1,421	1,337	441	3,199	11	19	–	3,229
Accruals and deferred income	265	–	130	395	205	30	–	630
Other creditors	1,619	529	796	2,944	2,898	1,262	(5,608)	1,496
Provisions	267	23	37	327	97	37	–	461
Derivative liabilities	3,401	863	32	4,296	292	244	–	4,832
Other liabilities	317	263	259	839	51	–	–	890
Total	11,204	6,424	2,925	20,553	4,659	2,191	(5,608)	21,795
Total liabilities	128,527	52,469	24,124	205,120	4,663	6,254	(5,608)	210,429
Total equity and liabilities	130,229	54,167	26,298	210,694	6,306	4,150	(5,608)	215,542

This analysis is shown below for the Group balance sheet by business segment at 31 December 2007.

By business segment	2007 £m							Group total
	Insurance operations			Total insurance operations	Asset management	Unallocated to a segment (central operations)	Intra-group eliminations	
	UK D2	US D3	Asia D4					
Assets								
Intangible assets attributable to shareholders:								
Goodwill	–	–	111	111	1,230	–	–	1,341
Deferred acquisition costs and other intangible assets	157	1,928	745	2,830	6	–	–	2,836
Total ^{H1}	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
Total ^{H2}	211	–	–	211	–	–	–	211
Total	368	1,928	856	3,152	1,236	–	–	4,388
Deferred tax assets ^{H4}	105	657	73	835	95	21	–	951
Other non-investment and non-cash assets ^{H3-H6}	4,110	994	689	5,793	426	4,292	(5,499)	5,012
Investment of long-term business and other operations:								
Investment properties	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	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 ^{note a, G1, H7, H8}	143,539	38,795	18,244	200,578	3,414	58	–	204,050
Held for sale assets ^{H9}	30	–	–	30	–	–	–	30
Cash and cash equivalents ^{H10}	1,869	169	679	2,717	1,840	394	–	4,951
Total assets	150,021	42,543	20,541	213,105	7,011	4,765	(5,499)	219,382

Notes on the Group financial statements

B: Summary of results

continued

B6: Group balance sheet continued

By business segment	2007 £m							Group total
	Insurance operations			Total insurance operations	Asset management E2	Unallocated to a segment (central operations)	Intra-group eliminations	
	UK D2	US D3	Asia D4					
Equity and liabilities								
Equity								
Shareholders' equity ^{H11}	1,364	2,690	1,369	5,423	1,677	(1,038)	–	6,062
Minority interests	42	1	7	50	52	–	–	102
Total equity	1,406	2,691	1,376	5,473	1,729	(1,038)	–	6,164
Liabilities								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Insurance contract liabilities ^{H12}	82,938	32,926	16,912	132,776	–	–	–	132,776
Investment contract liabilities with discretionary participation features ^{G1}	29,466	–	84	29,550	–	–	–	29,550
Investment contract liabilities without discretionary participation features ^{G1}	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) ^{D2,ei,H12}	13,813	–	146	13,959	–	–	–	13,959
Total policyholder liabilities and unallocated surplus of with-profits funds^{note b}	138,290	34,848	17,179	190,317	–	–	–	190,317
Core structural borrowings of shareholder-financed operations: ^{H13}								
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 ^{G1,H13}								
Borrowings attributable to with-profits funds ^{G1,H13}	12	591	–	603	1	2,477	–	3,081
Other non-insurance liabilities: ^{G1,H4,H9,H14,H15}								
Obligations under funding, securities lending and sale and repurchase agreements	1,360	2,721	–	4,081	–	–	–	4,081
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	1,751	65	506	2,322	1,234	–	–	3,556
Current tax liabilities	507	–	24	531	36	670	–	1,237
Deferred tax liabilities	2,383	639	362	3,384	11	7	–	3,402
Accruals and deferred income	289	–	111	400	199	–	–	599
Other creditors	1,913	333	627	2,873	3,440	206	(5,499)	1,020
Provisions	326	19	33	378	166	31	–	575
Derivative liabilities	699	158	2	859	176	45	–	1,080
Other liabilities	98	353	321	772	19	–	–	791
Total	9,326	4,288	1,986	15,600	5,281	959	(5,499)	16,341
Total liabilities	148,615	39,852	19,165	207,632	5,282	5,803	(5,499)	213,218
Total equity and liabilities	150,021	42,543	20,541	213,105	7,011	4,765	(5,499)	219,382

This analysis is shown below for the Group balance sheet by business type at 31 December 2008.

By business type	2008 £m						2007 £m	
	Participating funds	Unit-linked and variable annuity	Non-linked business D4	Asset management operations E2	Unallocated to a segment (central operations)	Intra-group eliminations	Group total	Group total
Assets								
Intangible assets attributable to shareholders:								
Goodwill	–	–	111	1,230	–	–	1,341	1,341
Deferred acquisition costs and other intangible assets	–	–	5,343	6	–	–	5,349	2,836
Total ^{H1}	–	–	5,454	1,236	–	–	6,690	4,177
Intangible assets attributable to with-profits funds:								
In respect of acquired subsidiaries for venture fund and other investment purposes	174	–	–	–	–	–	174	192
Deferred acquisition costs and other intangible assets	126	–	–	–	–	–	126	19
Total ^{H2}	300	–	–	–	–	–	300	211
Total	300	–	5,454	1,236	–	–	6,990	4,388
Deferred tax assets ^{H4}	279	–	2,304	160	143	–	2,886	951
Other non-investment and non-cash assets ^{H3-H6}	3,095	579	4,523	135	3,553	(5,608)	6,277	5,012
Investment of long-term business and other operations:								
Investment properties	9,911	710	1,371	–	–	–	11,992	13,688
Investments accounted for using the equity method	–	–	–	–	10	–	10	12
Loans	2,154	113	6,461	1,763	–	–	10,491	7,924
Equity securities and portfolio holdings in unit trusts	31,821	29,211	1,067	23	–	–	62,122	86,157
Debt securities	42,965	6,298	44,970	991	–	–	95,224	83,984
Other investments	3,768	204	1,588	462	279	–	6,301	4,396
Deposits	4,828	903	1,499	64	–	–	7,294	7,889
Total investments ^{note a, G1, H7, H8}	95,447	37,439	56,956	3,303	289	–	193,434	204,050
Held for sale assets ^{H9}	–	–	–	–	–	–	–	30
Cash and cash equivalents ^{H10}	1,733	1,148	1,437	1,472	165	–	5,955	4,951
Total assets	100,854	39,166	70,674	6,306	4,150	(5,608)	215,542	219,382

Notes on the Group financial statements

B: Summary of results

continued

B6: Group balance sheet continued

	2008 £m						2007 £m	
	Participating funds	Unit-linked and variable annuity	Non-linked business D4	Shareholder-backed		Intra-group eliminations	Group total	Group total
Asset management operations E2				Unallocated to a segment (central operations)				
By business type								
Equity and liabilities								
<i>Equity</i>								
Shareholders' equity ^{H11}	–	–	5,520	1,642	(2,104)	–	5,058	6,062
Minority interests	47	–	7	1	–	–	55	102
Total equity	47	–	5,527	1,643	(2,104)	–	5,113	6,164
<i>Liabilities</i>								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Insurance contract liabilities ^{H12}	58,310	27,799	49,921	–	–	–	136,030	132,776
Investment contract liabilities with discretionary participation features ^{G1}	23,446	–	–	–	–	–	23,446	29,550
Investment contract liabilities without discretionary participation features ^{G1}	32	10,277	4,192	–	–	–	14,501	14,032
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds) ^{D2ei,H12}	8,414	–	–	–	–	–	8,414	13,959
Total policyholder liabilities and unallocated surplus of with-profits funds^{note b}	90,202	38,076	54,113	–	–	–	182,391	190,317
Core structural borrowings of shareholder-financed operations: ^{H13}								
Subordinated debt	–	–	–	–	1,987	–	1,987	1,570
Other	–	–	173	–	798	–	971	922
Total	–	–	173	–	2,785	–	2,958	2,492
Operational borrowings attributable to shareholder-financed operations ^{G1,H13}	–	–	695	4	1,278	–	1,977	3,081
Borrowings attributable to with-profits funds ^{G1,H13}	1,308	–	–	–	–	–	1,308	987
Other non-insurance liabilities:								
Obligations under funding, securities lending and sale and repurchase agreements	1,570	–	4,002	–	–	–	5,572	4,081
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	1,775	877	126	1,065	–	–	3,843	3,556
Current tax liabilities	61	–	142	40	599	–	842	1,237
Deferred tax liabilities	1,225	–	1,974	11	19	–	3,229	3,402
Accruals and deferred income	202	–	193	205	30	–	630	599
Other creditors	1,151	–	1,793	2,898	1,262	(5,608)	1,496	1,020
Provisions	76	–	251	97	37	–	461	575
Derivative liabilities	3,027	–	1,269	292	244	–	4,832	1,080
Other liabilities	210	213	416	51	–	–	890	791
Total	9,297	1,090	10,166	4,659	2,191	(5,608)	21,795	16,341
Total liabilities	100,807	39,166	65,147	4,663	6,254	(5,608)	210,429	213,218
Total equity and liabilities	100,854	39,166	70,674	6,306	4,150	(5,608)	215,542	219,382

a Investments

Reconciliation of movement in investments

A reconciliation of the Group's directly held investments from the beginning of the year to the end of the year is as follows:

	Insurance operations			Total insurance operations £m	Asset management £m	Unallocated to a segment £m	Group total £m
	UK £m	US £m	Asia £m				
At 1 January 2007							
Total investments (including derivative assets)	138,537	36,129	13,725	188,391	2,963	240	191,594
Less: investments held by consolidated investment funds	(1,179)	–	(547)	(1,726)	–	–	(1,726)
Less: derivative liabilities	(268)	(92)	(4)	(364)	(142)	(4)	(510)
Directly held investments, net of derivative liabilities*	137,090	36,037	13,174	186,301	2,821	236	189,358
Net cash inflow from operating activities	3,128	2,612	2,731	8,471	317	(210)	8,578
Realised gains (losses) in the year	4,660	(47)	1,484	6,097	8	(16)	6,089
Unrealised gains (losses) in the year	(2,789)	636	(128)	(2,281)	(22)	3	(2,300)
Foreign exchange translation differences	99	(601)	298	(204)	104	–	(100)
Movement in the year of directly held investments, net of derivative liabilities	5,098	2,600	4,385	12,083	407	(223)	12,267
At 31 December 2007/1 January 2008							
Total investments (including derivative assets)	143,539	38,795	18,244	200,578	3,414	58	204,050
Less: investments held by consolidated investment funds	(662)	–	(683)	(1,345)	–	–	(1,345)
Less: derivative liabilities ^{G3}	(689)	(158)	(2)	(849)	(186)	(45)	(1,080)
Directly held investments, net of derivative liabilities	142,188	38,637	17,559	198,384	3,228	13	201,625
Net cash inflow from operating activities	887	2,862	2,596	6,345	(615)	85	5,815
Realised gains (losses) in the year	73	(385)	(273)	(585)	9	(36)	(612)
Unrealised gains (losses) in the year	(26,932)	(8,825)	(4,199)	(39,956)	(156)	(19)	(40,131)
Foreign exchange translation differences	1,636	13,019	4,993	19,648	545	2	20,195
Movement in the year of directly held investments, net of derivative liabilities	(24,336)	6,671	3,117	(14,548)	(217)	32	(14,733)
At 31 December 2008							
Total investments (including derivative assets)	121,862	46,171	21,809	189,842	3,303	289	193,434
Less: investments held by consolidated investment funds	(609)	–	(1,101)	(1,710)	–	–	(1,710)
Less: derivative liabilities ^{G3}	(3,401)	(863)	(32)	(4,296)	(292)	(244)	(4,832)
Directly held investments, net of derivative liabilities	117,852	45,308	20,676	183,836	3,011	45	186,892

* The above reconciliation analyses the movement of directly held investments net of derivative liabilities. The deduction of derivative liabilities reflects the fact that these are considered an integral part of the Group's investment portfolio and the exclusion from investments is merely a matter of required balance sheet presentation. The analysis excludes investments held in the balance sheet as a result the consolidation of Open-Ended Investment Companies (OEICs) and unit trusts, as the Group's exposure is merely to its share of the value of the fund as a whole rather than to the underlying investments and other assets and liabilities.

Notes on the Group financial statements

B: Summary of results

continued

B6: Group balance sheet continued

i Information on the credit risks of debt securities

	2008						2007
	Insurance operations			Total insurance operations £m	Asset management £m	Group total £m	Group total £m
	UK £m	US £m	Asia £m				
S&P – AAA	18,981	5,321	2,632	26,934	342	27,276	28,014
S&P – AA+ to AA-	6,012	853	3,746	10,611	274	10,885	9,673
S&P – A+ to A-	15,929	5,244	808	21,981	319	22,300	17,087
S&P – BBB+ to BBB-	7,413	7,077	902	15,392	–	15,392	11,017
S&P – Other	1,033	1,321	253	2,607	–	2,607	2,204
	49,368	19,816	8,341	77,525	935	78,460	67,995
Moody's – Aaa	681	458	494	1,633	24	1,657	1,817
Moody's – Aa1 to Aa3	833	100	108	1,041	15	1,056	750
Moody's – A1 to A3	678	111	398	1,187	–	1,187	1,019
Moody's – Baa1 to Baa3	454	100	60	614	–	614	588
Moody's – Other	162	95	50	307	–	307	546
	2,808	864	1,110	4,782	39	4,821	4,720
Fitch	560	464	41	1,065	–	1,065	1,062
Other	6,135	3,105	1,621	10,861	17	10,878	10,207
Total debt securities	58,871	24,249	11,113	94,233	991	95,224	83,984

In the table above, 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 D2(d), D3(d), D4(d) and E2 provide further details on the credit risks of debt securities by segment.

ii Group exposure to holdings in asset-backed securities and monoline insurers

a Asset-backed securities

The Group's exposure to holdings in asset-backed securities which comprise residential mortgage-backed securities (RMBS), CDO funds and other asset-backed securities (ABS), at 31 December 2008 is as follows:

	2008 £m
Shareholder-backed operations:	
UK insurance operations ^{note i}	1,075
US insurance operations ^{note ii}	7,464
Asian insurance operations ^{note iii}	15
Other operations ^{note iv}	407
	8,961
With-profits operations:	
UK insurance operations ^{note i}	4,977
Asian insurance operations ^{note iii}	328
	5,305
Total	14,266

i UK insurance operations

The UK insurance operations' exposure to asset-backed securities at 31 December 2008 is analysed as follows:

	2008 £m
Shareholder-backed business (70% AAA, 19% AA)	1,075
With-profits operations (74% AAA, 10% AA)	4,977
	6,052

The UK insurance operations' exposure to asset-backed securities is mainly made up of exposure to AAA rated securities as shown in the table above.

All of the £1,075 million exposure of the shareholder-backed business relates to the UK market and primarily relate to investments held by PRIL. £2,721 million of the £4,977 million exposure of the with-profits operations relates to exposure to the UK market while the remaining £2,256 million relates to exposure to the US market.

ii US insurance operations

US insurance operations' exposure to asset-backed securities at 31 December 2008 comprises:

	2008 £m
RMBS:	
Sub-prime (91% AAA, 3% AA)	291
Alt-A (60% AAA, 15% AA)	646
Prime (87% AAA, 5% AA)	3,572
CMBS (85% AAA, 9% AA)	1,869
CDO funds (34% AAA, 14% AA)*, including £6 million exposure to sub-prime	320
ABS (31% AAA, 16% AA), including £51 million exposure to sub-prime	766
Total	7,464

* Including the Group's economic interest in Piedmont and other consolidated CDO funds. Further details on Jackson's RMBS sub-prime and Alt-A securities are given in note D3(d).

iii Asian insurance operations

The Asian insurance operations' exposure to asset-backed securities is primarily held by the with-profits operations. The £328 million asset-backed securities exposure of the Asian with-profits operations comprises:

	2008 £m
RMBS – all without sub-prime exposure	46
CMBS	88
CDO funds and ABS	194
Total	328

The £328 million includes £259 million held by investment funds consolidated under IFRS in recognition of the control arrangements for those funds and included an amount not owned by the Group with a corresponding liability of £32 million on the balance sheet for net asset value attributable to external unit-holders in respect of these funds, which are non-recourse to the Group. Of the £328 million, 70% are investment graded by Standard & Poor's.

iv Other operations

Other operations' exposure to asset-backed securities at 31 December 2008 is held by Prudential Capital and comprises:

	2008 £m
RMBS: Prime (75% AAA, 10% AA)	106
CMBS (68% AAA, 20% AA)	230
CDO funds – all without sub-prime exposure (AAA)	38
ABS (92% AAA)	33
Total	407

b Direct holdings in monoline insurers

The Group has no significant exposure to direct holdings in monoline insurers at 31 December 2008.

Notes on the Group financial statements

B: Summary of results

continued

B6: Group balance sheet continued

b Reconciliation of movement in policyholder liabilities and unallocated surplus of with-profits funds

A reconciliation of the total policyholder liabilities and unallocated surplus of with-profits funds of the Group from the beginning of the year to the end of the year is as follows:

	Insurance operations			Total insurance operations £m
	UK £m	US £m	Asia £m	
At 1 January 2007	133,904	31,746	12,889	178,539
Premiums	8,853	6,352	3,958	19,163
Surrenders	(4,528)	(3,476)	(1,032)	(9,036)
Maturities/Deaths	(6,787)	(490)	(395)	(7,672)
Shareholders' transfers post tax	(279)	–	(21)	(300)
Investment-related items and other movements	7,194	1,225	1,458	9,877
Foreign exchange translation differences	(67)	(509)	322	(254)
At 31 December 2007/1 January 2008	138,290	34,848	17,179	190,317
Premiums	9,372	6,728	4,162	20,262
Surrenders	(4,281)	(3,852)	(1,191)	(9,324)
Maturities/Deaths	(8,324)	(564)	(354)	(9,242)
Shareholders' transfers post tax	(284)	–	(23)	(307)
Investment-related items and other movements	(16,331)	(4,552)	(4,293)	(25,176)
Foreign exchange translation differences	(2,481)	12,753	5,589	15,861
At 31 December 2008	115,961	45,361	21,069	182,391

The items above represent the amount attributable to changes in policyholder liabilities and unallocated surplus of with-profits funds as a result of each of the components listed.

C: Group risk management

a Overview

As a provider of financial services, including insurance, the Group's business is the managed acceptance of risk. The control procedures and systems established within the Group are designed to manage, rather than eliminate, the risk of failure to meet business objectives. They can only provide reasonable and not absolute assurance against material misstatement or loss, and focus on aligning the levels of risk-taking with the achievement of business objectives.

The Group's internal control processes are detailed in the Group Governance Manual. This is supported by the Group risk framework, which provides an overview of the Group-wide philosophy and approach to risk management. Where appropriate, more detailed policies and procedures have been developed at Group and/or business unit levels. These include Group-wide mandatory policies on certain operational risks, including: health, safety, fraud, money laundering, bribery, business continuity, information security and operational security. Additional guidelines are provided for some aspects of actuarial and finance activity.

Prudential's risk governance framework requires that all of the Group's businesses and functions establish processes for identifying, evaluating and managing the key risks faced by the Group. The risk governance framework is based on the concept of 'three lines of defence': Risk management, risk oversight and independent assurance. Primary responsibility for strategy, performance management and risk control lies with the Board, the Group Chief Executive and the chief executives of each business unit. Risk oversight is provided by Group-level risk committees, chaired by the Chief Financial Officer with representation from business units and Group Head Office functions. The committees' oversight is supported by the Group Chief Risk Officer. Independent assurance on the Group's and business unit internal control and risk management systems is provided by Group-wide Internal Audit reporting to the Group and business unit audit committees.

The Group's risk reporting framework forms an important part of the Group's business planning process. Business units review their risks as part of the annual preparation of their business plans and review opportunities and risks against business objectives regularly with Group executive management.

Additional information on the Group's risk framework is included in the risk and capital management section of the Group's business review.

The management of the risk attached to the Group's financial instruments and insurance liabilities, together with the inter-relationship with the management of capital may be summarised in the following sections.

b Group risk appetite

The Group risk appetite framework sets out the Group's tolerance to risk management and return optimisation. The Group defines and monitors aggregate risk limits for its earnings volatility and its capital requirements.

i Earnings volatility:

The objectives of the limits are to ensure that (a) the volatility of earnings is consistent with stakeholder expectations, (b) the Group has adequate earnings (and cash flows) to service debt and expected dividends and (c) that earnings (and cash flows) are managed properly across geographies and are consistent with the Group's funding strategies. The two measures used currently are European Embedded Value (EEV) operating profit based on longer-term investment returns and International Financial Reporting Standards (IFRS) operating profit based on longer-term investment returns.

ii Capital requirements:

The objectives of the limits are to ensure that (a) the Group meets the economic capital requirements at all times, (b) the Group achieves its desired target rating to meet its business objectives and (c) supervisory intervention is avoided. The two measures used are EU Insurance Groups Directive (IGD) capital requirements and economic capital requirements.

Business units must establish suitable market, credit, underwriting and liquidity limits that maintain financial risk exposures within the defined Group risk appetite.

The Group's risk appetite framework forms an integral part of its annual business planning cycle. Throughout the year, the Group risk function monitors the Group's risk profile against the agreed limits. Using submissions from business units, Group risk function calculates the Group position (allowing for diversification effects between business units) relative to the limits implied by the risk appetite statements.

The current market dislocation and increased risk of default led the Group to place an increased emphasis on the management of market and credit risk in the course of 2008. Market risk is managed such that as conditions evolve the risk profile is maintained within risk appetite in addition to business unit operational limits on credit risk, the Group sets counterparty risk limits at Group level. Limits on the total Group-wide exposures to a single counterparty are specified within different credit rating 'categories'. Actual exposures are monitored against these limits on a monthly basis.

Notes on the Group financial statements

C: Group risk management

continued

c Risk mitigation and hedging

The Group manages its actual risk profile against our tolerance of risk. To do this, the Group maintains risk registers that include details of the identified risks and of the controls and mitigating actions employed in managing them. Any mitigation strategies involving large transactions, such as a material derivative transaction, are subject to scrutiny at Group level before implementation.

The Group uses a range of risk management and mitigation strategies. The most important of these include: adjusting asset portfolios to reduce investment risks (such as duration mismatches or overweight counterparty exposures); using derivatives to hedge market risks; implementing reinsurance programmes to limit insurance risk; implementing corporate insurance programmes to limit the impact of operational risks; and revising business plans where appropriate.

i Use of derivatives

In the UK and Asia, Prudential uses derivatives to reduce equity and credit risk, interest rate and currency exposures, and to facilitate efficient investment management. In the US, Prudential uses derivatives to reduce interest rate risk, to facilitate efficient portfolio management and to match liabilities under annuity policies, and for certain equity-based product management activities.

Further details of the Group's use of derivatives are explained in note G3.

ii Asset/liability management

Prudential manages its assets and liabilities locally, in accordance with local regulatory requirements and reflecting the differing types of liabilities of each business unit. Stochastic asset/liability modelling is carried out locally by business units to perform dynamic solvency testing and assess capital requirements. Reserve adequacy testing under a range of scenarios and dynamic solvency analysis is carried out, including under certain scenarios mandated by the US, the UK and Asian regulators.

A stochastic approach models the inter-relationship between asset and liability movements, taking into account asset correlation and policyholder behaviour, under a large number of possible scenarios. These scenarios are projected forward over a period of time, typically 25 years, and the liabilities and solvency position of the fund are calculated in each scenario in each future year. This allows the identification of which extreme scenarios will have the most adverse effects and what the best estimate outcome may be. The fund's policy on management actions, including bonus and investment policy, are then set in order that they are consistent with the available capital and the targeted risk of default. This differs from a deterministic model, which would only consider the results from one carefully selected scenario.

For businesses that are most sensitive to interest rate changes, such as immediate annuity business, Prudential uses cash flow analysis to create a portfolio of fixed income securities whose value changes in line with the value of liabilities when interest rates change. This type of analysis helps protect profits and the capital position from changing interest rates. In the UK, the cash flow analysis is used in Prudential's annuity business while, in the US, it is used for its interest-sensitive and fixed index annuities and stable value products such as Guaranteed Investment Contracts (GICs). Perfect matching is not possible, for example because of the nature of the liabilities (which might include guaranteed surrender values) and options for prepayment contained in the assets or the unavailability of assets with a sufficiently long duration.

For businesses that are most sensitive to equity price changes, Prudential uses stochastic modelling and scenario testing to look at the expected future returns on its investments under different scenarios that best reflect the large diversity in returns that equities can produce. This allows Prudential to devise an investment and with-profits policyholder bonus strategy that, on the model assumptions, allows it to optimise returns to its policyholders and shareholders over time, while maintaining appropriate financial strength. Prudential uses this method extensively in connection with its UK with-profits business.

All of Prudential's investments are held either for risk management or investment purposes. This is because almost all of the investments support policyholder or customer liabilities of one form or another. Any assets that Prudential holds centrally that are not supporting customer liabilities are predominantly invested in short-term fixed income and fixed maturity securities.

The Group has contingency plans in place for a range of operational risk scenarios, including incident management and business continuity plans. As a contingency plan for liquidity risk, the Group has arranged access to committed revolving credit facilities and committed securities lending facilities.

d Risk exposures

The Group publishes separately within 'Additional Information' of its Group Annual Report a section on key risk factors, which discusses inherent risks in the business and trading environment.

i Market risks

Market risk is the risk that arises from adverse changes in the value of, or income from, assets and changes in interest rates or exchange rates.

Equity and interest rate risk

Prudential faces equity risk and interest rate risk because most of its assets are investments that are either equity type investments and subject to equity price risk, or bonds, mortgages or cash deposits, the values of which are subject to interest rate risk. The amount of risk borne by Prudential's shareholders depends on the extent to which its customers share the investment risk through the structure of Prudential's products.

The split of Prudential's investments between equity investments and interest-sensitive instruments depends principally on the type of liabilities supported by those investments and the amount of capital Prudential has available. The nature of some liabilities allows Prudential to invest a substantial portion of its investment funds in equity and property investments that Prudential believes produce greater returns over the long term. On the other hand Prudential has some liabilities that contain guaranteed returns and allow instant access (for example, interest-sensitive fixed annuities and immediate annuities), which generally will be supported by fixed income investments.

Foreign exchange risk

Prudential faces foreign exchange risk, primarily because its presentation currency is pounds sterling, whereas approximately 53 per cent of Prudential's operating profit from continuing operations based on longer-term investment returns, as described in note B1, for the year ended 31 December 2008, came from Prudential's US and Asian operations. The exposure relating to the translation of reported earnings is not separately managed although its impact is reduced by interest payments on foreign currency borrowings and by the adoption of average exchange rates for the translation of foreign currency revenues.

Approximately 83 per cent of the Group's IFRS basis shareholders' equity at 31 December 2008 arose in Prudential's US and Asian operations (2007: approximately 70 per cent). To mitigate the exposure of the US component there are US\$1.55 billion of borrowings held centrally. The Group has also entered into a US\$2 billion net investment hedge which was reduced to US\$600 million in December 2008 (see note G3). Net of the currency position arising from these instruments some 49 per cent of the Group's shareholders' funds are represented by net assets in currencies other than sterling.

Additional details on the market risks' exposures of the UK, US and Asian insurance operations are provided in notes D2, D3 and D4, respectively.

ii Credit risk

Credit risk is the risk of loss to the Group if another party fails to perform its obligations, or fails to perform them in a timely manner. Credit risk is the Group's most significant financial risk.

Some of Prudential's businesses, in particular Jackson, the PAC with-profits fund and Prudential's UK pension annuity business hold large amounts of interest-sensitive investments that contain credit risk on which a certain level of defaults is expected. These expected losses are considered when Prudential determines the crediting rates, deposit rates and premium rates for the products that will be supported by these assets. The key shareholder business exposed to credit risks is Jackson. Certain over-the-counter derivatives contain a credit risk element that is controlled through evaluation of collateral agreements and master netting agreements on interest rate and currency swaps. Prudential is also exposed to credit-related losses in the event of non-performance by counterparties.

Further analysis of the credit quality for the Group is shown in note B6. Additional details on the credit quality of the debt security portfolios of UK, US and Asian insurance operations are shown in notes D2, D3 and D4, respectively.

iii Liquidity risk

Liquidity risk is the risk that Prudential, though solvent on a balance sheet basis, either does not have the financial resources to meet its obligations as they fall due or can secure the resources only at excessive cost. The parent company has significant internal resources of liquidity which are sufficient to meet all of its foreseeable future without having to utilise external funding. The Group maintains committed borrowing and securities lending facilities. In aggregate the Group has £2.1 billion of undrawn committed facilities of which it has recently renewed its £1.4 billion of the undrawn syndicated committed banking facility for a further three years as well as renewing the £500 million securities lending back-up facility.

iv Insurance risk

Insurance risk is the inherent uncertainty as to the occurrence, amount and timing of insurance liabilities. This includes adverse mortality, morbidity and persistency experience.

Prudential needs to make assumptions about a number of factors in determining the pricing of its products and for reporting the results of its long-term business operations. In common with other industry participants, the profitability of the Group's businesses depends on a mix of factors including mortality and morbidity trends, voluntary discontinuance rates, investment performance, unit cost of administration and new business acquisition expenses.

For example, the assumption that Prudential makes about future expected levels of mortality is particularly relevant for its UK annuity business where, in exchange for their accumulated pension fund, pension annuity policyholders receive a guaranteed payment, for as long as they live. Prudential conducts rigorous research into longevity risk using data from its substantial annuitant portfolio. As part of its pension annuity pricing and reserving policy, Prudential UK assumes that current rates of mortality continuously improve over time at levels based on adjusted data from the Continuous Mortality Investigations (CMI) projections as published by the Institute and Faculty of Actuaries.

Notes on the Group financial statements

C: Group risk management

continued

d Risk exposures continued

Prudential's voluntary discontinuance (persistence) assumptions reflect recent past experience for each relevant line of business, and any expectations of future persistence. Where appropriate, allowance is also made for the relationship, which is either assumed or historically observed, between persistence and investment returns and the resulting additional risk is allowed for.

v Non-financial risks - operational, business environment and strategic risk

Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, systems or from external events. Business environment risk may arise from exposure to forces in the external environment that could significantly change the fundamentals that drive the business's overall objectives and strategy. Strategic risk may arise from ineffective, inefficient or inadequate senior management processes for the development and implementation of business strategy in relation to the business environment and the Group's capabilities.

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

Quantitative analysis of operational risk exposures material to the Group is used to inform decisions on the overall amount of capital held and the adequacy of the corporate insurance programme.

e Regulatory capital requirements

Regulatory capital requirements apply at an individual company level for the Group's life assurance and asset management business. These are described in sections D5 and E3 respectively.

In addition, the Group as a whole is subject to the capital adequacy requirements of the Insurance Groups Directive (IGD) as implemented by the FSA. The IGD pertains to groups whose activities are primarily concentrated in the insurance sector. Under this test the surplus capital held in each of the regulated subsidiaries is aggregated with the free assets of non-regulated subsidiaries. From this total Group borrowings are deducted, other than subordinated debt issues which qualify as capital. No credit for the benefit of diversification is allowed for under this approach. The test is passed when this aggregate number is positive: a negative result at any point in time is a notifiable breach of UK regulatory requirements.

Due to the geographically diverse nature of Prudential's operations, the application of these requirements to Prudential is complex. In particular, for many of the Group's Asian operations the assets, liabilities and capital requirements have to be recalculated based on FSA regulations as if the companies were directly subject to FSA regulation.

The FSA has established a structure for determining how much hybrid debt can count as capital which is similar to that used for banks. It categorises capital as Tier 1 (equity and preference shares), Upper Tier 2 and Lower Tier 2. Up to 15 per cent of Tier 1 capital can be in the form of hybrid debt and is called 'Innovative Tier 1'. At 31 December 2008 the Group held £1,059 million (31 December 2007: £763 million) of Innovative Tier 1 capital in the form of perpetual securities, £nil (£nil) of Upper Tier 2 and £1,101 million (£932 million) of Lower Tier 2 capital. The increase in these amounts reflects exchange rate movements in 2008. Further details on these amounts and other Group borrowings are shown in note H13.

At 31 December 2007, Prudential met the requirements of the IGD. In addition, during 2008, Prudential met the 'hard test' of the FSA under the IGD. The IGD position as at 31 December 2008 will be submitted to the FSA by 30 April 2009 and at the time of preparation of these financial statements the surplus capital under the test was estimated to be around £1.7 billion before allowing for the 2008 final dividend giving a solvency ratio of 160 per cent. This is composed of the Group's IGD surplus at 31 December 2008 which is estimated at £1.4 billion and of an additional £0.3 billion which the FSA has allowed the Group to include in the Group's IGD surplus going forward as a result of an innovative structure the Group has developed. The £0.3 billion additional capital reflects the Group's ability to realise a portion of the shareholders' economic interest in the future transfers from the PAC with-profits fund. The intended sale of the Taiwan agency business announced on 20 February 2009, as discussed in note I10, will when completed increase the IGD surplus capital by approximately £0.8 billion, further strengthening IGD surplus capital to £2.5 billion.

Prudential's approach to capital allocation takes into account a range of factors, especially risk adjusted returns on capital, the impact of alternative capital measurement bases (accounting, regulatory, economic and ratings agency assessments), tax efficiency and wider strategic objectives.

Prudential optimises capital allocation across the Group by using a consistent set of capital performance metrics across all business units to ensure meaningful comparison. Capital utilisation, return on capital and new business value creation are measured at a product level. The use of these capital performance metrics is embedded into our decision-making processes for product launches, product design and product pricing.

Prudential's capital performance metrics are based on economic capital, which provides a realistic and consistent view of our capital requirements across the Group, allowing for diversification benefits. Economic capital also provides valuable insights into our risk profile and is used both for risk measurement and capital management.

Prudential's detailed understanding of risk adjusted performance allows to manage proactively its allocation of capital to write new business to maximise risk adjusted value creation.

D: Life assurance businesses

D1: Group overview

a Products and classification for IFRS reporting

The measurement basis of assets and liabilities of long-term business contracts is dependent upon the classification of the contracts under IFRS. Under IFRS 4, contracts are initially classified as being either 'insurance' contracts, if the level of insurance risk in the contracts is significant, or investment contracts, if the risk is insignificant.

Insurance contracts

Insurance contracts are permitted to be accounted for under previously applied GAAP. The Group has chosen to adopt this approach. However, as an improvement to accounting policy, permitted by IFRS 4, the Group has applied the measurement principles for with-profits contracts of UK regulated entities and disclosures of the UK Standard FRS 27 from 1 January 2005. An explanation of the provisions under FRS 27 is provided in note D2.

Under the previously applied GAAP, UK GAAP, the assets and liabilities of contracts are reported in accordance with the MSB of reporting as set out in the ABI SORP.

The insurance contracts of the Group's shareholder-backed business fall broadly into the following categories:

- UK insurance operations
 - bulk and individual annuity business, written primarily by Prudential Retirement Income Limited and other categories of non-participating UK business;
- Jackson
 - fixed and variable annuity business and life insurance; and
- Prudential Corporation Asia
 - non-participating term, whole life, and unit-linked policies, together with accident and health policies.

Investment contracts

Investment contracts are further delineated under IFRS 4 between those with and without discretionary participation features. For those contracts with discretionary participation features, IFRS 4 also permits the continued application of previously applied GAAP. The Group has adopted this approach, again subject to the FRS 27 improvement.

For investment contracts that do not contain discretionary participation features, IAS 39 and, where the contract includes an investment management element, IAS 18, apply measurement principles to assets and liabilities attaching to the contract that may diverge from those previously applied.

Contracts of the Group, which are classified as investment contracts that do not contain discretionary participation features, can be summarised as:

- UK
 - certain unit-linked savings and similar contracts;
- Jackson
 - GICs and funding agreements
 - minor amounts of 'annuity certain' contracts; and
- Prudential Corporation Asia
 - minor amounts for a number of small categories of business.

The accounting for the contracts of UK insurance operations and Jackson's GICs and funding agreements are considered in turn below:

i Certain UK unit-linked savings and similar contracts

Deferred acquisition costs

Acquisition costs are deferred to the extent that it is appropriate to recognise an asset that represents the entity's contractual right to benefit from providing investment management services and are amortised as the entity recognises the related revenue. IAS 18 further reduces the costs potentially capable of deferral to incremental costs only. Deferred acquisition costs are amortised to the income statement in line with service provision.

Deferred income reserves

These are required to be established under IAS 18 with amortisation over the expected life of the contract. The majority of the relevant UK contracts are single premium with the initial deferred income reflecting the 'front-end load' i.e. the difference between the premium paid and the amount credited to the unit fund. Deferred income is amortised to the income statement in line with service provision. The amortisation profile is either on a straight-line basis or, if more appropriate, a further deferral of income recognition is applied.

Notes on the Group financial statements

D: Life assurance businesses

continued

D1: Group overview continued

Sterling reserves

Prudent provisions established for possible future expenses not covered by future margins at a policy level reflecting the regulatory approach in the UK are not permitted for those contracts with insignificant insurance risk that are classified as investment contracts.

ii Jackson - GICs and funding arrangements

Under a traditional GIC, the policyholder makes a lump sum deposit. The interest rate paid is fixed and established when the contract is issued. Funding agreements are of a similar nature but the interest rate may be floating, based on a rate linked to an external index. The US GAAP accounting requirements for such contracts are very similar to those under IFRS on the amortised cost model for liability measurement.

b Concentration of risk

i Business accepted

The Group's exposure to life assurance risks is well-diversified. This is achieved through the geographical spread of the Group's operations and, within those operations, through a broad mix of product types.

As part of the risk management framework, the Group regularly monitors concentration of risk using a variety of risk monitoring tools. Scenario testing and sensitivity analysis for the Group capital and profitability metrics involving IGD, Group economic capital, EEV and IFRS help identify concentrations of risks by risk types, products and business units, as well as the benefits of diversification of risks.

Credit risk remains one of the largest risk exposures. This reflects the relative size of exposure in Jackson and the UK shareholder annuities business. An example of the diversification benefits for Prudential is that adverse scenarios do not affect all business units in the same way, providing natural hedges within the Group. For example, the Group's US business is sensitive to increasing interest rates, whereas, in contrast, several business units in Asia benefit from increasing rates. Conversely, these Asian business units are sensitive towards low interest rates, whereas for certain products in the US benefits from falling interest rates. The economic capital framework also takes into account situations where factors are correlated, for example the extent of correlation between UK and US economies.

The Group manages concentration of credit risks by setting limits on the maximum exposure to each counterparty based on their credit ratings. Business units are also required to disclose to the Group risk function all material risks, along with information on their severity and likelihood, and mitigating actions taken or planned.

ii Ceded business

The Group cedes certain business to other insurance companies. Although the ceding of insurance does not relieve the Group of liability to its policyholders, the Group participates in such agreements for the purpose of managing its loss exposure. The Group evaluates the financial condition of its reinsurers and monitors concentration of credit risk from similar geographic regions, activities or economic characteristics of the reinsurers to minimise its exposure from reinsurer insolvencies. There are no significant concentrations of reinsurance risk. At 31 December 2008, 98 per cent (2007: 98 per cent) of the reinsurance recoverable insurance assets were ceded by the Group's UK and US operations, of which 91 per cent (2007: 88 per cent) of the balance were from reinsurers with Standard & Poor's rating AA- and above. As a result of downgrading subsequent to the year end based on the ratings at the time of signing these consolidated financial statements, 93 per cent of the reinsurance recoverable insurance assets ceded by the Group UK and US operations were rated A and above with 39 per cent were rated AA- and above.

c Guarantees

Notes D2(e), D3(e), D4(e) and D4(j) provide details of guarantee features of the Group's life assurance products. In the UK, guarantees of the with-profits products are valued for accounting purposes on a market consistent basis for 2008 as described in section D2(g)(ii). The UK business also has products with guaranteed annuity option features, mostly within SAIF, as described in section D2(e). There is little exposure to financial options and guarantees in the shareholder-backed business of the UK operations. The US business annuity products have a variety of option and guarantee features as described in section D3(e). Jackson's derivative programme seeks to manage the exposures as described in section D3(f). The most significant exposure for the Group arises on Taiwan whole of life policies as described in section D4(j)(iii).

d Amount, timing and uncertainty of future cash flows from insurance contracts

The factors that affect the amount, timing and uncertainty of future cash flows from insurance contracts depend upon the businesses concerned as described in subsequent sections. In general terms, the Group is managed by reference to a combination of measures. These measures include IFRS basis earnings, net shareholder cash flow to or from business units from or to central funds, and movements in the present value of future expected distributable earnings of in-force long-term insurance business. The latter item when added to the net assets is commonly referred to as Embedded Value.

The Group prepares and publishes supplementary information in accordance with the European Embedded Value (EEV) principles issued by the CFO Forum of European Insurance Companies in May 2004 and expanded by the addition of Additional Guidance on EEV Disclosures published in October 2005. Key elements of the EEV principles are the approach applied to allowing for risk and the use of best estimate assumptions to project future cash flows arising from the contracts.

The business covered by the EEV basis results includes both investment contracts as well as insurance contracts (as defined under IFRS 4). Investment contracts form a relatively small part of the Group's long-term business as demonstrated by the carrying value of policyholder liabilities shown in the Group balance sheet.

The projected cash flows are those expected to arise under the contracts such as those arising from premiums, claims and expenses after appropriate allowance for future lapse behaviour and mortality and morbidity experience. The cash flows also include the expected future cash flows on assets covering liabilities and encumbered capital.

Encumbered capital is based on the Group's internal target for economic capital subject to it meeting at least the local statutory minimum requirements. Economic capital is assessed using internal models but does not take credit for the significant diversification benefits that exist within the Group.

The valuation of the future cash flows also takes account of the 'time value' of option and guarantee features of the Group's long-term business contracts. The time value reflects the variability of economic outcomes in the future. Where appropriate, a full stochastic valuation is undertaken to determine the value of the in-force business. Common principles are adopted across the Group for the stochastic asset model classes, for example, separate modelling of individual asset classes but with allowance for correlation between the various asset classes. In deriving the time value of financial options and guarantees, management actions in response to emerging investment and fund solvency conditions are modelled. In all instances, the modelled actions are in accordance with approved local practice and therefore reflect the options actually available to management. For the PAC with-profits sub-fund, the actions are consistent with those set out in the Principles and Practices of Financial Management.

The present value of the future distributable earnings is calculated using a risk discount rate which reflects both the time value of money and the risks associated with the cash flows that are not otherwise allowed for. The risk allowance covers market and non-market risks.

Under Capital Asset Pricing Methodology (CAPM), the discount rate is determined as the aggregate of the risk-free rate and the risk margin for market risk. The latter is calculated as the 'beta' multiplied by the equity risk premium. Under CAPM, the beta of a portfolio or product measures its relative market risk. The risk discount rates reflect the market risk inherent in each product group and hence the volatility of product cash flows. They are determined by considering how the profits from each product are impacted by changes in expected returns on various asset classes, and by converting this into a relative rate of return, it is possible to derive a product specific beta.

Product specific discount rates are used in order to reflect the risk profile of each major territory and product group. No allowance is required for non-market risks where these are assumed to be fully diversifiable. The majority of non-market risks are considered to be diversifiable. Finance theory cannot be used to determine the appropriate component of beta for non-diversifiable non-market risks since there is no observable risk premium associated with it that is akin to the equity risk premium. Recognising this, a pragmatic approach has been used. A constant margin of 50 basis points (2007: 50 basis points) has been added to the risk margin derived for market risk to cover the non-diversifiable non-market risks associated with the business. For the UK shareholder-backed annuity business an additional margin of 100 basis points was used (2007: 100 basis points).

Product level betas are calculated each year. They are combined with the most recent product mix to produce appropriate betas and risk discount rates for each major product grouping.

Notes on the Group financial statements

D: Life assurance businesses

continued

D1: Group overview continued

e Sensitivity of IFRS basis profit or loss and equity to market and other risks

i Overview of risks by business unit

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).

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

In addition, the profitability of the Group's life assurance businesses and, as described in Section E, Asset management business, is indirectly affected by the performance of the assets covering policyholder liabilities and related capital.

Three key points are to be noted, namely:

- The Group's with-profit and unit-linked funds absorb most market risk attaching to the fund's investments. Except for second order effects, for example on asset management fees and shareholders' share of cost of bonuses for with-profits business, shareholder results are not directly affected by market value movements on the assets of these funds;
- the Group's shareholder results are most sensitive to market risks for assets of shareholder-backed business; and
- 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.

The most significant items for which the IFRS basis profit or loss and equity for the Group's life assurance business is sensitive to these variables are shown in the following tables. The distinction between direct and indirect exposure is not intended to indicate the relative size of the sensitivity.

Type of business	Market and credit risk			Insurance and lapse risk
	Investments/derivatives	Liabilities/unallocated	Other exposure	
UK insurance operations (see also section D2(j))				
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
	Asset/liability mismatch risk			
Shareholder-backed annuity business	Credit risk			Mortality experience and assumptions for longevity
	Interest rate risk for assets in excess of liabilities i.e. representing shareholder capital			
US insurance operations (see also section D3(j))				
All business	Currency risk			Persistency risk
Variable annuity business	Net effect of market risk arising from incidence of guarantee features and variability of asset management fees offset by derivative hedging programme			
Fixed indexed annuity business	Derivative hedge programme to the extent not fully hedged against liability and fund performance	Incidence of equity participation features		
Fixed indexed annuity, Fixed annuity and GIC business	Credit risk Interest rate risk		Spread difference between earned rate and rate credited to policyholders	Lapse risk but the effects of extreme events are mitigated by the use of swaption contracts
	These risks are reflected in volatile profit or loss and shareholders' equity 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 (see also section D4(j))				
All business	Currency risk			Mortality and morbidity risk Persistency risk
With-profits business	Net neutral direct exposure (Indirect exposure only)		Investment performance subject to smoothing through declared bonuses	
Unit-linked business	Net neutral direct exposure (Indirect exposure only)		Investment performance through asset management fees	
Non-participating business (in particular Taiwan)	Interest rate and price risk	Long-term interest rates		

Notes on the Group financial statements

D: Life assurance businesses

continued

D1: Group overview continued

ii IFRS shareholder results - Exposures for market and other risk

Key Group exposures

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 (excluding movement in market implied volatility and based on average Corporate AA interest rates) not mitigated by the equity and interest derivative programmes. Jackson's total profit and equity are exposed to similar market movements (including the effects of movements in market implied volatility and actual Corporate AA interest rates). In each case, IFRS profit or loss and equity movements 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. 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 asset and liabilities for the insurance contracts, which is largely insensitive to current period market movements, the Jackson total profit (i.e. including short-term fluctuations in investment returns) is very sensitive to market movements. In addition to these effects the Jackson IFRS equity is sensitive to the impact of interest rate and credit spread movements on the value of fixed income securities. Movements in unrealised appreciation on these securities are included as movement in 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, the operating profit based on longer-term investment returns is mainly affected by the impact of market levels on unit-linked business persistency, and other insurance 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 of the effect any impairment on the loan book and fair value movements on debt securities held by Prudential Capital.

Market and credit risk

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 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-profit 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 correspond 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 cost of bonuses. 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 which as described above, changes to which do not affect shareholder results.

• Scottish Amicable Insurance Fund (SAIF)

SAIF is a ring-fenced fund in which, apart from asset 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 of Prudential Retirement Income Limited and the PAC non-profit sub-fund.

- 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/liability duration mismatch and exposure to credit risk, the sensitivity of the Group's results to market risk for movements in the carrying value of 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 substantially 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 asset management fees.

Jackson

The IFRS basis results of Jackson are highly sensitive to market risk on the assets covering liabilities other than variable annuity business segregated in the separate 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 bases which with the exception of certain items covered by the equity hedging programme, are generally insensitive to temporary changes in market conditions or the short-term returns on the attaching asset portfolios.

These differences in carrying value of debt securities, other invested assets, derivatives and insurance liabilities give rise to potentially significant volatility in the IFRS income statement and shareholders' equity. As with other shareholder-backed business the profit or loss for Jackson is presented in the Group's supplementary basis of reporting as described in note B1, by distinguishing the result for the year between an operating result based on longer-term investment returns and short-term fluctuations in investment returns. In this way the most significant direct effect of market changes that have taken place to the Jackson result are separately identified.

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

- Variable annuity business – net effect of market risk arising from the incidence and valuation guarantee features and variability of asset management fees offset by derivative hedging performance. The net effect of market risk in Jackson's guarantees and derivatives included in operating result excludes the impact of changes in market implied volatility. Further movements in reserves for guarantees reflected in operating result are also based on a long-term average Corporate AA credit curve instead of the actual Corporate AA credit curve at the valuation date;
- fixed annuity business – the spread differential between the earned rate and the rate credited to policyholders; and
- fixed index annuity business – the spread differential between the earned rate and the rate credited to policyholders and incidence of equity index participation features, net of the related hedging performance.

In addition, the total profit for Jackson is affected by the level of impairment losses on the debt securities portfolios, short-term value movements on derivatives held to manage the fixed annuity and other general account business, other temporary value movements on portfolio investments, and those arising on revaluing the embedded derivative components of variable annuity liabilities for the effects of short-term movements in AA corporate bond rate curves and equity volatility levels.

Notes on the Group financial statements

D: Life assurance businesses

continued

D1: Group overview continued

Asian operations

For Asian with-profits business the same features apply as described above for UK with-profits business. Similarly, as for other parts of the Group, for unit-linked business the main factor affecting IFRS basis results is investment performance through asset 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 are 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 dependant upon an assessment of longer-term interest rates. This key feature is described in more detail in notes D4(g) and (j)(iii).

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 shareholders' share of cost of bonus may be only marginally affected. However, altered persistency trends may affect 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 uses swaption derivatives to ameliorate the effect of a sharp rise in interest rates, which would be the most likely cause of a sudden change in policyholder behaviour.

iii Impact of diversification on risk exposure

The Group enjoys significant diversification benefits. This arises because not all risk scenarios will happen at the same time and across all geographic regions. 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.

f Duration of liabilities

Under the terms of the Group's contracts, as for life assurance contracts generally, the contractual maturity date is the earlier of the end of the contract term, death, other insurable events or surrender. The Group has therefore chosen to provide details of liability duration that reflect the actuarially determined best estimate of the likely incidence of these factors on contract duration. Details are shown in sections D2(k), D3(k) and D4(k).

In the years 2004 to 2008, claims paid on the Group's life assurance contracts including those classified as investment contracts under IFRS 4 ranged from £13 billion to £19 billion. Indicatively, it is to be expected that, of the Group's policyholder liabilities (excluding unallocated surplus) at 31 December 2008 of £174 billion, the amounts likely to be paid in 2009 will be of a similar magnitude.

D2: UK insurance operations

a Summary balance sheet

In order to explain the different types of UK business and fund structure, the balance sheet of the UK insurance operations may be analysed by the assets and liabilities of the Scottish Amicable Insurance Fund (SAIF), the PAC with-profits sub-fund, unit-linked, annuity (principally PRIL) and other business. The assets and liabilities of these funds and subsidiaries are shown in the table below.

	PAC with-profits sub-fund ^{note i}				Other funds and subsidiaries			UK insurance operations	
	Scottish Amicable Insurance Fund ^{note ii} £m	Excluding Prudential Annuities Limited £m	Prudential Annuities Limited ^{note iii} £m	Total ^{note iv} £m	Unit-linked assets and liabilities £m	Annuity and other long-term business £m	Total £m	2008	2007
								Total £m	Total £m
Assets									
Intangible assets attributable to shareholders:									
Deferred acquisition costs and other intangible assets						134	134	134	157
						134	134	134	157
Intangible assets attributable to PAC with-profits fund:									
In respect of acquired subsidiaries for venture fund and other investment purposes	–	174	–	174	–	–	–	174	192
Deferred acquisition costs	3	10	–	10	–	–	–	13	19
	3	184	–	184	–	–	–	187	211
Total	3	184	–	184	–	134	134	321	368
Deferred tax assets	7	174	98	272	–	234	234	513	105
Other non-investment and non-cash assets	244	2,246	380	2,626	443	1,649	2,092	4,962	4,110
Investments of long-term business and other operations:									
Investment properties	882	8,365	664	9,029	710	1,338	2,048	11,959	13,666
Financial investments:									
Loans ^{note v}	194	1,000	151	1,151	–	557	557	1,902	1,245
Equity securities and portfolio holdings in unit trusts	3,718	25,056	247	25,303	9,827	32	9,859	38,880	60,829
Debt securities ^{note vi}	4,218	21,658	11,888	33,546	4,409	16,698	21,107	58,871	57,180
Other investments ^{note vii}	777	2,761	219	2,980	136	267	403	4,160	3,391
Deposits	649	3,974	160	4,134	489	818	1,307	6,090	7,228
Total investments	10,438	62,814	13,329	76,143	15,571	19,710	35,281	121,862	143,539
Held for sale assets	–	–	–	–	–	–	–	–	30
Cash and cash equivalents	196	707	184	891	979	505	1,484	2,571	1,869
Total assets	10,888	66,125	13,991	80,116	16,993	22,232	39,225	130,229	150,021

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

	PAC with-profits sub-fund ^{note i}				Other funds and subsidiaries			UK insurance operations	
	Scottish Amicable Insurance Fund ^{note ii} £m	Excluding Prudential Annuities Limited £m	Prudential Annuities Limited ^{note iii} £m	Total ^{note iv} £m	Unit-linked assets and liabilities £m	Annuity and other long-term business £m	Total £m	2008	2007
								Total £m	Total £m
Equity and liabilities									
Equity									
Shareholders' equity	–	–	–	–	–	1,655	1,655	1,655	1,364
Minority interests	16	31	–	31	–	–	–	47	42
Total equity	16	31	–	31	–	1,655	1,655	1,702	1,406
Liabilities									
Policyholder liabilities and unallocated surplus of with-profits funds:									
Insurance contract liabilities	9,524	29,486	11,477	40,963	6,041	16,228	22,269	72,756	82,938
Investment contract liabilities with discretionary participation features	494	22,873	–	22,873	–	–	–	23,367	29,466
Investment contract liabilities without discretionary participation features	–	–	–	–	10,277	1,307	11,584	11,584	12,073
Unallocated surplus of with-profits funds (reflecting application of 'realistic' provisions for UK regulated with-profits funds)	–	6,705	1,549	8,254	–	–	–	8,254	13,813
Total	10,018	59,064	13,026	72,090	16,318	17,535	33,853	115,961	138,290
Operational borrowings attributable to shareholder-financed operations	–	–	–	–	–	54	54	54	12
Borrowings attributable to with-profits funds	112	1,196	–	1,196	–	–	–	1,308	987
Other non-insurance liabilities:									
Obligations under funding, securities lending and sale and repurchase agreements	260	997	313	1,310	–	681	681	2,251	1,360
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	–	924	19	943	555	38	593	1,536	1,751
Current tax liabilities	3	35	19	54	–	70	70	127	507
Deferred tax liabilities	28	663	295	958	–	435	435	1,421	2,383
Accruals and deferred income	17	185	–	185	–	63	63	265	289
Other creditors	20	567	8	575	–	1,024	1,024	1,619	1,913
Provisions	–	67	–	67	–	200	200	267	326
Derivative liabilities	414	2,303	280	2,583	–	404	404	3,401	699
Other liabilities	–	93	31	124	120	73	193	317	98
Total	742	5,834	965	6,799	675	2,988	3,663	11,204	9,326
Total liabilities	10,872	66,094	13,991	80,085	16,993	20,577	37,570	128,527	148,615
Total equity and liabilities	10,888	66,125	13,991	80,116	16,993	22,232	39,225	130,229	150,021

Notes

- i For the purposes of this table and subsequent explanation, references to the WPSF also include, for convenience, the amounts attaching to the Defined Charges Participating Sub-fund.
- ii SAIF is a separate sub-fund within the PAC long-term business fund.
- iii Wholly-owned subsidiary of the PAC WPSF that writes annuity business.
- iv Excluding policyholder liabilities of the Hong Kong branch of PAC.
- v The loans of the Group's UK insurance operations of £1,902 million (2007: £1,245 million) comprise mortgage loans of £701 million (2007: £449 million), policy loans of £29 million (2007: £35 million) and other loans of £1,172 million (2007: £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.
- vi Included in debt securities above are £13,026 million (2007: £11,149 million) of securities which are not quoted on active markets and for which fair value is determined using internal valuation techniques, or is provided by brokers or pricing services, where the specific securities have been valued using valuation techniques by these third-party providers. Of this amount, £12,341 million (2007: £10,640 million) related to securities held by with-profit operations and £685 million (2007: £509 million) related to securities held by the UK shareholder-backed business. See note G1 for additional details.
- vii Other investments comprise:

	2008 £m	2007 £m
Derivative assets ^{note G3}	1,326	571
Partnerships in investment pools and other	2,834	2,820
	4,160	3,391

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.

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

b Reconciliation of movement in investments

A reconciliation of the total investments of UK insurance operations from the beginning of the year to the end of the year is as follows:

	Scottish Amicable Insurance Fund £m	Excluding Prudential Annuities Limited £m	PAC with-profits sub-fund		Other funds and subsidiaries		UK insurance operations Total £m
			Prudential Annuities Limited £m	Total £m	Unit-linked assets and liabilities £m	Annuity and other long-term business £m	
At 1 January 2007							
Total investments	14,201	74,463	15,305	89,768	17,237	17,331	138,537
Less: Investments held by consolidated investment funds	–	–	–	–	–	(1,179)	(1,179)
Less: Derivative liabilities	(36)	(169)	(44)	(213)	–	(19)	(268)
Directly held investments, net of derivative liabilities	14,165	74,294	15,261	89,555	17,237	16,133	137,090
Net cash inflow from operating activities	(829)	1,100	(216)	884	595	2,478	3,128
Realised gains (losses) in the year	637	3,364	73	3,437	693	(107)	4,660
Unrealised gains (losses) in the year	(420)	(847)	(650)	(1,497)	(478)	(394)	(2,789)
Foreign exchange translation differences	–	99	–	99	–	–	99
Movement in the year of directly held investments, net of derivative liabilities	(612)	3,716	(793)	2,923	810	1,977	5,098
At 31 December 2007/1 January 2008							
Total investments	13,665	78,487	14,515	93,002	18,047	18,825	143,539
Less: Investments held by consolidated investment funds	–	–	–	–	–	(662)	(662)
Less: Derivative liabilities ^{note G3}	(112)	(477)	(47)	(524)	–	(53)	(689)
Directly held investments, net of derivative liabilities	13,553	78,010	14,468	92,478	18,047	18,110	142,188
Net cash inflow from operating activities	(1,245)	(1,396)	(211)	(1,607)	811	2,928	887
Realised gains (losses) in the year	276	84	25	109	(156)	(156)	73
Unrealised gains (losses) in the year	(2,560)	(17,991)	(1,236)	(19,227)	(3,568)	(1,577)	(26,932)
Foreign exchange translation differences	–	1,631	3	1,634	(1)	3	1,636
Movement in the year of directly held investments, net of derivative liabilities	(3,529)	(17,672)	(1,419)	(19,091)	(2,914)	1,198	(24,336)
At 31 December 2008							
Total investments	10,438	62,814	13,329	76,143	15,571	19,710	121,862
Less: Investments held by consolidated investment funds	–	(145)	–	(145)	(424)	(40)	(609)
Less: Derivative liabilities ^{note G3}	(414)	(2,331)	(280)	(2,611)	(14)	(362)	(3,401)
Directly held investments, net of derivative liabilities	10,024	60,338	13,049	73,387	15,133	19,308	117,852

c Reconciliation of movement in policyholder liabilities and unallocated surplus of with-profits funds

A reconciliation of the total policyholder liabilities and unallocated surplus of with-profits funds of UK insurance operations from the beginning of the year to the end of the year is as follows:

	SAIF and PAC with-profits sub-fund £m	Other funds and subsidiaries		UK insurance operations Total £m
		Unit-linked liabilities £m	Annuity and other long-term business £m	
At 1 January 2007	101,616	18,187	14,101	133,904
Premiums	4,459	2,115	2,279	8,853
Surrenders	(2,879)	(1,636)	(13)	(4,528)
Maturities/Deaths	(4,987)	(790)	(1,010)	(6,787)
Shareholders transfers post tax	(279)	–	–	(279)
Switches	(352)	352	–	–
Assumption changes (shareholder-backed business) ^{note D2(i)}	–	–	(34)	(34)
Investment-related items and other movements	6,256	749	223	7,228
Foreign exchange translation differences	(62)	–	(5)	(67)
At 31 December 2007/1 January 2008	103,772	18,977	15,541	138,290
Premiums	3,157	2,435	3,780	9,372
Surrenders	(2,336)	(1,838)	(107)	(4,281)
Maturities/Deaths	(6,309)	(666)	(1,349)	(8,324)
Shareholders transfers post tax	(284)	–	–	(284)
Switches	(360)	360	–	–
Assumption changes (shareholder-backed business) ^{note D2(i)}	–	–	447	447
Investment-related items and other movements	(13,049)	(2,952)	(777)	(16,778)
Foreign exchange translation differences	(2,483)	2	–	(2,481)
At 31 December 2008	82,108	16,318	17,535	115,961

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

d Information on credit risk of debt securities

The following table summarises by rating the securities held by UK insurance operations as at 31 December 2008 and 2007:

	PAC with-profits sub-fund				Other funds and subsidiaries		UK insurance operations	
	Scottish Amicable Insurance Fund	Excluding Prudential Annuities Limited	Prudential Annuities Limited	Total	Unit-linked assets and liabilities	Annuity and other long-term business	2008	2007
	£m	£m	£m	£m	£m	£m	Total £m	Total £m
S&P – AAA	1,139	5,765	3,176	8,941	2,866	6,035	18,981	21,556
S&P – AA+ to AA-	318	1,817	1,389	3,206	423	2,065	6,012	6,173
S&P – A+ to A-	1,058	5,804	3,295	9,099	815	4,957	15,929	12,557
S&P – BBB+ to BBB-	789	3,875	919	4,794	210	1,620	7,413	5,409
S&P – Other	152	794	16	810	71	–	1,033	942
	3,456	18,055	8,795	26,850	4,385	14,677	49,368	46,637
Moody's – Aaa	111	344	89	433	9	128	681	1,021
Moody's – Aa1 to Aa3	66	353	255	608	–	159	833	587
Moody's – A1 to A3	43	222	232	454	–	181	678	944
Moody's – Baa1 to Baa3	35	146	138	284	–	135	454	490
Moody's – Other	4	136	12	148	–	10	162	410
	259	1,201	726	1,927	9	613	2,808	3,452
Fitch	34	181	188	369	–	157	560	682
Other	469	2,221	2,179	4,400	15	1,251	6,135	6,409
Total debt securities	4,218	21,658	11,888	33,546	4,409	16,698	58,871	57,180

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

Where no external ratings are available internal ratings produced by the 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 2008 which are not externally rated, £2,325 million (2007: £2,972 million) were internally rated AAA to A-, £3,149 million (2007: £2,844 million) were internally rated BBB+ to B- and £661 million (2007: £593 million) were unrated. The majority of 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.

As detailed in note D2(j) below, the primary sensitivity of IFRS basis profit or loss and shareholders' equity relates to non-linked shareholder-backed business which covers other funds and subsidiaries in the table above.

e Products and guarantees

Prudential's long-term products in the UK consist of life insurance, pension products and pension annuities.

These products are written primarily in:

- One of three separate sub-funds of the PAC long-term fund, namely the with-profits sub-fund, SAIF, and the non-profit sub-fund;
- Prudential Annuities Limited, which is owned by the PAC with-profits sub-fund;
- Prudential Retirement Income Limited, a shareholder-owned subsidiary; or
- Other shareholder-backed subsidiaries writing mainly non-profit unit-linked business.

i With-profits products and PAC with-profits sub-fund

Within the balance sheet of UK insurance operations at 31 December 2008, as shown in note D2(a), there are policyholder liabilities and unallocated surplus of £72.1 billion (2007: £90.5 billion) that relate to the WPSF. These amounts include the liabilities and capital of Prudential Annuities Limited, a wholly owned subsidiary of the fund. The WPSF mainly contains with-profits business but it also contains some non-profit business (unit-linked, term assurances and annuities). The WPSF's profits are apportioned 90 per cent to its policyholders and 10 per cent to shareholders as surplus for distribution is determined via the annual actuarial valuation.

With-profits products provide returns to policyholders through bonuses that are 'smoothed'. There are two types of bonuses: 'annual' and 'final'. Annual bonuses are declared once a year, and once credited, are guaranteed in accordance with the terms of the particular product. Unlike annual bonuses, final bonuses are guaranteed only until the next bonus declaration.

When determining policy payouts, including final bonuses, Prudential considers policyholders' reasonable expectations, the need to smooth claim values and payments from year to year and competitive considerations, together with 'asset shares' for specimen policies. Asset shares broadly reflect the value of premiums paid plus the investment return on the assets notionally attributed to the policy, less the other items to be charged such as expenses and the cost of the life insurance cover.

For many years, UK with-profits product providers, such as Prudential, have been required by law and regulation to consider the reasonable expectations of policyholders in setting bonus levels. This concept is established by statute but is not defined. However, it is defined within the regulatory framework, which also more recently contains an explicit requirement to treat customers fairly.

The WPSF held a provision of £42 million at 31 December 2008 (2007: £45 million) to honour guarantees on a small amount of guaranteed annuity products. SAIF's exposure to guaranteed annuities is described below.

Beyond the generic guarantees described above, there are very few explicit options or guarantees such as minimum investment returns, surrender values or annuities at retirement and any granted have generally been at very low levels.

ii Annuity business

Prudential's conventional annuities include level, fixed increase and retail price index (RPI) annuities. They are mainly written within the subsidiaries PAL, PRIL, Prudential Pensions Limited and the PAC with-profits sub-fund, but there are some annuity liabilities in the non-profit sub-fund and SAIF.

Prudential's fixed-increase annuities incorporate automatic increases in annuity payments by fixed amounts over the policyholder's life. The RPI annuities that Prudential offers provide for a regular annuity payment to which an additional amount is added periodically based on the increase in the UK RPI.

Prudential's with-profits annuities, which are written in the WPSF, combine the income features of annuity products with the investment smoothing features of with-profits products and enable policyholders to obtain exposure to investment return on the WPSF's equity shares, property and other investment categories over time. Policyholders select an 'anticipated bonus' from the specific range Prudential offers for the particular product. The amount of the annuity payment each year depends upon the relationship between the anticipated bonus rate selected by the policyholder when the product is purchased and the bonus rates Prudential subsequently declares each year during the term of the product. If the total bonus rates fall below the anticipated rate, then the annuity income falls.

On 31 December 2007, Prudential completed the transfer of 62,000 with-profits annuity policies from Equitable Life, with assets of approximately £1.7 billion. The policies transferred form part of the Defined Charge Participating Sub-Fund of Prudential's with-profit fund. Profits to shareholders will emerge on a 'charges less expenses' basis and policyholders will be entitled to 100 per cent of the investment earnings.

At 31 December 2008, £29.4 billion (2007: £29.5 billion) of investments relate to annuity business of PAL and PRIL. These investments are predominantly in debt securities (including retail price index-linked bonds to match retail price index-linked annuities), loans and deposits and are duration matched with the estimated duration of the liabilities they support.

iii SAIF

SAIF is a ring-fenced sub-fund of the PAC long-term fund formed following the acquisition of the mutually owned Scottish Amicable Life Assurance Society in 1997. No new business may be written in SAIF, although regular premiums are still being paid on policies in force at the time of the acquisition and incremental premiums are permitted on these policies.

The fund is solely for the benefit of policyholders of SAIF. Shareholders have no interest in the profits of this fund although they are entitled to asset management fees on this business.

The process for determining policyholder bonuses of SAIF with-profits policies, which constitute the vast majority of obligations of the funds, is similar to that for the with-profits policies of the WPSF. However, in addition, the surplus assets in SAIF are allocated to policies in an orderly and equitable distribution over time as enhancements to policyholder benefits i.e. in excess of those based on asset share.

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

The Group's main exposure to guaranteed annuities in the UK is through SAIF and a provision of £391 million was held in SAIF at 31 December 2008 (2007: £563 million) to honour the guarantees. As SAIF is a separate sub-fund solely for the benefit of policyholders of SAIF this provision has no impact on the financial position of the Group's shareholders' equity.

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

iv Unit-linked (non-annuity) and other non-profit business

Prudential UK insurance operations also have an extensive book of unit-linked policies of varying types and provide a range of other non-profit business such as credit life and protection contracts. These contracts do not contain significant financial guarantees.

There are no guaranteed maturity values or guaranteed annuity options on unit-linked policies except for minor amounts for certain policies linked to cash units within SAIF.

f Exposure to market risk

i Non-linked life and pension business

For with-profits business, the absence of guaranteed surrender values and the flexibility given by the operation of the bonus system means that the majority of the investments backing the with-profits business are in equities and real estate with the balance in debt securities, deposits and loans.

The investments supporting the protection business are small in value and tend to be fixed maturities reflecting the guaranteed nature of the liabilities.

ii Pension annuity business

Prudential's UK annuity business mainly employs fixed income investments (including UK retail price index-linked assets) because the liabilities consist of guaranteed payments for as long as each annuitant or surviving partner is alive. Retail price index-linked assets are used to back pension annuities where the payments are linked to the RPI.

iii Unit-linked business

Except through the second order effect on asset management fees, the unit-linked business of the UK insurance operations is not exposed to market risk. The lack of exposure arises from the contract nature whereby policyholder benefits reflect asset value movements of the unit-linked funds.

g Process for setting assumptions and determining contract liabilities

i Overview

The calculation of the contract liabilities involves the setting of assumptions for future experience. This is done following detailed review of the relevant experience including, in particular, mortality, expenses, tax, economic assumptions and where applicable, persistency.

For with-profits business written in the WPSF or SAIF, a market consistent valuation is performed (as described in section (ii) below). Additional assumptions required are for persistency and the management actions under which the fund is managed. Assumptions used for a market consistent valuation typically do not contain margins, whereas those used for the valuation of other classes of business do.

Mortality assumptions are set based on the results of the most recent experience analysis looking at the experience over recent years of the relevant business. For non-profit business, a margin for adverse deviation is added. Different assumptions are applied for different product groups. For annuitant mortality, assumptions for current mortality rates are based on recent experience investigations and expected future improvements in mortality. The expected future improvements are based on recent experience and projections of the business and industry experience generally.

Maintenance and, for some classes of business, termination expense assumptions are expressed as per policy amounts. They are set based on the expenses incurred during the year, including an allowance for ongoing investment expenditure and allocated between entities and product groups in accordance with the operation's internal cost allocation model. For non-profit business a margin for adverse deviation is added to this amount. Expense inflation assumptions are set consistent with the economic basis and based on the difference between yields on nominal gilts and index-linked gilts.

The actual renewal expenses charged to SAIF continued to be based on the tariff arrangement specified in the Scottish Amicable Life Assurance Society Scheme up to 31 December 2007, when the tariff arrangement terminated. This provided an additional margin in SAIF as the unit costs derived from actual expenses (and used to derive the recommended assumptions) were generally significantly greater than the tariff costs. From 1 January 2008 the full expenses incurred are being charged to SAIF.

The assumptions for asset management expenses are based on the charges specified in agreements with the Group's asset management operations, plus a margin for adverse deviation for non-profit business.

Tax assumptions are set equal to current rates of taxation.

For non-profit business excluding unit-linked business, the valuation interest rates used to discount the liabilities are based on the yields as at the valuation date on the assets backing the technical provisions. For fixed interest securities the gross redemption yield is used except for the PAL and PRIL annuity business where the internal rate of return of the assets backing the liabilities is used. For property it is the rental yield, and for equities it is the greater of the dividend yield and the average of the dividend yield and the earnings yield. An adjustment is made to the yield on non risk-free fixed interest securities and property to reflect credit risk. To calculate the non-unit reserves for linked business, assumptions have been set for the gross unit growth rate and the rate of inflation of maintenance expenses, as well as for the valuation interest rate as described above.

ii WPSF and SAIF

The policyholder liabilities reported for the WPSF are primarily for two broad types of business. These are accumulating and conventional with-profits contracts. The policyholder liabilities of the WPSF are accounted for under FRS 27.

The provisions have been determined on a basis consistent with the detailed methodology included in regulations contained in the FSA's rules for the determination of reserves on the FSA's 'realistic' Peak 2 basis. In aggregate, the regime has the effect of placing a value on the liabilities of UK with-profits contracts, which reflects the amounts expected to be paid based on the current value of investments held by the with-profits funds and current circumstances. These contracts are a combination of insurance and investment contracts with discretionary participation features, as defined by IFRS 4.

The FSA's Peak 2 calculation under the realistic regime requires the value of liabilities to be calculated as:

- The with-profits benefits reserve (WPBR); plus
- future policy related liabilities (FPRL); plus
- the realistic current liabilities of the fund.

The WPBR is primarily based on the retrospective calculation of accumulated asset shares but is adjusted to reflect future expected policyholder benefits and other outgoings. Asset shares are calculated as the accumulation of all items of income and outgo that are relevant to each policy type. Income comprises credits for premiums, investment returns (including unrealised gains), and miscellaneous profits. Outgo comprises charges for tax (including an allowance for tax on unrealised gains), guarantees and smoothing, mortality and morbidity, shareholders' profit transfers, miscellaneous losses, and expenses and commission (net of any tax relief).

The FPRL must include a market consistent valuation of costs of guarantees, options and smoothing, less any related charges, and this amount must be determined using either a stochastic approach, hedging costs or a series of deterministic projections with attributed probabilities.

The assumptions used in the stochastic models are calibrated to produce risk-free returns on each asset class. Volatilities of, and correlations between, investment returns from different asset classes are as determined by the Group's Portfolio Management Group and aim to be market consistent.

The cost of guarantees, options and smoothing is very sensitive to the bonus, market value reduction (MVR), and investment policy employed and therefore the stochastic modelling incorporates a range of management actions that would help to protect the fund in adverse investment scenarios. Substantial flexibility has been included in the modelled management actions in order to reflect the discretion that is retained in adverse investment conditions, thereby avoiding the creation of unreasonable minimum capital requirements. The management actions assumed are consistent with the Group's management policy for with-profits funds and the Group's disclosures in the publicly available Principles and Practices of Financial Management.

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

iii Annuity business

Credit risk provisions

For IFRS reporting, the results for UK shareholder-backed annuity business are particularly sensitive to the allowances made for credit risk. The allowance is reflected in the deduction from the valuation rate of interest for discounting projected future annuity payments to policyholders that would have otherwise applied. The valuation rate that is applied includes a liquidity premium that reflects the residual element of current bond spreads over swap rates after providing for the credit risk allowance.

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

The weighted components of the bond spread over swap rates for shareholder-backed fixed and linked annuity business for PRIL on the IFRS basis at 31 December 2008 based on the asset mix at that date are as follows:

	2008		
	Pillar I Regulatory basis (bps)	Adjustment from regulatory to IFRS basis (bps)	IFRS (bps)
Bond spread over swap rates ^{note i}	323	–	323
Credit risk allowance			
Long-term expected defaults ^{note ii}	15	–	15
Long-term credit risk premium ^{note iii}	11	–	11
Short-term allowance for credit risk ^{note iv}	54	(25)	29
Total credit risk allowance	80	(25)	55
Liquidity premium	243	25	268

By comparison, for 2007, the weighted components of the bond spread over swap rates for shareholder-backed fixed and linked annuity business on the IFRS basis at 31 December 2007 based on the asset mix of the portfolio at that date were as follows:

	2007		
	Pillar I Regulatory basis (bps)	Adjustment from regulatory to IFRS basis (bps)	IFRS (bps)
Bond spread over swap rates ^{note i}	76	–	76
Credit risk allowance			
Long-term expected defaults ^{note ii}	13	–	13
Long-term credit risk premium ^{note iii}	10	(3)	7
Short-term allowance for credit risk ^{note iv}	10	(10)	–
Total credit risk allowance	33	(13)	20
Liquidity premium	43	13	56

Notes

- i Bond spread over swap rates reflect market observed data to credit spreads.
- ii Long-term expected defaults; this is derived by applying Moody's data from 1970 to 2004 uplifted by between 100 per cent (B) and 200 per cent (AAA) according to credit rating on the annuity asset portfolio. The credit rating assigned to each asset held is based on external credit rating and for this purpose the credit rating assigned to each asset held is the lowest credit rating published by Moody's, Standard and Poors and Fitch.
- iii Long-term credit risk premium; this provides compensation against the risk of potential volatility in the level of defaults and is derived by applying the 95th percentile from Moody's data from 1970 to 2004 to the annuity asset portfolio.
- iv During the second half of 2007, corporate bond spreads widened significantly and the methodology was reviewed to ensure that it still made appropriate allowance for credit risk. As a result of this review a short-term allowance for credit risk was established to allow for the concern that credit ratings applied by rating agencies to individual bonds might be over optimistic.
The short-term allowance for credit risk assumed in the Pillar I solvency valuation has been determined as 25 per cent of the increase in corporate bond spreads (as estimated from the movements in published corporate bond indices) since 31 December 2006.
The approach for IFRS, however, aims to establish liabilities that are closer to 'best estimate'. The very prudent Pillar I regulatory basis reflects the overriding objective of ensuring sufficient provisions and capital to ensure payments to policyholders can be made. In previous years long-term IFRS default assumptions were set mid-way between the EEV and Pillar I assumptions. At 31 December 2008, in light of the increase uncertainty surrounding future credit default experience, the IFRS long-term assumptions have been strengthened to bring them into line with the long-term Pillar I default assumptions. In addition a short-term allowance for credit risk has been established but at a lower level than allowed for in the Pillar I regulatory basis.

Mortality

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

2008	PAL		PRIL	
	Males	Females	Males	Females
In payment	102% – 126% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120	84% – 117% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120	97% – 102% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120	88% – 98% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

2007	PAL		PRIL	
	Males	Females	Males	Females
In payment	106% – 126% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120	84% – 117% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120	99% – 114% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 2.25% up to age 90, tapering to zero at age 120	85% – 103% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 1.25% up to age 90, tapering to zero at age 120
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

2006	PAL		PRIL	
	Males	Females	Males	Females
In payment	106% – 126% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 1.25%	84% – 117% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 0.75%	99% – 114% PNMA00 (C = 2000) with medium cohort improvement table with a minimum annual improvement of 1.25%	85% – 103% PNFA00 (C = 2000) with 75% of medium cohort improvement table with a minimum annual improvement of 0.75%
In deferment	AM92 minus 4 years	AF92 minus 4 years	AM92 minus 4 years	AF92 minus 4 years

iv Unit-linked (non-annuity) and other non-profit business

The majority of other long-term business written in the UK insurance operations is unit-linked business or other business with similar features. For these contracts the attaching liability reflects the unit value obligation and provision for expenses and mortality risk. The latter component is determined by applying mortality assumptions on a basis that is appropriate for the policyholder profile.

For unit-linked business, the assets covering unit liabilities are exposed to market risk, but the residual risk when considering the unit-linked liabilities and assets together is limited to the effect on fund-based charges.

For those contracts where the level of insurance risk is insignificant the assets and liabilities arising under the contracts are distinguished between those that relate to the financial instrument liability and acquisition costs and deferred income that relate to the component of the contract that relates to investment management. Acquisition costs and deferred income are recognised consistent with the level of service provision in line with the requirements of IAS 18.

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

h Reinsurance

The Group's UK insurance business cedes only minor amounts of business outside the Group. During 2008, reinsurance premiums for externally ceded business were £61 million (2007: £59 million) and reinsurance recoverable insurance assets were £416 million (2007: £335 million) in aggregate. The gains and losses recognised in profit and loss for these contracts were immaterial.

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

2008

Mortality

Recent mortality experience has been in line with expectations and no change is therefore required to the overall strength of mortality assumptions at 31 December 2008. However, current mortality assumptions have been rebalanced across different categories of business so that they are more closely aligned to the actual experience of each product category. The overall effect of rebalancing the assumptions between different product groups is financially neutral.

Credit risk

In total, for 2008, the effect of changes to the allowance for credit risk and the effect of portfolio rebalancing gives rise to a charge of £23 million. For shareholder-backed annuity and lifetime mortgage business, the operating profit based on longer-term investment returns includes a charge of £413 million for the additional credit risk allowance in line with the assumptions shown above in D2(g), for the annuity portfolio as a whole. Partially offsetting this is a credit of £390 million for the effect of £2.8 billion of portfolio rebalancing to more closely align with management benchmark. The credit reflects the additional yield expected after allowing for additional credit risk arising from the rebalancing.

Aggregate effect of assumptions changes

For UK insurance operations, the effects of assumptions changes were as follows:

	2008 £m	
	With-profits sub-fund	Shareholder-backed business
Effect of (strengthening) weakening of mortality assumptions	(60)	(4)
Modelling of management actions ^{note a}	421	–
(Strengthening) weakening of other assumptions	75	–
	436	(4)
Release of other margins:		
Projected benefit related	10	10
Investment related:		
Additional credit default margins	(369)	^{note b} (413)
Deflation risk margins	(30)	(32)
Expense related	36	(8)
Net credit to unallocated surplus	83	
Net charge to shareholder result		(447)

Notes

- a The £421 million credit for modelling of management actions relates primarily to enhancements for actions in the event of solvency distress scenarios.
b Net of additional credit risk allowance attaching to effect of portfolio balancing described above.
c In 2008, no changes to mortality assumptions were made or necessary.

2007

The 2007 results for shareholder-backed annuity business were determined after making changes to mortality assumptions with a resulting charge of £276 million and releasing excess margins in the aggregate liabilities that had previously been set aside as an indirect extra allowance for longevity related risks of £310 million as shown in the table below.

For UK insurance operations, the 2007 results were determined after making changes to mortality assumptions for the annuity business and other assumptions for the WPSF and releasing excess margins in the aggregate liabilities that had previously been set aside as an indirect extra allowance for longevity related risks, as shown below.

	2007 £m	
	With-profits sub-fund	Shareholder-backed business
Effect of strengthening of mortality assumptions ^{note a}	(435)	(276)
Modelling of management actions ^{note b}	(167)	–
Strengthening of other assumptions ^{note c}	(62)	–
	(664)	(276)
Release of other margins:		
Projected benefit related ^{note d}	13	104
Investment related: ^{note e}		
Default margins	199	48
Asset management fees	60	–
	259	48
Expense related ^{notes c,f}	–	68
Other ^{notes c,g}	–	90
Net charge to unallocated surplus	272	310
Net credit to shareholder result	(392)	34

Notes

- a The mortality assumptions have been strengthened by increasing the minimum level of future improvement rate.
- b Given the continuing strong financial position of the fund, the assumed management actions relating to with-profits business have been revised in order to better reflect the benefits to policyholders that can be supported by the fund.
- c The effects of the strengthening of other assumptions for the WPSF of £62 million is net of a release of PAL's expense reserve of £11 million and other additional margins in PAL's liabilities of £40 million.
- d The release of projected benefit related margins primarily relates to modelling improvements that have been made during 2007.
- e The release of investment-related margins includes £48 million in respect of default margins for shareholder-backed business and £199 million for PAL. The resulting assumptions for expected defaults, after allowing for the release of margins, remain appropriate given economic conditions at 31 December 2007. In addition, for PAL, there is a release of £60 million in respect of asset management fees.
- f A release of expense reserves has been made following recent expense reductions.
- g This amount reflects the release of other additional margins in the liabilities that are no longer appropriate in light of the explicit strengthening of the mortality assumptions.

j Sensitivity of IFRS basis profit or loss and equity to market and other risks

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

i With-profits business

SAIF

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

With-profits sub-fund business

For with-profits business (including non-participating business of PAL which is owned by the 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. The effects for 2008 and 2007 are demonstrated in note D5.

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

ii 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 one per cent would decrease gross profits by approximately £35 million (2007: £35 million). A decrease in credit default assumptions of five basis points would increase gross profits by £71 million (2007: £72 million). A decrease in renewal expenses (excluding asset management expenses) of five per cent would increase gross profits by £15 million (2007: £13 million). The effect on profits would be approximately symmetrical for changes in assumptions that are directionally opposite to those explained above.

iii Unit-linked and other business

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

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.

iv Shareholder exposure to interest rate risk and other market risk

By virtue of the fund structure, product features and basis of accounting described in note D2(e) and (g), 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 ameliorated 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 the same as detailed in note D2(g)(iii), with contingency reserves and some other margins for prudence within the assumptions required under the FSA regulatory solvency basis not included for IFRS reporting purposes. As a result IFRS equity is higher than regulatory capital and therefore more sensitive to interest rate risk.

In light of the recent market conditions, the Group has extended the range of the movements in interest rates that are reasonably possible to occur at 31 December 2008 in its interest rate sensitivity analysis. Consequently, in addition to the movement in interest rates of one per cent as applied at 31 December 2007, for 2008, the Group has also estimated the sensitivity to movement in interest rates of two per cent. The estimated sensitivity of the UK non-linked shareholder-backed business (principally pension annuities business) to a movement in interest rates of one per cent as at 31 December 2008 and 2007 and of a movement in interest rates of two per cent as at 31 December 2008 are as follows.

	2008 £m				2007 £m	
	A decrease of 2%	A decrease of 1%	An increase of 1%	An increase of 2%	A decrease of 1%	An increase of 1%
Carrying value of debt securities and derivatives	4,362	1,983	(1,676)	(3,108)	1,930	(1,634)
Policyholder liabilities	(3,974)	(1,798)	1,503	2,773	(1,777)	1,467
Related deferred tax effects	(109)	(52)	48	94	(43)	47
Net sensitivity of profit after tax and shareholders' equity	279	133	(125)	(241)	110	(120)

In addition the shareholder-backed portfolio of UK non-linked insurance operations covering liabilities and shareholders' equity includes equity securities and investment property. Similar to the sensitivity analysis to interest rate movement above, the Group has also extended the range of reasonably possible movements in the value of equity securities and investment property at 31 December 2008. In addition to the movement of 10 per cent as applied at 31 December 2007, for 2008, the Group has also estimated the sensitivity to movements of 20 and 40 per cent. Excluding any second order effects on the measurement of the liabilities for future cash flow to the policyholder, a 10 per cent fall in their value at 31 December 2008 and 2007 and a 20 and 40 per cent fall in their value at 31 December 2008 would have given rise to the following effects on pre-tax profit, profit after tax, and shareholders' equity.

	2008 £m			2007 £m
	A decrease of 40%	A decrease of 20%	A decrease of 10%	A decrease of 10%
Pre-tax profit	(508)	(254)	(127)	(86)
Related deferred tax effects	142	71	35	24
Net sensitivity of profit after tax and shareholders' equity	(366)	(183)	(92)	(62)

A 10, 20 or 40 per cent increase in their value would have an approximately equal and opposite effect on profit and shareholders' equity to the sensitivities shown above. The market risk sensitivities shown above reflect the impact of temporary market movements and, therefore, the primary effect of such movements would, in the Group's supplementary analysis of profits, be included within the short-term fluctuations in investment returns.

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

k Duration of liabilities

With the exception of most unitised with-profits bonds and other whole of life contracts the majority of the contracts of the UK insurance operations have a contract term. However, in effect, the maturity term of contracts reflects the earlier of death, maturity, or lapsation. In addition, with-profit contract liabilities as noted in note D2(g) above include projected future bonuses based on current investment values. The actual amounts payable will vary with future investment performance of SAIF and the WPSF.

The tables below show the carrying value of the policyholder liabilities. Separately, the Group uses cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results. The tables below also show the maturity profile of the cash flows used for 2008 and 2007 for that purpose for insurance contracts, as defined by IFRS, i.e. those containing significant insurance risk, and investment contracts, which do not.

	2008 £m								
	With-profits business			Annuity business (Insurance contracts)			Other		
	Insurance contracts	Investment contracts	Total	PAL	PRIL	Total	Insurance contracts	Investment contracts	Total
Policyholder liabilities	39,010	23,367	62,377	11,477	12,513	23,990	9,756	11,584	21,340
	2008 %								
Expected maturity:									
0 to 5 years	47	26	38	30	29	29	31	32	32
5 to 10 years	26	23	25	24	23	23	23	22	23
10 to 15 years	13	19	15	18	17	18	18	18	18
15 to 20 years	7	15	10	12	13	13	12	12	12
20 to 25 years	4	11	7	8	8	8	8	7	7
Over 25 years	3	6	5	8	10	9	8	9	8

	2007 £m								
	With-profits business			Annuity business (Insurance contracts)			Other		
	Insurance contracts	Investment contracts	Total	PAL	PRIL	Total	Insurance contracts	Investment contracts	Total
Policyholder liabilities	47,915	29,480	77,395	12,564	13,402	25,966	9,057	12,059	21,116
	2007 %								
Expected maturity:									
0 to 5 years	47	25	38	32	31	32	32	31	31
5 to 10 years	27	23	26	24	23	24	23	22	23
10 to 15 years	13	19	16	18	17	17	18	20	19
15 to 20 years	7	15	10	12	12	12	12	13	12
20 to 25 years	4	11	6	7	8	7	8	6	7
Over 25 years	2	7	4	7	9	8	7	8	8

Notes

- i The cash flow projections of expected benefit payments used in the maturity profile table above are from value of in-force business and exclude the value of future new business, including vesting of internal pension contracts.
- ii Benefit payments do not reflect the pattern of bonuses and shareholder transfers in respect of the with-profits business.
- iii Investment contracts under Other comprise certain unit-linked and similar contracts accounted for under IAS 39 and IAS 18.
- iv For business with no maturity term included within the contracts, for example with-profits investment bonds such as Prudence Bond, an assumption is made as to likely duration based on prior experience.
- v The maturity tables shown above have been prepared on a discounted basis. Details of undiscounted cash flow for investment contracts are shown in note G2.

D3: US insurance operations

a Summary results and balance sheet

i Results and movements on shareholders' equity

	2008 £m	2007 £m
Operating profit based on longer-term investment returns	406	444
Short-term fluctuations in investment returns	(1,058)	(18)
(Loss) profit before shareholder tax	(652)	426
Tax	72	(126)
(Loss) profit for the year	(580)	300
	2008 £m	2007 £m
(Loss) profit for the year	(580)	300
Items recognised directly in equity:		
Exchange movements	785	(42)
Unrealised valuation movements on securities classified as available-for-sale:		
Unrealised holding losses arising during the year	(3,197)	(231)
Less losses included in the income statement	487	(13)
	(2,710)	(244)
Related change in amortisation of deferred income and acquisition costs	1,070	88
Related tax	569	54
Total items of income and expense recognised directly in equity	(286)	(144)
Total income and expense for the year	(866)	156
Transfers to Central companies	(126)	(122)
Net (decrease) increase in equity	(992)	34
Shareholders' equity at beginning of year	2,690	2,656
Shareholders' equity at end of year	1,698	2,690

Included within the movements in shareholders' equity is a net reduction in value of Jackson's debt securities classified as 'available-for-sale' under IAS 39 of £2,710 million (2007: £244 million). This reduction reflects the effects of widening of global credit spreads partially offset by the effect of reduced risk-free interest rates and a steepening yield curve. These temporary market movements do not reflect defaults or 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 debt securities classified as 'available-for-sale', unless impaired, fair value movements are recorded as a movement in shareholder reserves direct to equity. Realised gains and losses, including impairments, are recorded in the income statement. In 2008, Jackson recorded £497 million (2007: £35 million) of impairment losses arising from:

	2008 £m	2007 £m
Residential mortgage-backed securities	167	–
Public fixed income	311	21
Other	19	14
	497	35

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

Further details on the impairment losses recognised in the year are shown in note B1. Jackson's portfolio of debt securities is managed proactively with credit analysts closely monitoring and reporting on the credit quality of its holdings. Jackson continues to review its investments on a case-by-case basis to determine whether any decline in fair value represents an impairment. In addition, investment in structured securities where market prices are depressed are subject to a rigorous review of their future estimated cash flows, including expected and stress case scenarios, to identify potential shortfalls in contractual payments. Impairment charges are generally recorded on structured securities when the Company forecasts a contractual payment shortfall. The impairment loss reflects the difference between the fair value and book value.

A portion of the impairment losses arising in 2008 arose on residential mortgage-backed securities (RMBS). The impairment testing for RMBS was determined using a cash flow modelling approach designed to estimate future principal losses on underlying collateral mortgage loans supporting the investments in the structures. Principal loss estimates were based on the current delinquency/foreclosure statistics for the underlying pools. In aggregate, the more severe the current delinquency/foreclosure statistics for an underlying pool, the higher the principal losses projected. Projected underlying losses for each collateral pool are then run through a model of the bond structure to calculate the expected future cash flows of the bond. This cash flow simulation will indicate the extent of estimated future principal losses on securitisation tranches held by Jackson. In 2008, the collateral performance of these RMBS has deteriorated coupled with the deterioration of the market price of these securities.

Note D3(d) below shows fair value of certain structured debt securities of Jackson when the markets are not active due to market illiquidity.

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 2008, there was a movement in the balance sheet value for debt securities classified as available-for-sale from a net unrealised loss of £136 million to a net unrealised loss of £2,897 million (2007: net unrealised gain of £110 million to a net unrealised loss of £136 million). During 2008, as a result of these factors, the gross unrealised gain in the balance sheet decreased from £303 million at 31 December 2007 to £281 million at 31 December 2008 while the gross unrealised loss increased from £439 million at 31 December 2007 to £3,178 million at 31 December 2008. Details of the securities in an unrealised loss position are shown in D3(d) below.

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

	2008	Changes in unrealised appreciation [†]	Foreign exchange translation	2007
	£m	£m	£m	£m
Assets fair valued at below book value				
Book value	20,600			10,730
Unrealised loss	(3,178)	(2,572)	(167)	(439)
Fair value (as included in balance sheet)	17,422			10,291
Assets fair valued at or above book value				
Book value	6,296			8,041
Unrealised gain	281	(138)	116	303
Fair value (as included in balance sheet)	6,577			8,344
Total				
Book value	26,896			18,771
Net unrealised (loss) gain	(2,897)	(2,710)	(51)	(136)
Fair value (as included in balance sheet)*	23,999			18,635
Reflected as part of movement in shareholders' equity				
Movement in unrealised appreciation	(2,710)			(244)
Exchange movements	(51)			(2)
	(2,761)			(246)

* Debt securities for US operations as included in the balance sheet of £24,249 million (2007: £19,002 million) comprise £23,999 million (2007: £18,635 million) in respect of securities classified as 'available-for-sale' and £250 million (2007: £367 million) for securities of consolidated investment funds classified as 'fair value through profit and loss'.

[†] Translated at the closing rate of US\$1.44: £1

Included within the movement in unrealised losses for the debt securities of Jackson of £2,572 million (2007: £183 million) as shown above was a value reduction of £134 million (2007: £55 million) relating to the sub-prime and Alt-A securities as referred to in section B6.

ii Balance sheet

	Variable annuity separate account assets and liabilities note i £m	Fixed annuity, GIC and other business note i £m	US insurance operations	
			2008 Total £m	2007 Total £m
Assets				
Intangible assets attributable to shareholders:				
Deferred acquisition costs and other intangible assets	–	3,962	3,962	1,928
Total	–	3,962	3,962	1,928
Deferred tax assets	–	1,969	1,969	657
Other non-investment and non-cash assets	–	1,819	1,819	994
Investments of long-term business and other operations:				
Investment properties	–	13	13	8
Financial investments:				
Loans ^{note ii}	–	5,121	5,121	3,258
Equity securities and portfolio holdings in unit trusts	14,538	604	15,142	15,507
Debt securities ^{D3d}	–	24,249	24,249	19,002
Other investments ^{note iii}	–	1,256	1,256	762
Deposits	–	390	390	258
Total investments	14,538	31,633	46,171	38,795
Cash and cash equivalents	–	246	246	169
Total assets	14,538	39,629	54,167	42,543
Equity and liabilities				
Equity				
Shareholders' equity	–	1,698	1,698	2,690
Minority interests	–	–	–	1
Total equity	–	1,698	1,698	2,691
Liabilities				
Policyholder liabilities: ^{note iv}				
Insurance contract liabilities	14,538	27,938	42,476	32,926
Investment contract liabilities without discretionary participation features (GIC and annuity certain)	–	2,885	2,885	1,922
Total	14,538	30,823	45,361	34,848
Core structural borrowings of shareholder-financed operations	–	173	173	125
Operational borrowings attributable to shareholder-financed operations	–	511	511	591
Other non-insurance liabilities:				
Obligations under funding, securities lending and sale and repurchase agreements	–	3,321	3,321	2,721
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	–	88	88	65
Deferred tax liabilities	–	1,337	1,337	639
Other creditors	–	529	529	333
Provisions	–	23	23	19
Derivative liabilities	–	863	863	158
Other liabilities	–	263	263	353
Total	–	6,424	6,424	4,288
Total liabilities	14,538	37,931	52,469	39,852
Total equity and liabilities	14,538	39,629	54,167	42,543

Notes

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

ii Loans

The loans of Jackson of £5,121 million (2007: £3,258 million) comprise mortgage loans of £4,534 million (2007: £2,841 million) and policy loans of £587 million (2007: £417 million). All of the mortgage loans are commercial mortgage loans which are collateralised 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 is therefore not 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.

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

Notes continued

iii Other investments comprise:

	2008 £m	2007 £m
Derivative assets ^{note G3}	675	390
Partnerships in investment pools and other	581	372
	1,256	762

Partnerships in investment pools and other comprise primarily investments in limited partnerships. These include interest in the PPM America Private Equity Fund and diversified investments in 157 (2007: 164) other partnerships by independent money managers that generally invest in various equities and fixed income loans and securities.

iv Summary policyholder liabilities (net of reinsurance) and reserves at 31 December 2008

The policyholder liabilities, net of reinsurers' share of £800 million (2007: £436 million), reflect balances in respect of the following:

	2008 £m	2007 £m
Policy reserves and liabilities on non-linked business:		
Reserves for future policyholder benefits and claims payable	2,518	916
Deposits on investment contracts (as defined under US GAAP)	24,962	16,784
Guaranteed investment contracts	2,543	1,685
Unit-linked (variable annuity) business	14,538	15,027
	44,561	34,412

In addition to the policyholder liabilities above, Jackson has entered into a programme of funding arrangements under contracts which, in substance, are almost identical to GICs. The liabilities under these funding arrangements totalled £3,233 million (2007: £2,607 million) and are included in 'other non-insurance liabilities' in the balance sheet above.

b Reconciliation of movement in investments

A reconciliation of the total investments of US insurance operations from the beginning of the year to the end of the year is as follows:

	Variable annuity separate account assets and liabilities £m	Fixed annuity, GIC and other business £m	US insurance operations Total £m
At 1 January 2007			
Total investments	11,367	24,762	36,129
Less: Derivative liabilities	–	(92)	(92)
Directly held investments, net of derivative liabilities	11,367	24,670	36,037
Net cash inflow (outflow) from operating activities	3,227	(615)	2,612
Realised gains (losses) in the year	–	(47)	(47)
Unrealised gains (losses) in the year	620	16	636
Foreign exchange translation differences	(187)	(414)	(601)
Movement in the year of directly held investments, net of derivative liabilities	3,660	(1,060)	2,600
At 31 December 2007/1 January 2008			
Total investments	15,027	23,768	38,795
Less: Derivative liabilities ^{note G3}	–	(158)	(158)
Directly held investments, net of derivative liabilities	15,027	23,610	38,637
Net cash inflow from operating activities	1,363	1,499	2,862
Realised gains (losses) in the year	–	(385)	(385)
Unrealised gains (losses) in the year	(5,924)	(2,901)	(8,825)
Foreign exchange translation differences	4,072	8,947	13,019
Movement in the year of directly held investments, net of derivative liabilities	(489)	7,160	6,671
At 31 December 2008			
Total investments	14,538	31,633	46,171
Less: Derivative liabilities ^{note G3}	–	(863)	(863)
Directly held investments, net of derivative liabilities	14,538	30,770	45,308

c Reconciliation of movement in policyholder liabilities

A reconciliation of the total policyholder liabilities of US insurance operations from the beginning of the year to the end of the year is as follows:

	Variable annuity separate account liabilities £m	Fixed annuity, GIC and other business £m	US insurance operations Total £m
At 1 January 2007	11,367	20,379	31,746
Premiums	3,970	2,382	6,352
Surrenders	(960)	(2,516)	(3,476)
Maturities/Deaths	(92)	(398)	(490)
Investment-related items and other movements	914	311	1,225
Foreign exchange translation differences	(172)	(337)	(509)
At 31 December 2007/1 January 2008	15,027	19,821	34,848
Premiums	2,637	4,091	6,728
Surrenders	(1,053)	(2,799)	(3,852)
Maturities/Deaths	(161)	(403)	(564)
Investment-related items and other movements	(6,288)	1,736	(4,552)
Foreign exchange translation differences	4,376	8,377	12,753
At 31 December 2008	14,538	30,823	45,361

The positive investment-related and other movement during 2008 within fixed annuity, GIC and other business principally represents interest credited to the policyholder account and increases in reserves for variable annuity guarantees. Variable annuity separate account liabilities are mainly impacted by market movements.

d Information on credit risks of debt securities

Summary	2008 £m	2007 £m
	Carrying value	Carrying value
Corporate security and commercial loans:		
Publicly traded and SEC Rule 144A traded	13,198	10,345
Non-SEC Rule 144A traded	3,273	2,613
	16,471	12,958
Residential mortgage-backed securities	4,509	3,177
Commercial mortgage-backed securities	1,869	1,532
Other debt securities	1,400	1,335
Total debt securities	24,249	19,002

i Credit quality

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 adviser, PPM America, provides the designation for the purposes of disclosure below.

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

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 2008 and 2007 by NAIC classifications:

	2008		2007	
	Carrying value		Carrying value	
	£m	% of total	£m	% of total
NAIC designation:				
1	5,380	41	4,338	42
2	6,849	52	5,194	50
3	690	5	542	5
4	200	1	231	2
5	75	1	40	1
6	4	–	–	–
	13,198	100	10,345	100

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

	2008		2007	
	Carrying value		Carrying value	
	£m	% of total	£m	% of total
NAIC designation:				
1	1,268	39	1,011	39
2	1,655	50	1,351	52
3	285	9	206	8
4	54	2	45	1
5	11	0	–	–
	3,273	100	2,613	100

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

	2008	2007
	Carrying value £m (unless otherwise stated)	Carrying value £m (unless otherwise stated)
Residential mortgage-backed securities (included within debt securities)		
Total residential mortgage-backed securities	4,509	3,177
Residential mortgage-backed securities rated AAA or equivalent by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch):		
Amount	3,754	2,724
Percentage of total	83.3%	85.7%
Residential mortgage-backed securities rated NAIC 1:		
Amount	4,241	3,170
Percentage of total	94.1%	99.8%
Commercial mortgage-backed securities (included within debt securities)		
Total commercial mortgage-backed securities	1,869	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	1,586	1,264
Percentage of total	84.9%	82.5%
Commercial mortgage-backed securities rated NAIC 1:		
Amount	1,815	1,462
Percentage of total	97.1%	95.4%

Included within other debt securities of £1,400 million (2007: £1,335 million) in the summary shown above are £893 million (2007: £706 million) of asset-backed securities held directly by Jackson, of which £663 million (2007: £579 million) were NAIC designation 1 and £159 million (2007: £127 million) NAIC designation 2. In addition, other debt securities includes £257 million (2007: £316 million) in respect of securities held by the Piedmont trust entity and £250 million (2007: £313 million) from the consolidation of investment funds managed by PPM America.

In addition to the ratings disclosed above, the following table summarises by rating the debt securities held by US insurance operations as at 31 December 2008 using Standard and Poor's (S&P), Moody's and Fitch ratings:

	2008 £m	2007 £m
	Carrying value	Carrying value
S&P – AAA	5,321	3,896
S&P – AA+ to AA-	853	1,187
S&P – A+ to A-	5,244	3,657
S&P – BBB+ to BBB-	7,077	5,415
S&P – Other	1,321	1,113
	19,816	15,268
Moody's – Aaa	458	549
Moody's – Aa1 to Aa3	100	118
Moody's – A1 to A3	111	47
Moody's – Baa1 to Baa3	100	79
Moody's – Other	95	78
	864	871
Fitch	464	380
Other	3,105	2,483
Total debt securities	24,249	19,002

In the table above, 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.

The amounts within Other which are not rated by S&P, Moody's or Fitch have the following NAIC classifications:

	2008 £m	2007 £m
NAIC 1	1,334	1,079
NAIC 2	1,650	1,311
NAIC 3-6	121	93
	3,105	2,483

ii Determining the fair value of debt securities when the markets are not active

Under IAS 39, unless categorised as 'held to maturity' debt securities are required to be fair valued. Where available, quoted market prices are used. However, where securities are in inactive markets, IAS 39 requires that valuation techniques be applied. Included in debt securities are debt securities with a fair value of £24,246 million (2007: £18,996 million) which are not quoted on active markets and for which fair value is determined using internal valuation techniques, or is provided by brokers or pricing services, where the specific securities have been valued using valuation techniques by these third-party providers. Jackson selects the source of pricing and/or the valuation technique with the objective of arriving at a fair value measurement which reflects the price at which an orderly transaction would take place between market participants on the measurement date. Jackson performs quantitative and qualitative analysis of prices received from third-parties e.g. independent brokers or pricing services to consider whether these prices represent fair value, particularly when the markets are not active for the securities concerned.

Debt securities of US insurance operations valued using internally derived valuation techniques in 2008 include certain asset-backed securities which had previously been valued using prices provided by a pricing service or brokers in the context of active markets. The use of such pricing sources has historically generated reliable fair values for these assets. The current market dislocations have caused a reassessment of the valuation process for these asset-backed securities. In particular, beginning at the end of the third quarter of 2008, the external prices obtained for certain asset-backed securities were deemed to be inappropriate in the current market conditions.

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

For the valuations at 31 December 2008, Jackson has therefore utilised internal valuation models, provided by PPM America, to derive fair values of all non agency residential mortgage-backed securities and asset-backed securities and certain commercial mortgage-backed securities. The use of internal valuation models has resulted in a fair value of these securities that was higher than those provided from pricing services and brokers of £760 million on a total amortised cost of £3.5 billion.

See note G1 for further details on the fair value measurement using valuation techniques when the markets are not active.

iii Sub-prime, Alt-A and CDO funds exposures

Included within the debt securities of Jackson at 31 December 2008 are exposures to sub-prime and Alt-A mortgages and CDO funds as follows:

	2008 £m	2007 £m
	Carrying value	Carrying value
Sub-prime mortgages (91% S&P rated AAA, 3% AA (2007: 100% S&P rated AAA))	291	237
Alt-A mortgages (60% AAA, 15% AA (2007: 77% AAA, 17% AA))	646	660
	937	897
CDO funds*	320	260
	1,257	1,157

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

Jackson defines its exposure to sub-prime mortgages as investments in residential mortgage-backed securities in which the underlying borrowers have a US Fair Isaac Credit Organisation (FICO) credit score of 659 or lower. With an average FICO score of 610-620, Jackson's sub-prime collateral could be categorised as 'near prime' with a score close to a prime score of 660.

iv Debt securities classified as available-for-sale in an unrealised loss position

Debt securities above are shown net of cumulative impairment losses on retained securities of £846 million (2007: £246 million).

The unrealised losses in the US insurance operations balance sheet on unimpaired securities are £(3,178) million (2007: £(439) million). This reflects assets with fair market value and book value of £17,422 million (2007: £10,291 million) and £20,600 million (2007: £10,730 million) respectively.

The following table shows the fair value of the debt securities in a gross unrealised loss position for various percentages of book value and by maturity of security at 31 December 2008:

Fair value of securities as a percentage of book value	2008 £m		2007 £m	
	Fair value	Unrealised loss	Fair value	Unrealised loss
Between 90% and 100%	8,757	(431)	9,370	(274)
Between 80% and 90%	4,581	(809)	784	(122)
Below 80%	4,084	(1,938)	137	(43)
	17,422	(3,178)	10,291	(439)

By maturity of security	2008 £m	2007 £m
	Unrealised loss	Unrealised loss
Less than 1 year	(21)	(1)
1 to 5 years	(537)	(54)
5 to 10 years	(1,236)	(164)
More than 10 years	(395)	(60)
Mortgage-backed securities	(989)	(160)
Total	(3,178)	(439)

As shown in the table above, £1,938 million of the £3,178 million of gross unrealised losses at 31 December 2008 related to securities whose fair value were below 80 per cent of the book value. The analysis of the £1,938 million, by category of debt securities and by age analysis indicating the length of time for which their fair value was below 80 per cent of the book value, are as follows:

Category analysis	2008 £m		2007 £m	
	Fair value	Unrealised loss	Fair value	Unrealised loss
Residential mortgage-backed securities				
Prime	287	(115)	2	(1)
Alt-A	144	(127)	27	(10)
Sub-prime	48	(39)	–	–
	479	(281)	29	(11)
Commercial mortgage-backed securities	198	(86)	4	(1)
Other asset-backed securities	811	(375)	4	(1)
Total structured securities	1,488	(742)	37	(13)
Corporates	2,596	(1,196)	100	(30)
Total	4,084	(1,938)	137	(43)

Age analysis	2008 £m		2007 £m	
	Fair value	Unrealised loss	Fair value	Unrealised loss
Less than 3 months	3,118	(1,364)	137	(43)
3 months to 6 months	696	(403)	–	–
More than 6 months	270	(171)	–	–
	4,084	(1,938)	137	(43)

The following table shows the aged analysis for all the unrealised losses in the portfolio by reference to the length of time the securities have been in an unrealised loss position:

Aged analysis of unrealised losses for the periods indicated	2008 £m			2007 £m		
	Non-investment grade	Investment grade	Total	Non-investment grade	Investment grade	Total
Less than 6 months	(108)	(362)	(470)	(9)	(58)	(67)
6 months to 1 year	(125)	(1,164)	(1,289)	(21)	(115)	(136)
1 year to 2 years	(154)	(622)	(776)	(2)	(21)	(23)
2 years to 3 years	(15)	(91)	(106)	(34)	(140)	(174)
3 years to 4 years	(56)	(418)	(474)	(1)	(8)	(9)
4 years to 5 years	(5)	(31)	(36)	–	(27)	(27)
5 years to 6 years	–	(27)	(27)	–	–	–
6 years to 7 years	–	–	–	(1)	(2)	(3)
	(463)	(2,715)	(3,178)	(68)	(371)	(439)

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

Fair value of securities as a percentage of book value	2008 £m		2007 £m	
	Fair value	Unrealised loss	Fair value	Unrealised loss
Between 90% and 100%	479	(27)	572	(24)
Between 80% and 90%	120	(19)	132	(22)
Below 80%	192	(166)	28	(10)
	791	(212)	732	(56)

Sub-prime and Alt-A securities with unrealised losses of £91 million (2007: £37 million) in the balance sheet at 31 December 2008 have been in an unrealised loss position for less than one year with the remaining securities with unrealised losses of £121 million (2007: £19 million) being in an unrealised loss position for more than one year.

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

e Products and guarantees

Jackson provides long-term savings and retirement products to retail and institutional customers throughout the US. Jackson offers fixed annuities (interest-sensitive, fixed indexed and immediate annuities), variable annuities (VA), life insurance and institutional products.

i Fixed annuities

Interest-sensitive annuities

At 31 December 2008, interest-sensitive fixed annuities accounted for 29 per cent (2007: 25 per cent) of policy and contract liabilities of Jackson. Interest-sensitive fixed annuities are primarily deferred annuity products that are used for retirement planning and for providing income in retirement. They permit tax-deferred accumulation of funds and flexible payout options.

The policyholder of an interest-sensitive fixed annuity pays Jackson a premium, which is credited to the policyholder's account. Periodically, interest is credited to the policyholder's account and in some cases administrative charges are deducted from the policyholder's account. Jackson makes benefit payments at a future date as specified in the policy based on the value of the policyholder's account at that date.

The policy provides that at Jackson's discretion it may reset the interest rate, subject to a guaranteed minimum. The minimum guarantee varies from 1.5 per cent to 5.5 per cent (2007: 1.5 per cent to 5.5 per cent) depending on the jurisdiction of issue and the date of issue, with 83 per cent (2007: 80 per cent) of the fund at three per cent or less. The average guarantee rate is 3.1 per cent (2007: 3.1 per cent).

Approximately 34 per cent (2007: 30 per cent) of the interest-sensitive fixed annuities Jackson wrote in 2008 provide for a market value adjustment, that could be positive or negative, on surrenders in the surrender period of the policy. This formula-based adjustment approximates the change in value that assets supporting the product would realise as interest rates move up or down. The minimum guaranteed rate is not affected by this adjustment.

Fixed indexed annuities

Fixed indexed annuities accounted for eight per cent (2007: seven per cent) of Jackson's policy and contract liabilities at 31 December 2008. Fixed indexed annuities vary in structure, but generally are deferred annuities that enable policyholders to obtain a portion of an equity-linked return (based on participation rates and caps) but provide a guaranteed minimum return. These guaranteed minimum rates are generally set at three per cent.

Jackson hedges the equity return risk on fixed indexed products using futures and options linked to the relevant index. The cost of these hedges is taken into account in setting the index participation rates or caps. Jackson bears the investment and surrender risk on these products.

Immediate annuities

At 31 December 2008, immediate annuities accounted for two per cent (2007: two per cent) of Jackson's policy and contract liabilities. Immediate annuities guarantee a series of payments beginning within a year of purchase and continuing over either a fixed period of years and/or the life of the policyholder. If the term is for the life of the policyholder, then Jackson's primary risk is mortality risk. The implicit interest rate on these products is based on the market conditions that exist at the time the policy is issued and is guaranteed for the term of the annuity.

ii Variable annuities

At 31 December 2008, VAs accounted for 39 per cent (2007: 45 per cent) of Jackson's policy and contract liabilities. VAs are deferred annuities that have the same tax advantages and payout options as interest-sensitive and fixed indexed annuities.

The primary differences between VAs and interest-sensitive or fixed indexed annuities are investment risk and return. If a policyholder chooses a VA, the rate of return depends upon the performance of the selected fund portfolio. Policyholders may allocate their investment to either the fixed or variable account. Investment risk on the variable account is borne by the policyholder, while investment risk on the fixed account is borne by Jackson through guaranteed minimum fixed rates of return. At 31 December 2008, approximately 18 per cent (2007: approximately nine per cent) of VA funds were in fixed accounts.

Jackson issues VA contracts where it contractually guarantees to the contractholder either a) return of no less than total deposits made to the contract adjusted for any partial withdrawals, b) total deposits made to the contract adjusted for any partial withdrawals plus a minimum return, or c) the highest contract value on a specified anniversary date adjusted for any withdrawals following the contract anniversary. These guarantees include benefits that are payable in the event of death (guaranteed minimum death benefit (GMDB)), annuitisation (guaranteed minimum income benefit (GMIB)), or at specified dates during the accumulation period (guaranteed minimum withdrawal benefit (GMWB)) and guaranteed minimum accumulation benefit (GMAB). Jackson hedges these risks using equity options and futures contracts as described in note D3(f). The GMIB is reinsured.

iii Life insurance

Jackson's life insurance products accounted for 10 per cent (2007: nine per cent) of Jackson's policy and contract liabilities at 31 December 2008. The products offered include variable universal life insurance, term life insurance and interest-sensitive life insurance.

iv Institutional products

Jackson's institutional products consist of GICs, funding agreements (including agreements issued in conjunction with Jackson's participation in the US Federal Home Loan Bank programme) and medium-term note funding agreements. At 31 December 2008, institutional products accounted for 12 per cent of policy and contract liabilities (2007: 12 per cent). Under a traditional GIC, the policyholder makes a lump sum deposit. The interest rate paid is fixed and established when the contract is issued. If deposited funds are withdrawn earlier than the specified term of the contract, an adjustment is made that approximates a market value adjustment.

Under a funding agreement, the policyholder either makes a lump sum deposit or makes specified periodic deposits. Jackson agrees to pay a rate of interest, which may be fixed but which is usually a floating short-term interest rate linked to an external index. The average term of the funding arrangements is one to two years. Funding agreements terminable by the policyholder with less than 90 days' notice account for one per cent (2007: less than one per cent) of total policyholder reserves.

Medium-term note funding agreements are generally issued to support trust instruments issued on non-US exchanges or to qualified investors (as defined by SEC Rule 144A). Through the funding agreements, Jackson agrees to pay a rate of interest, which may be fixed or floating, to the holders of the trust instruments.

f Exposure to market risk and risk management

Jackson's main exposures are to market risk through its exposure to interest rate risk and equity risk. Approximately 90 per cent (2007: 90 per cent) of its general account investments support interest-sensitive and fixed indexed annuities, life business and surplus and 10 per cent (2007: 10 per cent) support institutional business. All of these types of business contain considerable interest rate guarantee features and, consequently, require that the assets that support them are primarily fixed income or fixed maturity.

Prudential is exposed primarily to the following risks in the US arising from fluctuations in interest rates:

- The risk of loss related to meeting guaranteed rates of accumulation following a sharp and sustained fall in interest rates;
- the risk of loss related to policyholder withdrawals following a sharp and sustained increase in interest rates; and
- the risk of mismatch between the expected duration of certain annuity liabilities and prepayment risk and extension risk inherent in mortgage-backed securities.

Prudential is also exposed to the following risks in the US arising from equity market movements:

- The risk of loss related to the incidence of benefits related to guarantees issued in conjunction with its VA contracts;
- the risk of loss related to meeting contractual accumulation requirements in FIA contracts; and
- the risk that the hedge programme is not effective in mitigation of periodic accounting risk.

Jackson enters into financial derivative transactions, including those noted below to reduce and manage business risks. These transactions manage the risk of a change in the value, yield, price, cash flows, or quantity of, or a degree of exposure with respect to assets, liabilities or future cash flows, which Jackson has acquired or incurred.

Jackson uses free-standing derivative instruments for hedging purposes. Additionally, certain liabilities, primarily trust instruments supported by funding agreements, fixed indexed annuities, certain GMWB variable annuity features and reinsured GMIB variable annuity features contain embedded derivatives as defined by IAS 39, 'Financial Instruments: Recognition and Measurement'. Jackson does not account for such derivatives as either fair value or cash flow hedges as might be permitted if the specific hedge documentation requirements of IAS 39 were followed. Financial derivatives, including derivatives embedded in certain host liabilities that have been separated for accounting and financial reporting purposes are carried at fair value.

Value movements on the derivatives are reported within the income statement. Under the Group's accounting policies supplementary analysis of the profit before taxes attributable to shareholders is provided as shown in note B1. In preparing this analysis, value movements on Jackson's derivative contracts, other than for certain equity-based product management activities, are included within short-term fluctuations in investment returns and excluded from operating results based on longer-term investment returns. Value movements on derivative instruments used for certain equity-based product management activities, based on a static long-term volatility assumption and, for embedded liabilities, average Corporate AA interest rates, are included within operating results based on longer-term investment returns, as the value movements broadly offset the economic impact of changed levels of benefit payments and reserves as equity markets fluctuate. Any differences in value movements on these derivatives between the static long-term volatility assumption and implied volatility or average Corporate AA interest rates and ending Corporate AA interest rates is reflected as a component of short-term fluctuations. The types of derivatives used by Jackson and their purpose are as follows:

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

- Interest rate swaps generally involve the exchange of fixed and floating payments over the life of the agreement without an exchange of the underlying principal amount. These agreements are used for hedging purposes;
- put-swaption contracts provide the purchaser with the right, but not the obligation, to require the writer to pay the present value of a long-duration interest rate swap at future exercise dates. Jackson purchases and writes put-swaptions with maturities up to 10 years. On a net basis, put-swaptions hedge against significant upward movements in interest rates;
- equity index futures contracts and equity index call and put options are used to hedge Jackson's obligations associated with its issuance of fixed indexed immediate and deferred annuities and certain VA guarantees. These annuities and guarantees contain embedded options which are fair valued for financial reporting purposes;
- total return swaps in which Jackson receives equity returns or returns based on reference pools of assets in exchange for short-term floating rate payments based on notional amounts, are held for both hedging and investment purposes;
- cross-currency swaps, which embody spot and forward currency swaps and additionally, in some cases, interest rate swaps and equity index swaps, are entered into for the purpose of hedging Jackson's foreign currency denominated funding agreements supporting trust instrument obligations;
- spread cap options are used as a macro-economic hedge against declining interest rates. Jackson receives quarterly settlements based on the spread between the two-year and the 10-year constant maturity swap rates in excess of a specified spread; and
- credit default swaps, represent agreements under which Jackson has purchased default protection on certain underlying corporate bonds held in its portfolio. These contracts allow Jackson to sell the protected bonds at par value to the counterparty in the event of their default in exchange for periodic payments made by Jackson for the life of the agreement.

Note D3(j) parts (iii) and (iv) show the sensitivities of Jackson's results through its exposure to equity risk and interest rate risk.

g Process for setting assumptions and determining contract liabilities

Under the MSB of reporting applied under IFRS 4 for insurance contracts, providing the requirements of the Companies Act, UK GAAP standards and the ABI SORP are met, it is permissible to reflect the previously applied UK GAAP basis. Accordingly, and consistent with the basis explained in note A4, in the case of Jackson the carrying values of insurance assets and liabilities are consolidated into the Group accounts based on US GAAP.

Under US GAAP, investment contracts (as defined for US GAAP purposes) are accounted for by applying in the first instance a retrospective deposit method to determine the liability for policyholder benefits. This is then augmented by potentially three additional amounts. These amounts are for:

- Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (i.e. deferred income);
- any amounts previously assessed against policyholders that are refundable on termination of the contract; and
- any probable future loss on the contract (i.e. premium deficiency).

Capitalised acquisition costs and deferred income for these contracts are amortised over the life of the book of contracts. The present value of the estimated gross profits is generally computed using the rate of interest that accrues to policyholder balances (sometimes referred to as the contract rate). Estimated gross profits include estimates of the following elements, each of which will be determined based on the best estimate of amounts of the following individual elements over the life of the book of contracts without provision for adverse deviation for:

- Amounts expected to be assessed for mortality less benefit claims in excess of related policyholder balances;
- amounts expected to be assessed for contract administration less costs incurred for contract administration;
- amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances;
- amounts expected to be assessed against policyholder balances upon termination of contracts (sometimes referred to as surrender charges); and
- other expected assessments and credits.

VA contracts written by Jackson may, as described above, provide for GMDB, GMIB, GMWB and GMAB features. In general terms, liabilities for these benefits are accounted for under US GAAP by using estimates of future benefits and fees under best estimate persistency assumptions.

The GMDB liability is determined each period end by estimating the expected value of death benefits in excess of the projected account balance and recognising the excess ratably over the life of the contract based on total expected assessments. At 31 December 2008, the GMDB liability was valued using a series of deterministic investment performance scenarios, a mean investment return of 8.4 per cent (2007: 8.4 per cent) and assumptions for lapse, mortality and expense that are the same as those used in amortising the capitalised acquisition costs.

The direct GMIB liability is determined by estimating the expected value of the annuitisation benefits in excess of the projected account balance at the date of annuitisation and recognising the excess ratably over the accumulation period based on total expected assessments.

The assumptions used for calculating the direct GMIB liability at 31 December 2008 and 2007 are consistent with those used for calculating the GMDB liability.

Jackson regularly evaluates estimates used and adjusts the additional GMDB and GMIB liability balances, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised.

GMIB benefits are essentially fully reinsured, subject to annual claim limits. As this reinsurance benefit is net settled, it is considered to be a derivative under IAS 39 and is, therefore, recognised at fair value with the change in fair value included as a component of short-term derivative fluctuations.

Most GMWB features are considered to be embedded derivatives under IAS 39. Therefore, provisions for these benefits are recognised at fair value, with the change in fair value included in operating profit based on longer-term investment returns. Certain GMWB features guarantee payments over a lifetime and, therefore, include mortality risk. Provisions for these GMWB amounts are valued consistent with the GMDB valuation method discussed above.

For periods prior to 2008, the fair values of Jackson's GMWB reserves and GMIB reinsurance were calculated based on actuarial and capital market assumptions related to projected cash flows, including benefits and related contract charges, over the lives of the contracts, incorporating expectations concerning policyholder behaviour such as lapses, fund selection, resets and withdrawal utilisation. Because of the dynamic and complex nature of these cash flows, best estimate assumptions and a stochastic process involving the generation of thousands of scenarios that assume risk neutral returns consistent with swap rates and incorporating implied volatility data and evaluations of historical volatilities for various indices were used. Estimating these cash flows involved numerous estimates and subjective judgements including those regarding expected market rates of return, market volatility, correlations of market index returns to funds, fund performance, discount rates, utilisation of the benefit by policyholders under varying conditions and policyholder lapsation.

At each valuation date, Jackson assumed expected returns based on risk-adjusted spot rates as represented by the LIBOR forward curve as of that date and market volatility as determined with reference to implied volatility and evaluations of historical volatilities for various indices. The risk-adjusted spot rates as represented by the LIBOR spot curve as of the valuation date were used to determine the present value of expected future cash flows produced in the stochastic process. As GMWB obligations are relatively new in the marketplace, actual policyholder behaviour experience is limited. As a result, estimates of future policyholder behaviour are subjective and based on internal and external data. As markets change, mature and evolve and actual policyholder behaviour emerges, management continually evaluates the appropriateness of its assumptions for this component of the fair value model.

Effective 1 January 2008, Jackson re-evaluated certain assumptions used in the calculation of the reserves related to GMWB and GMIB reinsurance. As a result, Jackson now bases its volatility assumptions solely on implied market volatility with no reference to historical volatility levels and explicitly incorporates Jackson's own credit risk in place of the risk-adjusted rates referenced above. Volatility assumptions are now based on a weighting of available market data on implied volatility for durations up to 12 years, at which point the projected volatility is held constant. Non-performance risk is incorporated into the calculation through the use of interest rates sourced from a AA corporate credit curve. Other risk margins, particularly for market illiquidity and policyholder behaviour are also incorporated into the model through the use of explicitly conservative assumptions. On a periodic basis, Jackson rationalises the resulting fair values based on comparisons to other models and market movements.

With the exception of the GMDB, GMIB, GMWB and GMAB features of VA contracts, the financial guarantee features of Jackson's contracts are in most circumstances not explicitly valued, but the impact of any interest guarantees would be reflected as they are earned in the current account value (i.e. the US GAAP liability).

For traditional life insurance contracts, provisions for future policy benefits are determined under US GAAP standards SFAS 60, 'Accounting and Reporting by Insurance Enterprises' using the net level premium method and assumptions as of the issue date as to mortality, interest, policy lapses and expenses plus provisions for adverse deviation.

Institutional products are accounted for as investment contracts under IFRS with the liability classified as being in respect of financial instruments rather than insurance contracts, as defined by IFRS 4. In practice, there is no material difference between the IFRS and US GAAP basis of recognition and measurement for these contracts.

Certain institutional products representing obligations issued in currencies other than US dollars have been hedged for changes in exchange rates using cross-currency swaps. The fair value of derivatives embedded in funding agreements, as well as foreign currency transaction gains and losses, are included in the carrying value of the trust instruments supported by funding agreements recorded in other non-insurance liabilities.

h Reinsurance

The principal reinsurance ceded by Jackson outside the Group is on term life insurance, direct and assumed accident and health business and GMIB variable annuity guarantees. In 2008, the premiums for such ceded business amounted to £68 million (2007: £60 million). Net commissions received on ceded business and claims incurred ceded to external reinsurers totalled £10 million and £49 million, respectively, during 2008 (2007: £10 million and £47 million respectively). There were no deferred gains or losses on reinsurance contracts in either 2008 or 2007. The reinsurance asset for business ceded outside the Group was £800 million (2007: £436 million).

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

i Assumptions used to measure insurance assets and liabilities

2008

a Measurement basis for embedded derivatives of variable annuity business

There were no changes of assumptions that had a material effect on the Jackson results. However, there has been a significant change of estimation technique for two aspects of the basis of measuring 'embedded derivatives' for Guaranteed Minimum Withdrawal Benefit (GMWB) features of Jackson's variable annuity products and the reinsurance of the Guaranteed Minimum Income Benefit (GMIB). The two aspects are for the application of:

- i Implied current equity volatility levels rather than historic long-term average levels, which had been applied previously, and
- ii The reference basis for determining the discount rate to apply to future cash flows in the projection of the effect of the guarantees.

The change is to apply AA corporate bond rates based off appropriate Merrill Lynch indices, rather than LIBOR based swap rates that, in 2008, had become both anomalously low and distorted by comparison to US Treasury bond curve rates. In broad terms, corporate AA rates were approximately 400 basis points higher than the LIBOR based swap rates at the end of 2008. Similarly, at the beginning of 2008 corporate AA rates were approximately 100 basis points higher than the LIBOR based swap rate.

The effect of the change in respect of equity volatility is to increase the total loss for 2008 for Jackson by £126 million. The effect of the change for the reference basis for discounting is to reduce the total loss by £173 million.

b Deferred acquisition costs

Income statement – amortisation for variable annuity business

Under IFRS 4, the Group applies US GAAP to the insurance assets and liabilities of Jackson. Under the US GAAP standard FAS 97, acquisition costs for Jackson's fixed and variable annuity business are deferred and then amortised in line with the expected emergence of margins. The amortisation profile is dependant on assumptions which, for variable annuity business, the key assumption is the expected level of equity market returns. For 2008 and recent previous years a rate of 8.4 per cent has been applied using, as is industry practice, a mean reversion methodology.

The mean reversion methodology is applied with the objective of adjusting the amortisation of deferred acquisition costs that would otherwise be highly volatile for the fact that the expected level of future gross profits fluctuates for altered variable annuity asset values arising from changes in equity market levels at the end of each reporting period.

The mean reversion methodology achieves this objective by dynamic adjustment to the level of expectations of short-term future investment returns. Under the methodology the projected returns for the next five years are, for the purposes of determining the amortisation profile, set so that normally combined with the actual returns for the current and preceding two years the average rate of return is 8.4 per cent. The mean reversion methodology does, however, include a cap of 15 per cent per annum on the project return for each of the next five years. For 2008 this capping effect applied to restrict the projected returns below the rate of approximately 20 per cent per annum level that would have otherwise applied. Projected returns after the next five years are set at 8.4 per cent.

In 2008, US equity market indices fell by some 38.5 per cent. If there had been no mean reversion methodology in place there would have been an increased amortisation charge of approximately £250 million.

However, as noted above, the mean reversion methodology allows for a substantial, but not complete, recovery of the lost fund value. As a result, DAC amortisation, reflected in the 2008 results after incorporating the mean reversion has instead increased by some £140 million, of which £40 million arises due to the capping feature.

Statement of changes in equity – 'shadow DAC adjustments'

Consequent upon the negative unrealised valuation movement in 2008 of £(2,710) million (2007: £(244) million) there is a credit of £1,070 million (2007: £88 million) for altered 'shadow' amortisation booked within the statement of changes in equity. These adjustments reflect the changes to the pattern of reported gross profits that would have happened if the assets had been sold, crystallising the loss, and the proceeds reinvested at correspondingly higher current yields. In the event of further unrealised losses, this dynamic would be constrained under two circumstances. Firstly, the DAC asset would not be written up any further beyond the original deferral plus a provision for interest accrual on the asset. Secondly, and more generally, the write up of DAC would be constrained if not supported by expectations of future profitability.

2007

The operating profit based on longer-term investment returns of £444 million for US insurance operations for 2007 has been determined after taking account of several changes of assumptions during the year. Generally, assumptions were modified in 2007 to conform to more recent experience. These changes included revisions to the assumptions regarding mortality rates, resulting in an increase in operating profits of £14 million, and utilisation of free partial withdrawal options, resulting in a decrease to operating profits of £4 million. In addition, several smaller changes relating to lapse rates and other assumptions resulted in a decrease of £2 million in operating profits. Combined with other minor modifications, the resulting net impact of all changes during the year was an increase in pre-tax profits of £8 million.

j Sensitivity of IFRS basis profit and equity to market and other risks

i 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 2008, the rates were US\$1.85 (2007: US\$2.00) and US\$1.44 (2007: US\$1.99) 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	
	2008	2007	2008	2007
(Loss) profit before tax attributable to shareholders*	59	(39)	(72)	48
(Loss) profit for the year	51	(29)	(62)	35
Shareholders' equity attributable to US insurance operations	(158)	(242)	193	296

* Sensitivity on (loss) profit before tax i.e. aggregate of the operating profit based on longer-term investment returns and short-term fluctuations, as discussed in note B1.

The opposite effect of a 10 per cent increase and decrease of exchange rates on (loss) profit for 2008 compared to 2007 is due to a loss before and after tax for 2008 compared to a profit before and after tax for 2007.

ii 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 the effectiveness of the related hedge programme; 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 2008 and 2007 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. The mean reversion methodology dampens the impact of equity market movements during a particular year, but does not fully eliminate the effects of movements in the equity markets.

In addition, the mean reversion methodology includes both a cap and a floor that determine the maximum impact that the methodology may have. Due to the significant market movements during 2008, Jackson exceeded the cap on future equity market returns, resulting in a higher level of DAC amortisation than would have been recognised had the cap not been met.

- 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.

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

iii Exposure to equity risk

As noted in note D3(f), Jackson is exposed to equity risk through the options embedded in the fixed indexed liabilities and GMDB and GMWB guarantees included in certain VA benefits. This risk is managed using 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 mute the immediate impact of the market movements as the free-standing derivatives reset immediately while the hedged liabilities reset more slowly (see note D3(g) for further details on the valuation of the guarantees) and fees are recognised prospectively.

At 31 December 2008 based on the hedges in place at that time, it is estimated that an immediate decrease in the equity markets of 10 per cent would result in an accounting charge, net of related DAC amortisation, before tax of up to £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 2008 of up to £15 million. An immediate decrease in the equity markets of 20 and 40 per cent would result in an accounting charge, net of related DAC amortisation, before tax of up to £40 million and £90 million respectively, 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 2008 of up to £30 million and £60 million respectively. Since the year-end we have implemented additional equity hedging to reduce the exposure to further falls in the level of the S&P index.

An immediate increase in the equity markets of the percentages above would result in an approximately equal and opposite estimated effect on profit and shareholders' equity. At 31 December 2007, it was estimated that an immediate decrease in the equity markets at 10 per cent would result in an accounting benefit, net of related DAC amortisation, before tax of up to £30 million, excluding the impact on future separate account fees. After related deferred tax, it was estimated that there would have been an increase in shareholders' equity of up to £20 million. The difference in the effects of a decrease in the equity markets at 31 December 2008 and 2007 was due to an increased number of GMDB and GMWB guarantees being 'in the money'. As a result of this changed position, the adverse effects from a decreasing equity market at 31 December 2008 more than offsets the benefits from the hedging instruments.

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.

Jackson has extended the range of reasonably possible movements in the value of equity securities, partnerships in investment pools and other financial derivatives at 31 December 2008. Consequently, in addition to the movement of 10 per cent as applied at 31 December 2007, for 2008, Jackson has also estimated the sensitivity to movements of 20 and 40 per cent. A 10 per cent fall in their value at 31 December 2008 and 2007 and a 20 and 40 per cent fall in their value at 31 December 2008 would have given rise to the following effects on pre-tax profit, net of related changes in amortisation of DAC, profit after tax and shareholders' equity.

	2008 £m			2007 £m
	A decrease of 40%	A decrease of 20%	A decrease of 10%	A decrease of 10%
Pre-tax profit, net of related changes in amortisation of DAC	(255)	(141)	(98)	(76)
Related deferred tax effects	89	49	34	26
Net sensitivity of profit after tax and shareholders' equity	(166)	(92)	(64)	(50)

iv Exposure to interest rate risk

Notwithstanding the market risk exposure described in note D3(f), except in the circumstances of interest rate scenarios where the guarantee rates included in contract terms are higher than crediting rates that can be supported from assets held to cover liabilities, the accounting measurement of fixed annuity liabilities of Jackson products is not generally sensitive to interest rate risk. This position derives from the nature of the products and the US GAAP basis of measurement described in notes D3(e) and D3(g). The GMWB features attaching to variable annuity business represents embedded derivatives which are fair valued and so will be sensitive to changes in interest rate.

Debt securities and related derivatives are marked to fair value. Value movements on derivatives, again net of related changes to amortisation of DAC and deferred tax, are recorded within profit and loss. Fair value movements on debt securities, net of related changes to amortisation of DAC and deferred tax, are recorded within the statement of changes in equity. Similar to the sensitivity analysis to equity prices movement above, Jackson has extended the range of the movements in interest rates that are reasonably possible to occur at 31 December 2008 in its sensitivity analysis. In addition to the movement in interest rates of one per cent as applied at 31 December 2007, for 2008, Jackson has also estimated the sensitivity to movement in interest rates of two per cent. The estimated sensitivity of these items and policyholder liabilities to a one per cent decrease and increase in interest rates at 31 December 2008 and 2007 and to a two per cent decrease and increase in interest rates at 31 December 2008 is as follows:

	2008 £m				2007 £m	
	A 2% decrease	A 1% decrease	A 1% increase	A 2% increase	A 1% decrease	A 1% increase
Profit and loss						
Direct effect						
Derivatives value change	(575)	(268)	283	639	(116)	163
Policyholder liabilities	(517)	(218)	182	350	(38)	29
Related effect on amortisation of DAC	498	215	(193)	(395)	52	(58)
Pre-tax profit effect						
Operating profit based on longer-term investment returns	(128)	(59)	64	146	(15)	11
Short-term fluctuations in investment returns	(466)	(212)	208	448	(87)	123
	(594)	(271)	272	594	(102)	134
Related effect on charge for deferred tax	206	94	(95)	(207)	36	(47)
Net profit effect	(388)	(177)	177	387	(66)	87
Statement of changes in equity						
Direct effect on carrying value of debt securities	2,476	1,238	(1,238)	(2,476)	848	(848)
Related effect on amortisation of DAC	(619)	(310)	310	619	(212)	212
Related effect on movement in deferred tax	(650)	(325)	325	650	(223)	223
Net effect	1,207	603	(603)	(1,207)	413	(413)
Total net effect on IFRS equity	819	426	(426)	(820)	347	(326)

k Duration of liabilities

The Group uses cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results. The maturity profile of the cash flows used for that purpose for 2008 and 2007 is as follows:

	2008 £m		2007 £m	
	Fixed annuity and other business (including GICs and similar contracts)	Variable annuity	Fixed annuity and other business (including GICs and similar contracts)	Variable annuity
Policyholder liabilities	30,823	14,538	19,821	15,027
	%	%	%	%
Expected maturity:				
0 to 5 years	49	46	51	48
5 to 10 years	26	28	26	30
10 to 15 years	11	14	11	13
15 to 20 years	6	7	5	6
20 to 25 years	3	3	3	2
Over 25 years	5	2	4	1

The maturity tables shown above have been prepared on a discounted basis. Details of undiscounted cash flows for investment contracts are shown in note G2.

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations

a Summary balance sheet

	With-profits business <small>note i</small> £m	Unit-linked assets and liabilities £m	Other £m	Asian insurance operations	
				2008 Total £m	2007 Total £m
Assets					
Intangible assets attributable to shareholders:					
Goodwill	–	–	111	111	111
Deferred acquisition costs and other intangible assets	–	–	1,247	1,247	745
Total	–	–	1,358	1,358	856
Intangible assets attributable to with-profit funds:					
Deferred acquisition costs and other intangible assets	113	–	–	113	–
Deferred tax assets	–	–	101	101	73
Other non-investment and non-cash assets	225	136	1,055	1,416	689
Investments of long-term business and other operations:					
Investment properties	–	–	20	20	14
Financial investments:					
Loans ^{note ii}	809	113	783	1,705	1,087
Equity securities and portfolio holdings in unit trusts	2,800	4,846	431	8,077	9,804
Debt securities ^{note d}	5,201	1,889	4,023	11,113	6,920
Other investments	11	68	65	144	42
Deposits	45	414	291	750	377
Total investments	8,866	7,330	5,613	21,809	18,244
Cash and cash equivalents	646	169	686	1,501	679
Total assets	9,850	7,635	8,813	26,298	20,541

	With-profits business note 1 £m	Unit-linked assets and liabilities £m	Other £m	Asian insurance operations	
				2008 Total £m	2007 Total £m
Equity and liabilities					
Equity					
Shareholders' equity	–	–	2,167	2,167	1,369
Minority interests	–	–	7	7	7
Total equity	–	–	2,174	2,174	1,376
Liabilities					
Policyholder liabilities and unallocated surplus of with-profits funds:					
Insurance contract liabilities	7,823	7,220	5,755	20,798	16,912
Investment contract liabilities with discretionary participation features	79	–	–	79	84
Investment contract liabilities without discretionary participation features	32	–	–	32	37
Unallocated surplus of with-profits funds	160	–	–	160	146
Total	8,094	7,220	5,755	21,069	17,179
Other non-insurance liabilities:					
Operational borrowings attributable to shareholders-financed operations					
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	832	322	–	1,154	506
Current tax liabilities	4	–	72	76	24
Deferred tax liabilities	239	–	202	441	362
Accruals and deferred income	–	–	130	130	111
Other creditors	556	–	240	796	627
Provisions	9	–	28	37	33
Derivative liabilities	30	–	2	32	2
Other liabilities	86	93	80	259	321
Total	1,756	415	754	2,925	1,986
Total liabilities	9,850	7,635	6,639	24,124	19,165
Total equity and liabilities	9,850	7,635	8,813	26,298	20,541

Notes

- i The balance sheet for with-profits business comprises the with-profits assets and liabilities of the Hong Kong, Malaysia and Singapore with-profits operations. Assets and liabilities of other participating business are included in the column for 'other business'.
- ii The loans of the Group's Asian insurance operations of £1,705 million (2007: £1,087 million) comprise mortgage loans of £238 million (2007: £132 million), policy loans of £675 million (2007: £430 million) and other loans of £792 million (2007: £525 million). The mortgage and policy loans are secured by properties and life insurance policies respectively. The majority of the other loans are commercial loans held by the Malaysian operation and which are all investment graded by two local rating agencies.

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations continued

Summary policyholder liabilities (net of reinsurance) and unallocated surplus

The policyholder liabilities (net of reinsurance of £24 million (2007: £12 million)) and unallocated surplus shown in the table above reflect the following balances:

	2008 £m	2007 £m
With-profits business	7,934	6,397
Unallocated surplus of Asian with-profits operations	160	146
Unit-linked business	7,220	6,971
Other business	5,731	3,653
	21,045	17,167

At 31 December 2008, the policyholder liabilities (net of reinsurance) and unallocated surplus for Asian operations of £21.0 billion (2007: £17.2 billion) comprised the following:

	2008 £m	2007 £m
Singapore	5,426	5,462
Hong Kong	5,100	3,901
Taiwan	4,024	2,781
Malaysia	1,587	1,201
Japan	1,100	695
Other countries	3,808	3,127
Total Asian operations	21,045	17,167

b Reconciliation of movement in investments

A reconciliation of the total investments of Asian insurance operations from the beginning of the year to the end of the year is as follows:

	With-profits business £m	Unit-linked assets and liabilities £m	Other £m	Asian insurance operations Total £m
At 1 January 2007				
Total investments	5,945	4,066	3,714	13,725
Less: Investments held by consolidated investment funds	(242)	0	(305)	(547)
Less: Derivative liabilities	0	0	(4)	(4)
Directly held investments, net of derivative liabilities	5,703	4,066	3,405	13,174
Net cash inflow from operating activities	858	1,965	(92)	2,731
Realised gains (losses) in the year	783	327	374	1,484
Unrealised gains (losses) in the year	(255)	286	(159)	(128)
Foreign exchange translation differences	111	146	41	298
Movement in the year of directly held investments, net of derivative liabilities	1,497	2,724	164	4,385
At 31 December 2007/1 January 2008				
Total investments	7,418	6,790	4,036	18,244
Less: Investments held by consolidated investment funds	(218)	0	(465)	(683)
Less: Derivative liabilities ^{note G3}	0	0	(2)	(2)
Directly held investments, net of derivative liabilities	7,200	6,790	3,569	17,559
Net cash inflow from operating activities	342	1,786	468	2,596
Realised gains (losses) in the year	(236)	(99)	62	(273)
Unrealised gains (losses) in the year	(1,362)	(2,685)	(152)	(4,199)
Foreign exchange translation differences	2,217	1,385	1,391	4,993
Movement in the year of directly held investments, net of derivative liabilities	961	387	1,769	3,117
At 31 December 2008				
Total investments	8,866	7,330	5,613	21,809
Less: Investments held by consolidated investment funds	(705)	(153)	(243)	(1,101)
Less: Derivative liabilities ^{note G3}	-	-	(32)	(32)
Directly held investments, net of derivative liabilities	8,161	7,177	5,338	20,676

c Reconciliation of movement in policyholder liabilities and unallocated surplus of with-profits funds

A reconciliation of the total policyholder liabilities and unallocated surplus of with-profits funds of Asian insurance operations from the beginning of the year to the end of the year is as follows:

	With-profits business £m	Unit-linked assets and liabilities £m	Other £m	Asian insurance operations Total £m
At 1 January 2007	5,500	4,134	3,255	12,889
Premiums	860	2,457	641	3,958
Surrenders	(146)	(689)	(197)	(1,032)
Maturities/Deaths	(183)	(52)	(160)	(395)
Shareholders transfer post tax	(21)	–	–	(21)
Investment-related items and other movements	441	914	103	1,458
Foreign exchange translation differences	96	207	19	322
At 31 December 2007/1 January 2008	6,547	6,971	3,661	17,179
Premiums	1,038	2,261	863	4,162
Surrenders	(354)	(614)	(223)	(1,191)
Maturities/Deaths	(181)	(14)	(159)	(354)
Shareholders' transfers post tax	(23)	–	–	(23)
Investment-related items and other movements	(1,320)	(3,158)	185	(4,293)
Foreign exchange translation differences	2,387	1,774	1,428	5,589
At 31 December 2008	8,094	7,220	5,755	21,069

The positive investment related items and other movements seen within Other during 2008 are principally driven from unwinding the discounted liabilities using the valuation interest rate. Variable annuity separate account liabilities are mainly impacted by market movements.

d Information on credit risks of debt securities

The following table summarises the credit quality of the debt securities of the Asian insurance operations as at 31 December 2008 by rating agency rating:

	2008 £m				2007 £m
	With-profits business	Unit-linked business	Other business	Total	Total
S&P – AAA	2,085	341	206	2,632	2,284
S&P – AA+ to AA-	997	303	2,446	3,746	1,994
S&P – A+ to A-	640	96	72	808	675
S&P – BBB+ to BBB-	198	184	520	902	193
S&P – Other	77	63	113	253	149
	3,997	987	3,357	8,341	5,295
Moody's – Aaa	382	54	58	494	201
Moody's – Aa1 to Aa3	77	20	11	108	45
Moody's – A1 to A3	80	287	31	398	28
Moody's – Baa1 to Baa3	50	6	4	60	19
Moody's – Other	8	39	3	50	58
	597	406	107	1,110	351
Fitch	7	30	4	41	1
Other	600	466	555	1,621	1,273
Total debt securities	5,201	1,889	4,023	11,113	6,920

The increase in holdings of debt securities for Asian operations was principally due to exchange rate movements, a rise in the number of unit trusts and similar funds requiring consolidation, and portfolio change for equities to bonds.

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations continued

Of the £555 million (2007: £598 million) debt securities for other business which are not rated in the table above, £231 million (2007: £317 million) are in respect of government bonds, £221 million (2007: £83 million) corporate bonds rated as investment grade by local external ratings agencies, and nil (2007: £71 million) structured deposits issued by banks which are themselves rated but where the specific deposits have not been.

e Products and guarantees

The life insurance products offered by the Group's Asian operations include a range of with-profits and non-participating term, whole life, endowment and unit-linked policies. The Asian operations also offer health, disability, critical illness and accident coverage to supplement its core life products.

The terms and conditions of the contracts written by the Asian operations and, in particular, the products' options and guarantees, vary from territory to territory depending upon local market circumstances.

In general terms, the Asian participating products provide savings and protection where the basic sum assured can be enhanced by a profit share (or bonus) from the underlying fund as determined at the discretion of the insurers. The Asian operations' non-participating term, whole life and endowment products offer savings and/or protection where the benefits are guaranteed or determined by a set of defined market-related parameters. Unit-linked products combine savings with protection, the cash value of the policy depends on the value of the underlying unitised funds. Accident and Health (A&H) policies provide mortality or morbidity benefits and include health, disability, critical illness and accident coverage. A&H products are commonly offered as supplements to main life policies but can be sold separately.

Subject to local market circumstances and regulatory requirements, the guarantee features described in note D2(e) in respect of UK business broadly apply to similar types of participating contracts written in the Hong Kong branch, Singapore and Malaysia. Participating products have both guaranteed and non-guaranteed elements.

Non-participating long-term products are the only ones where the insurer is contractually obliged to provide guarantees on all benefits. Investment-linked products have the lowest level of guarantee if indeed they have any.

Product guarantees in Asia can be broadly classified into four main categories, namely premium rate, cash value and interest rate guarantees, policy renewability, and convertibility options.

The risks on death coverage through premium rate guarantees are low due to appropriate product pricing.

Cash value and interest rate guarantees are of three types:

- **Maturity values**
Maturity values are guaranteed for non-participating products and on the guaranteed portion of participating products. Declared annual bonuses are also guaranteed once vested. Future bonus rates and cash dividends are not guaranteed on participating products.
- **Surrender values**
Surrender values are guaranteed for non-participating products and on the guaranteed portion of participating products. The surrender value of declared reversionary bonuses are also guaranteed once vested. Market value adjustments and surrender penalties are used where the law permits such adjustments in cash values.
- **Interest rate guarantees**
It is common in Asia for regulations or market-driven demand and competition to provide some form of capital value protection and minimum crediting interest rate guarantees. This would be reflected within the guaranteed maturity and surrender values. The guarantees are borne by shareholders for non-participating and investment-linked (non-investment guarantees only) products. Participating product guarantees are predominantly supported by the segregated life funds and their estates.

The most significant book of non-participating business in the Asian operations is Taiwan's whole of life contracts. For these contracts there are floor levels of policyholder benefits that accrue at rates set at inception which are set by reference to minimum terms established by local regulation also at the time of inception. These rates do not vary subsequently with market conditions.

Under these contracts, the cost of premiums are also fixed at inception based on a number of assumptions at that time, including long-term interest rates, mortality assumptions and expenses. The guaranteed maturity and surrender values reflect the pricing basis. The main variable that determines the amounts payable under the contracts is the duration of the contracts, which is determined by death or surrender. The sensitivity of the IFRS result for these contracts is shown in note (j) below.

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 2008 of £312 million and £742 million respectively (2007: £261 million and £728 million respectively). The business is much less sensitive to returns than Taiwan with a 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 significantly increased leaving the potential for losses if bond values had depreciated significantly. However, the business is matched to a relatively short realistic liability duration.

The method for determining liabilities of insurance contracts for UK GAAP, and hence IFRS, purposes for some Asian operations is based on US GAAP principles and this method applies to contracts with cash value and interest rate guarantees. Following standard US GAAP procedure, premium deficiency reserve calculations are performed each year to establish whether the carrying values of the liabilities are sufficient.

On the US GAAP basis the calculations are deterministic, that is to say based on a single set of projections, and expected long-term rates of return are applied.

f Exposure to market risk

The Asian operations sell with-profits and unit-linked policies and, although the with-profits business generally has a lower terminal bonus element than in the UK, the investment portfolio still contains a proportion of equities and, to a lesser extent, property. Non-participating business is largely backed by debt securities or deposits. With the principal exception of Taiwan's whole of life policy book, as described in note (j) below, the exposure to market risk of the Group arising from its Asian operations is at modest levels. This arises from the fact that the Asian operations have a balanced portfolio of with-profits, unit-linked and other types of business.

g Process for setting assumptions and determining liabilities

The future policyholder benefit provisions for Asian businesses in the Group's IFRS accounts and previously under the MSB, are determined in accordance with methods prescribed by local GAAP adjusted to comply, where necessary, with UK GAAP.

For Asian operations in countries where local GAAP is not well established and in which the business written is primarily non-participating and linked business, US GAAP is used as the most appropriate reporting basis. Of the more significant Asian operations, this basis is applied in Taiwan, Japan and Vietnam. The future policyholder benefit provisions for non-linked business are determined under FAS 60 using the net level premium method, with an allowance for surrenders, maintenance and claims expenses. Rates of interest used in establishing the policyholder benefit provisions vary by operation depending on the circumstances attaching to each block of business.

For the traditional business in Taiwan, the economic scenarios used to calculate the IFRS results reflect the assumption of a phased progression of bond yields from current rates to long-term expected rates. The projections assume that the current bond yields of around 1.4 per cent (2007: 2.5 per cent) trend towards 5.5 per cent (2007: 5.5 per cent) at 31 December 2018 (2007: 2013).

h Reinsurance

The Asian businesses cede only minor amounts of business outside the Group with immaterial effects on reported profit. During 2008, reinsurance premiums for externally ceded business were £76 million (2007: £52 million) and the reinsurance assets were £24 million (2007: £12 million) in aggregate.

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

a Changes in key assumptions

For 2008, the result for Asian operations was reduced by the effect of a number of individually small assumptions changes of, in aggregate, £21 million. There were no changes of assumptions that had a material impact on the 2007 results for Asian operations.

For the Taiwanese life operation the profits attaching to legacy interest rate guaranteed products 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 previously applied 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 reinvestment income. The assumed earned rates are used to discount the future cash flows. For 2008 the projection assumes that the current bond yields at 31 December 2008 of 1.4 per cent trend towards 5.5 per cent at 31 December 2018. This compares to the 2007 results for which the projections assume the current bond yields of around 2.5 per cent trend towards 5.5 per cent at 31 December 2013. Under the liability adequacy testing applied for IFRS the change of progression period had no effect on the carrying value of the deferred acquisition costs or liability to policyholders.

The liability adequacy test is more sensitive to changes in the expected long-term rate, further delays in the assumed progression period, or a combination thereof. However, as explained in note 110, on 20 February 2009 the Company announced the intended sale of the legacy agency book and agency force in Taiwan to China Life Insurance of Taiwan.

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations continued

b Deferral and amortisation of acquisition costs

Under IFRS, the basis of accounting for insurance assets and liabilities reflects 'grandfathered' GAAP under the Modified Statutory Basis. In general, this requires the deferral and amortisation of acquisition costs in line with the emergence of margins. In 2008, the basis of deferral and amortisation has been adjusted for a number of territories to better reflect the MSB requirement as follows:

For the India life operation, reflecting the initial development stage of the business, acquisition costs had previously not been deferred. In 2008, £19 million of deferred acquisition costs, net of amortisation in the year, has been established.

For the Korea life business, the deferral of acquisition costs had previously followed the local regulatory basis as being an appropriate proxy for the MSB basis. The regulatory basis is subject to constraints in respect of assumptions for expense loadings, the amortisation period, and the DAC balance not being higher than the cash surrender value. This basis is no longer appropriate and on adjusting the basis £9 million of DAC has been established that reflects a revised estimate of the 1 January 2008 balance and a charge of £26 million for current year acquisition costs (net of amortisation) for applying the more appropriate basis.

For Singapore, refinements have been made with a £21 million benefit (of which £7 million relates to the 1 January 2008 position) where the local risk based capital approach does not provide an appropriate basis of implicit allowance for acquisition costs for certain products.

In Hong Kong, adjustments have been made with a net overall effect of £10 million.

j Sensitivity of IFRS basis profit and equity to market and other risks

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. For 2008, the rates for the most significant operations are given in note B4.

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	
	2008 £m	2007 £m	2008 £m	2007 £m
Profit before tax attributable to shareholders*	(14)	(16)	18	20
Profit for the year	(6)	(10)	8	13
Shareholders' equity, excluding goodwill, attributable to Asian operations	(202)	(124)	246	151

*Sensitivity on profit before tax i.e. aggregate of the operating profit based on longer-term investment returns, short-term fluctuations in investment returns, and actuarial gains and losses on defined benefit pension schemes, as discussed in note B1.

Other 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 is 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 which is most sensitive to interest rates 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 eight per cent to current levels of around 1.4 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 £50 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 2008 and 2007, it has been projected that rates of return for Taiwanese bond yields will trend from the current levels of some 1.4 per cent (2.5 per cent) to 5.5 per cent by 31 December 2018 (2007: 5.5 per cent by 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 2009 and 2010 and the target date for attainment of the long-term bond yield deferred to 31 December 2020, 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 2008 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 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 2008, if the assumed long-term bond yield applied had been reduced by both 0.5 and 1.0 per cent from 5.5 per cent to 4.5 per cent and continued to apply the same progression period to 31 December 2018, 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. 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 £150 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 rate to the long-term rate and the assumed timing of attainment of the rate may be insufficient and they would have been deferred. Based on the in-force business at 31 December 2008, a delay of one to two years in the attainment of the long-term rate of 5.5 per cent would not give rise to an additional charge. Based on the in-force business at 31 December 2008, a delay of three to four years in the attainment of the long-term rate of 5.5 per cent would not give rise to a significant charge. A delay of five years would give rise to a charge of some £60 million.

For the Korean and Japanese life business exposures described in note (e) above, the results are comparatively unaffected by changes of assumption.

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.

Excluding with-profit and unit-linked business along with Taiwan, which is detailed above, 71 per cent (2007: 72 per cent) of the bond portfolio for other business of Asian operations at 31 December 2008 was held in Japan, Singapore and Vietnam with corporate bond rates varying from territory to territory and ranging from 1.17 per cent to 10.18 per cent at 31 December 2008 (1.5 per cent to 9.1 per cent at 31 December 2007) 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 0.5 per cent for Japan, 1.0 per cent for Singapore and 1.5 per cent for Vietnam.

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations continued

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 2008 has been assessed, with rate movements ranging from 0.5 per cent to 1.5 per cent (2007: 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 £56 million (2007: £30 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 £45 million (2007: £22 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.

In light of the recent market conditions, the Group has extended the range of reasonably possible movements in the value of equity prices at 31 December 2008. Consequently, in addition to the movement of 10 per cent as applied at 31 December 2007, for 2008, the Group has also estimated the sensitivity to movements of 20 and 40 per cent. The estimated sensitivity to a 10 per cent change in equity prices for shareholder-backed Asian other business, which would be reflected in the short-term fluctuation component of the Group's supplementary analysis of profit before tax, at 31 December 2008 and 2007 and to a 20 and 40 per cent change in equity prices at 31 December 2008 would be as follows:

	2008 £m			2007 £m
	A decrease of 40%	A decrease of 20%	A decrease of 10%	A decrease of 10%
Pre-tax	(176)	(88)	(44)	(73)
Related deferred tax (where applicable)	5	3	1	5
Net effect on profit and equity	(171)	(85)	(43)	(68)

A 10, 20 or 40 per cent increase in their value would have an approximately equal and opposite effect on profit and shareholders' equity to the sensitivities shown above. The low tax rate effect relates to the availability of losses in some of the territories.

k Duration of liabilities

The Group uses cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results. The maturity profile of the cash flows, taking account of expected future premiums and investment returns, is as follows:

	2008 £m	2007 £m
Policyholder liabilities	20,909	17,033
	%	%
Expected maturity:		
0 to 5 years	23	22
5 to 10 years	21	22
10 to 15 years	15	16
15 to 20 years	13	13
20 to 25 years	10	9
Over 25 years	18	18

D5: Capital position statement for life assurance businesses

a Summary statement

The Group's estimated capital position for life assurance businesses with reconciliations to shareholders' equity is shown below. Available capital for each fund or group of companies is determined by reference to local regulation at 31 December 2008 and 2007.

	2008 £m									
	SAIF	WPSF note i	Total PAC with- profits fund	Other UK life assurance subsidi- aries and funds note ii	Jackson	Asian life assurance subsidi- aries	Total life assurance opera- tions	M&G (including Prudential Capital)	Parent company and share- holders' equity of other subsidi- aries and funds	Group total
31 December 2008										
Group shareholders' equity										
Held outside long-term funds:										
Net assets				735	1,698	2,056	4,489	147	(1,839)	2,797
Goodwill	–	–	–	–	–	111	111	1,153	77	1,341
Total				735	1,698	2,167	4,600	1,300	(1,762)	4,138
Held in long-term funds ^{note iii}				920	–	–	920	–	–	920
Total Group shareholders' equity	–	–	–	1,655	1,698	2,167	5,520	1,300	(1,762)	5,058
Adjustments to regulatory basis										
Unallocated surplus of with-profits funds ^{note v}		8,254	8,254	–	–	160	8,414			
Shareholders' share of realistic liabilities		(2,028)	(2,028)	–	–	–	(2,028)			
Deferred acquisition costs of non-participating business not recognised for regulatory reporting purposes	(3)	(10)	(13)	(128)	(3,962)	(876)	(4,979)			
Jackson surplus notes ^{note iv}	–	–	–	–	173	–	173			
Investment and policyholder liabilities valuation differences between IFRS and regulatory basis for Jackson ^{note ix}					4,819		4,819			
Adjustment from IAS 19 basis pension deficit attributable to WPSF to pension liability for regulatory purposes ^{note vii}		(147)	(147)	–	–		(147)			
Valuation difference on PAL between IFRS basis and regulatory basis		(1,350)	(1,350)	–	–		(1,350)			
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) ^{note v}	3	643	646	(474)	30	(41)	161			
Total adjustments	–	5,362	5,362	(602)	1,060	(757)	5,063			
Total available capital resources of life assurance businesses on local regulatory bases	–	5,362	5,362	1,053	2,758	1,410	10,583			

Notes on the Group financial statements

D: Life assurance businesses

continued

D5: Capital position statement for life assurance businesses continued

31 December 2008	2008 £m						Total life assurance operations
	SAIF	WPSF note i	Total PAC with- profits fund	Other UK life assurance subsidiaries and funds note ii	Jackson	Asian life assurance subsidiaries	
Policyholder liabilities							
With-profits liabilities of UK regulated with-profits funds:							
Insurance contracts	9,260	26,466	35,726	–		4,416	40,142
Investment contracts (with discretionary participating features)	494	22,873	23,367	–		79	23,446
Total	9,754	49,339	59,093	–		4,495	63,588
Other liabilities:							
Insurance contracts:							
With-profits liabilities of non-UK regulated funds						3,407	3,407
Unit-linked, including variable annuity	–	1,872	1,872	6,041	14,538	7,220	29,671
Other life assurance business	264	12,625	12,889	16,228	27,938	5,755	62,810
Investment contracts without discretionary participation features (principally unit-linked and similar contracts in the UK and GIC liabilities of Jackson) ^{note vi}	–	–	–	11,584	2,885	32	14,501
Total	264	14,497	14,761	33,853	45,361	16,414	110,389
Total policyholder liabilities shown in the consolidated balance sheet	10,018	63,836	73,854	33,853	45,361	20,909	173,977

2007 £m

31 December 2007	SAIF	WPSF note 1	Total PAC with- profits fund	Other UK life assurance subsidi- aries and funds note 2	Jackson	Asian life assurance subsidi- aries	Total life assurance opera- tions	M&G (including Prudential Capital)	Parent company and share- holders' equity of other subsidi- aries and funds	Group total
Group shareholders' equity										
Held outside long-term funds:										
Net assets	-	-	-	550	2,690	1,258	4,498	271	(862)	3,907
Goodwill	-	-	-	-	-	111	111	1,153	77	1,341
Total	-	-	-	550	2,690	1,369	4,609	1,424	(785)	5,248
Held in long-term funds ^{note iii}	-	-	-	814	-	-	814	-	-	814
Total Group shareholders' equity	-	-	-	1,364	2,690	1,369	5,423	1,424	(785)	6,062
Adjustments to regulatory basis										
Unallocated surplus of with-profits funds ^{note v}	-	13,813	13,813	-	-	146	13,959			
Shareholders' share of realistic liabilities	-	(4,178)	(4,178)	-	-	-	(4,178)			
Deferred acquisition costs of non- participating business and goodwill not recognised for regulatory reporting purposes	(4)	(15)	(19)	(143)	(1,928)	(790)	(2,880)			
Jackson surplus notes ^{note iv}	-	-	-	-	125	-	125			
Adjustment from IAS 19 basis pension deficit attributable to WPSF to pension liability for regulatory purposes ^{note vii}	-	(138)	(138)	-	-	-	(138)			
Valuation difference on PAL between IFRS basis and regulatory basis	-	(1,117)	(1,117)	-	-	-	(1,117)			
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) ^{note v}	4	355	359	(239)	1,364	149	1,633			
Total adjustments	-	8,720	8,720	(382)	(439)	(495)	7,404			
Total available capital resources of life assurance businesses on local regulatory bases	-	8,720	8,720	982	2,251	874	12,827			

Notes on the Group financial statements

D: Life assurance businesses

continued

D5: Capital position statement for life assurance businesses continued

31 December 2007	2007 £m						
	SAIF	WPSF note i	Total PAC with- profits fund	Other UK life assurance subsidiaries and funds note ii	Jackson	Asian life assurance subsidiaries	Total life assurance operations
Policyholder liabilities							
With-profits liabilities of UK regulated with-profits funds:							
Insurance contracts	12,672	34,029	46,701	–	–	3,307	50,008
Investment contracts (with discretionary participating features)	693	28,773	29,466	–	–	84	29,550
Total	13,365	62,802	76,167	–	–	3,391	79,558
Other liabilities:							
Insurance contracts:							
With-profits liabilities of non-UK regulated funds						2,973	2,973
Unit-linked, including variable annuity		2,029	2,029	8,338	15,027	6,971	32,365
Other life assurance business	255	11,494	11,749	14,121	17,899	3,661	47,430
Investment contracts without discretionary participation features (principally unit-linked and similar contracts in the UK and GIC liabilities of Jackson) ^{note vi}		14	14	12,059	1,922	37	14,032
Total	255	13,537	13,792	34,518	34,848	13,642	96,800
Total policyholder liabilities shown in the consolidated balance sheet	13,620	76,339	89,959	34,518	34,848	17,033	176,358

Notes

- i WPSF unallocated surplus includes amounts related to the Hong Kong branch. Policyholder liabilities of the Hong Kong branch are included in the amounts of Asian life assurance subsidiaries.
- ii Excluding PAC shareholders' equity that are included in 'parent company and shareholders' equity of other subsidiaries and funds'.
- iii The term shareholders' equity held in long-term funds refers to the excess of assets over liabilities attributable to shareholders of funds which are required by law to be maintained with segregated assets and liabilities.
- iv For regulatory purposes the Jackson surplus notes are accounted for as capital.
- v Other adjustments to shareholders' equity and unallocated surplus include amounts for the value of non-participating business for UK regulated with-profits funds, deferred tax, admissibility and other items measured differently on the regulatory basis. For Jackson the principal reconciling item is deferred tax related to the differences between IFRS and regulatory basis as shown in the table above and other methodology differences.
- vi Insurance business accounted for as financial instruments under IAS 39.
- vii In determining the IAS 19 adjustment for the purposes of this table the deficit in the Group's main pension scheme used for the calculation includes amounts for investments in Prudential insurance policies (see note I1).
- viii Asia 2007 comparative adjustments reflect adjustments for intra-group balances that are recognised on a local regulatory basis.
- ix The investment and policyholder liabilities valuation difference between IFRS and regulatory bases for Jackson is mainly due to not all investments being carried at fair value under the regulatory basis and also for the valuation difference on annuity reserves.

b Basis of preparation, capital requirements and management

Each of the Group's long-term business operations is capitalised to a sufficiently strong level for its individual circumstances. Details by the Group's major operations are shown below.

i UK insurance operations

The FSA rules which govern the Prudential regulation of insurance form part of the Prudential Sourcebook for Insurers, the General Prudential Sourcebook and Interim Prudential Sourcebook for Insurers. Overall, the net requirements of the General Prudential Sourcebook are intended to align the capital adequacy requirements for insurance business more closely with those of banking and investment firms and building societies, for example, by addressing tiers of capital, rather than looking at net admissible assets. An insurer must hold capital resources equal at least to the Minimum Capital Requirement (MCR).

The Prudential Sourcebook for Insurers also contains rules on Individual Capital Assessments. Under these rules and the rules of the General Prudential Sourcebook all insurers must assess for themselves the amount of capital needed to back their business. If the FSA views the results of this assessment as insufficient, it may draw up its own Individual Capital Guidance for a firm, which can be superimposed as a requirement.

PAC WPSF and SAIF

Under FSA rules, insurers with with-profits liabilities of more than £500 million must hold capital equal to the higher of the MCR and the Enhanced Capital Requirement (ECR). The ECR is intended to provide a more risk responsive and 'realistic' measure of a with-profit insurer's capital requirements, whereas the MCR is broadly speaking equivalent to the previous required minimum margin under the Interim Prudential Sourcebook and satisfies the minimum EU Standards.

Determination of the ECR involves the comparison of two separate measurements of the firm's resources requirement, which the FSA refers to as the 'twin peaks' approach.

The two separate peaks are:

- i The requirement comprised by the mathematical reserves plus the 'Long-Term Insurance Capital Requirement' (LTICR), together known as the 'regulatory peak'; and
- ii a calculation of the 'realistic' present value of the insurer's expected future contractual liabilities together with projected 'fair' discretionary bonuses to policyholders, plus a risk capital margin, together known as the 'realistic peak'.

Available capital of the WPSF and SAIF of £5.4 billion (2007: £8.7 billion) represents the excess of assets over liabilities on the FSA realistic basis. Unlike the previously discussed FRS 27 basis, realistic liabilities on the regulatory basis include the shareholders' share of future bonuses. These amounts are shown before deduction of the risk capital margin (RCM) which is estimated to be £2.1 billion at 31 December 2008 (2007: £2.0 billion).

The FSA's basis of setting the RCM is to target a level broadly equivalent to a Standard & Poor's credit rating of BBB and to judge this by ensuring there are sufficient assets to absorb a 1 in 200 year event. The RCM calculation achieves this by setting rules for the determination of margins to cover defined stress changes in asset values and yields for market risk, credit risk and termination risk for with-profits policies.

As noted in section D2(g)(ii), PAC has discretion in its management actions in the case of adverse investment conditions. Management actions encompass, but are not confined to, investment allocation decisions, levels of reversionary bonuses, crediting rates and total claim values. To illustrate the flexibility of management actions, rates of regular bonus are determined for each type of policy primarily by targeting them at a prudent proportion of the long-term expected future investment return on the underlying assets. The expected future investment return is reduced as appropriate for each type of policy to allow for items such as expenses, charges, tax and shareholders' transfers. However, the rates declared may differ by product type, or by date of payment of the premiums or date of issue of the policy, if the accumulated annual bonuses are particularly high or low relative to a prudent proportion of the achieved investment return.

When target bonus levels change, the PAC board has regard to the overall financial strength of the long-term fund when determining the length of time over which it will seek to achieve the amended product target bonus level.

In normal investment conditions, PAC expects changes to regular bonus rates to be gradual over time and changes are not expected to exceed one per cent per annum over any year. However, discretion is retained as to whether or not a regular bonus is declared each year, and there is no limit on the amount by which regular bonus rates can be changed.

Notes on the Group financial statements

D: Life assurance businesses

continued

D5: Capital position statement for life assurance businesses continued

As regards smoothing of maturity and death benefits, in normal circumstances PAC does not expect most pay-out values on policies of the same duration to change by more than 10 per cent up or down from one year to the next, although some larger changes may occur to balance pay-out values between different policies. Greater flexibility may be required in certain circumstances, for example following a significant rise or fall in market values (either sudden or over a period of years) and in such situations the PAC board may decide to vary the standard bonus smoothing limits to protect the overall interests of policyholders.

For surrender benefits, any substantial fall in the market value of the assets of the with-profits sub-fund would lead to immediate changes in the application of MVRs for accumulating with-profits policies, firstly to increase the size of MVRs already being applied and, secondly, to extend the range of policies for which an MVR is applied.

Other UK life assurance subsidiaries and funds

The available capital of £1,053 million (2007: £982 million) reflects the excess of regulatory basis assets over liabilities of the subsidiaries and funds, before deduction of the capital resources requirement of £884 million (2007: £841 million).

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

ii Jackson

The regulatory framework for Jackson is governed by the requirements of the US NAIC approved risk-based capital standards. Under these requirements life insurance companies report on a formula-based capital standard that they calculate by applying factors to various asset, premium and reserve items. The formula takes into account the risk characteristics of a company, including asset risk, insurance risk, interest rate risk and business risk.

The available capital of Jackson shown above of £2,758 million (2007: £2,251 million) reflects US regulatory basis assets less liabilities including asset valuation reserves. The asset valuation reserve is designed to provide for future credit-related losses on debt securities and losses on equity investments. Available capital includes a reduction for the effect of the interest maintenance reserve, which is designed by state regulators to defer recognition of non-credit related realised capital gains and losses and to recognise them rateably in the future.

Jackson's risk-based capital ratio is significantly in excess of regulatory requirements. Effective for 2008 reporting, the local regulator granted Jackson three permitted practices, which expire 1 October 2009, unless extended by the local regulator. One permitted practice allows Jackson to carry interest rate swaps at book value, as if statutory hedge accounting were in place, instead of at fair value as would have been otherwise required. Jackson must also demonstrate the effectiveness of its interest rate swap programme pursuant to the Michigan Insurance Code. The local regulator also granted a permitted practice to allow Jackson to recognise book to tax differences that will reverse within the next three years (instead of one year as required by the NAIC) in determining the admissible tax asset (subject to a limitation of 15 per cent of capital and surplus versus the 10 per cent limitation imposed by the NAIC guidance). Finally, the local regulator granted a permitted practice to allow Jackson to use an average interest rate in calculating certain regulatory requirements. The permitted practice requires that Jackson maintain certain minimum capital levels excluding the effect of the permitted practices. The total effect of these permitted practices was to increase statutory surplus by £588 million and reduce authorised control level required capital by £57 million at 31 December 2008.

iii Asian operations

The available capital shown above of £1,410 million (2007: £874 million) represents the excess of local regulatory basis assets over liabilities before deduction of required capital of £407 million (2007: £265 million). These amounts have been determined applying the local regulations in each of the operations.

The businesses in Asia are subject to local capital requirements in the jurisdictions in which they operate. The Hong Kong business branch of PAC and its capital requirements are subsumed within those of the PAC long-term fund. For the other material Asian operations, the details of the basis of determining regulatory capital and regulatory capital requirements are as follows:

Singapore

In Singapore a risk-based regulatory framework applies rather than one based on a net premium approach.

For participating business, a gross premium reserve, determined using prudent best estimate assumptions and which makes allowance for future bonus, is held. The amount held is subject to a minimum of the higher of the assets attributed to participating business and a gross premium reserve calculated on specified assumptions, but without allowance for future bonus, that include prescribed provisions for adverse deviations (PADs).

For non-participating business, gross premium reserves are held. For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

Taiwan

Basic policy reserves are determined using a net premium method. Both mortality and interest rates are specified. For more recent issues, the valuation rate of interest has been linked to the prevailing market rate on 10-year government bonds.

Solvency capital is determined using a risk-based capital approach. In 2008, due to the financial crisis, the local regulator provided relief to ease certain of the requirements in determining the risk-based capital surplus. This relief applies to 2008 and 2009.

Japan

Mathematical reserves for traditional business are determined on a net premium basis using prescribed mortality and interest rates. Interest rates reflect the original pricing assumptions.

For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

With regard to solvency, the adjusted solvency capital assets of the Company must exceed 200 per cent of the risk related capital requirement value at risk. It is thus a risk-based capital approach.

Malaysia

Mathematical reserves for traditional business are determined on a modified net premium basis using prescribed mortality and interest rates (no higher than four per cent).

For linked business the value of units is held together with a non-unit reserve calculated in accordance with standard actuarial methodology.

The capital requirement is determined as four per cent of reserves plus a specified percentage of sums at risk. There is an overriding minimum capital requirement of 100 million Malaysian Ringgit.

Malaysia is adopting a risk-based capital framework from 2009, which has not been reflected in the tables presented.

Vietnam

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

The capital requirement is determined as four per cent of reserves plus a specified percentage of 0.1 per cent of sums at risk for policies with original term less than or equal to five years or 0.3 per cent of sums at risk for policies with original term of more than five years. An additional capital requirement of Vietnamese Dong 200 billion is also required for companies transacting unit-linked business.

Korea

Policy reserves for traditional business are determined on net premium reserve basis using pricing mortality and prescribed standard interest rates.

For linked business, the value of units is held together with the non-unit reserves calculated in accordance with regulatory standard actuarial methodology.

The capital requirement in Korea is determined as four per cent of the policy reserves and expected claims after reinsurance. Insurance companies in Korea are expected to maintain a level of free surplus in excess of the capital requirements with the usual level of solvency margin being around 200 per cent of the required capital.

iv Group capital requirements

In addition to the requirements at individual company level, FSA requirements under the IGD apply additional prudential requirements for the Group as a whole. Discussion of the Group's estimated IGD position at 31 December 2008 is provided in the business review section of the Group's 2008 Annual Report and in section C.

Notes on the Group financial statements

D: Life assurance businesses

continued

D5: Capital position statement for life assurance businesses continued

c Movements in total available capital

Total available capital for the Group's life assurance operations has changed during 2008 as follows:

	2008 £m				
	WPSF note i	Other UK life assurance subsidiaries and funds note iii	Jackson note ii	Asian life assurance subsidiaries note iv	Group total
Available capital at 31 December 2007	8,720	982	2,251	874	12,827
Changes in assumptions	(149)	(624)	–	(7)	(780)
Changes in management policy	–	372	–	60	432
Changes in regulatory requirements	–	–	(57)	134	77
New business and other factors	(3,209)	323	564	349	(1,973)
Available capital at 31 December 2008	5,362	1,053	2,758	1,410	10,583

Detail on the movement for 2007 is as follows:

	2007 £m				
	WPSF note i	Other UK life assurance subsidiaries and funds note iii	Jackson note ii	Asian life assurance subsidiaries note iv	Group total
Available capital at 31 December 2006	8,688	903	2,083	745	12,419
Changes in assumptions	(335)	(33)	–	4	(364)
Changes in management policy	–	–	–	12	12
Changes in regulatory requirements	–	–	(7)	–	(7)
New business and other factors	367	112	175	113	767
Available capital at 31 December 2007	8,720	982	2,251	874	12,827

Notes

i WPSF

The decrease in 2008 reflects primarily the negative investment returns earned on the opening available capital and £149 million negative effect of changes in assumptions on a regulatory basis compares to the £83 million effect of change in assumptions on an IFRS basis as shown in note D2(i). The increase in 2007 reflects investment return earned on the opening available capital partially offset by the £335 million effect of assumption changes and a £214 million impact from a change in the risk-free yield curve which affects the outlook for future investment returns. The £335 million effect of assumption changes on a regulatory basis compares to the £392 million effect of change in assumptions on an IFRS basis as shown in note D2(i).

ii Jackson

The increase of £507 million reflects an underlying decrease of £358 million (applying the 2008 year end exchange rate of 1.44) and £865 million of exchange translation gain. The increase of £168 million in 2007 reflects an underlying increase of £203 million (applying the 2007 year end exchange rate of 1.99) and £35 million of exchange translation loss.

iii Other UK life assurance subsidiaries and funds

The effect from the changes in assumptions of valuation interest rates on insurance liabilities is broadly matched by the corresponding effect on assets leaving no significant impact on the available capital.

iv Asian life assurance subsidiaries

Asia's 2006 and 2007 comparative adjustments reflect the intra-group balances that are recognised on a local regulatory basis.

d Transferability of available capital

For PAC and all other UK long-term insurers, long-term business assets and liabilities must, by law, be maintained in funds separate from those for the assets and liabilities attributable to non-life insurance business or to shareholders. Only the 'established surplus' – the excess of assets over liabilities in the long-term fund determined through a formal valuation – may be transferred so as to be available for other purposes. Distributions from the with-profits sub-fund to shareholders reflect the shareholders' one-ninth share of the cost of declared policyholders' bonuses.

Accordingly, the excess of assets over liabilities of the PAC long-term fund is retained within that company. The retention of the capital enables it to support with-profits and other business of the fund by, for example, providing the benefits associated with smoothing and guarantees. It also provides investment flexibility for the fund's assets by meeting the regulatory capital requirements that demonstrate solvency and by absorbing the costs of significant events or fundamental changes in its long-term business without affecting the bonus and investment policies.

For other UK long-term business subsidiaries, the amounts retained within the companies are at levels which provide an appropriate level of capital strength in excess of the regulatory minimum.

For Jackson, capital retention is maintained at a level consistent with an appropriate rating by Standard & Poor's. Currently Jackson is rated AA. Jackson can pay dividends on its capital stock only out of earned surplus unless prior regulatory approval is obtained. Furthermore, dividends which exceed the greater of 10 per cent of Jackson's statutory surplus or statutory net gain from operations for the prior year require prior regulatory approval.

For Asian subsidiaries, the amounts retained within the companies are at levels that provide an appropriate level of capital strength in excess of the local regulatory minimum. For ring-fenced with-profits funds, the excess of assets over liabilities is retained with distribution tied to the shareholders' share of bonuses through declaration of actuarially determined surplus. The Singapore and Malaysian businesses may, in general, remit dividends to the UK, provided the statutory insurance fund meets the capital adequacy standard required under local statutory regulations.

Available capital of the non-insurance business units is transferable to the life assurance businesses after taking account of an appropriate level of operating capital, based on local regulatory solvency targets, over and above basis liabilities. The economic capital model described in section D1 (concentration of risks) takes into account restrictions on mobility of capital across the Group with capital transfers to and from business units triggered at a solvency level consistent with these targets. The model takes into account restrictions on the availability to the Group of the estate of the various with-profits funds throughout the Group.

e Sensitivity of liabilities and total capital to changed market conditions and capital management policies

Prudential manages its assets, liabilities and capital locally, in accordance with local regulatory requirements and reflecting the different types of liabilities Prudential has in each business. As a result of the diversity of products offered by Prudential and the different regulatory requirements in which it operates, Prudential employs differing methods of asset/liability and capital management, depending on the business concerned.

Stochastic modelling of assets and liabilities is undertaken in the UK, Jackson and Asia to assess the economic capital requirements under different confidence intervals and time horizons. In addition, reserve adequacy testing under a range of scenarios and dynamic solvency testing is carried out, including under certain scenarios mandated by the UK, the US and Asian regulators.

A stochastic approach models the inter-relationship between asset and liability movements, taking into account asset correlation, management actions and policyholder behaviour under a large number of alternative economic scenarios. These scenarios are projected forward over a period of time, typically 25 years or longer, and the liabilities and solvency position of the fund are calculated in each scenario in each future year. The fund's policy on management actions, including bonus and investment policy, continue to be set in order that they are consistent with the available capital and the targeted risk of default.

The sensitivity of liabilities and other components of total capital vary depending upon the type of business concerned and thus conditions the approach to asset/liability management.

For example, for businesses that are most sensitive to interest rate changes, such as immediate annuity business, Prudential uses cash flow analysis to create a portfolio of debt securities whose value changes in line with the value of liabilities when interest rates change. This type of analysis helps protect profits from changing interest rates. This type of analysis is used in the UK for annuity business and by Jackson for its interest-sensitive and fixed indexed annuities and stable value products.

For businesses that are most sensitive to equity price changes, Prudential uses stochastic modelling and scenario testing to look at the future returns on its investments under different scenarios which best reflect the large diversity in returns that equities can produce. This allows Prudential to devise an investment and with-profits policyholder bonus strategy that, on the model assumptions, allows it to optimise returns to its policyholders and shareholders over time while maintaining appropriate financial strength. Prudential uses this methodology extensively in connection with its UK with-profits business.

f Intra-group arrangements in respect of SAIF

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

Due to the quality and diversity of the assets in SAIF and the ability of SAIF to revise guaranteed benefits in the event of an asset shortfall, the directors believe that the probability of either the PAC long-term fund or the Group's shareholders' funds, under their obligation to maintain the capital position of long-term funds generally, having to contribute to SAIF is remote.

Notes on the Group financial statements

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

The Group's asset management operations are based in the UK, Asia and the US where they operate different models and under different brands tailored to their markets.

Asset management in the UK is undertaken through M&G which is made up of three distinct businesses, being Retail, Wholesale and Finance, and whose operations include retail asset management, institutional fixed income, pooled life and pension funds, property and private finance.

Asset management in Asia serves both the life companies in Asia by managing the life funds and funds underlying the investment linked products and third-party customers through mutual fund business. Asia offers mutual fund investment products in a number of countries within the region, allowing customers to participate in debt, equity and money market investments.

Asset management in the US is undertaken through PPM America which manages assets for the Group's US, UK and Asian affiliates plus also provides investment services to other affiliated and unaffiliated institutional clients including CDOs, private investment funds, institutional accounts and mutual funds. In addition, broker-dealer activities are undertaken in the US where trades in securities are carried out for both third-party customers and for its own account.

Other operations covers unallocated corporate activities and includes the head office functions.

E1: Income statement for asset management operations

The profit included in the income statement in respect of asset management operations for the year is as follows:

	Asset management operations				2007 £m
	2008 £m			Total	
	M&G	US	Asia		Total
Revenue*	53	409	202	664	1,397
Charges	28	(402)	(150)	(524)	(1,053)
Profit before tax	81	7	52	140	344
Profit before tax for asset management operations comprise:					
Operating profit based on longer-term investment returns [†]	286	7	52	345	334
Short-term fluctuations in investment returns [‡]	(195)	–	–	(195)	5
Shareholders' share of actuarial gains and losses on defined benefit schemes	(10)	–	–	(10)	5
Profit before tax	81	7	52	140	344

* Included within revenue for M&G are realised and unrealised net losses of £673 million in respect of consolidated investment funds and Prudential Capital. The investment funds are managed on behalf of third-parties and are consolidated under IFRS in recognition of the control arrangements for the funds. The investment losses in respect of the investment funds are non-recourse to M&G and the Group and are added back through charges and consequently there is no impact on the profit before tax. Excluding the anomaly in respect of the consolidated investment funds the revenue for M&G would be £494 million and the charges, £413 million.

[†] Operating profit based on longer-term investment returns includes a £28 million charge for an impairment loss on a holding in Lehman Brothers.

[‡] Short-term fluctuations for M&G are primarily in respect of unrealised value movements, on Prudential Capital's bond portfolio.

E2: Balance sheet for asset management operations

Assets, liabilities and shareholders' funds included in the Group consolidated balance sheet in respect of asset management operations are as follows:

	Asset management operations				2007 £m
	2008 £m			Total	
	M&G	US	Asia		
Assets					
Intangible assets:					
Goodwill	1,153	16	61	1,230	1,230
Deferred acquisition costs	6	–	–	6	6
Total	1,159	16	61	1,236	1,236
Other non-investment and non-cash assets	27	169	99	295	521
Financial investments:					
Loans ^{note i}	1,763	–	–	1,763	2,334
Equity securities and portfolio holdings in unit trusts	11	–	12	23	17
Debt securities ^{note ii}	975	–	16	991	882
Other investments ^{note v}	432	24	6	462	155
Deposits	35	16	13	64	26
Total investments	3,216	40	47	3,303	3,414
Cash and cash equivalents ^{note v}	1,329	39	104	1,472	1,840
Total assets	5,731	264	311	6,306	7,011
Equity and liabilities					
Equity					
Shareholders' equity ^{note iii}	1,300	114	228	1,642	1,677
Minority interests	1	–	–	1	52
Total equity	1,301	114	228	1,643	1,729
Liabilities					
Intra Group debt represented by operational borrowings at Group level ^{note iv}	1,278	–	–	1,278	2,477
Net asset value attributable to external holders of consolidated funds ^{note v}	1,065	–	–	1,065	1,234
Other liabilities	2,087	150	83	2,320	1,571
Total liabilities	4,430	150	83	4,663	5,282
Total equity and liabilities	5,731	264	311	6,306	7,011

Notes

- i Loans
The M&G loans of £1,763 million relates to bridging loan finance managed by Prudential Capital. The bridging loan finance assets generally have no external credit ratings available, with internal ratings prepared by the Group's asset management operations as part of the risk management process rating £1,100 million BBB+ to BBB- and £663 million BB+ to BB-.
- ii Debt securities
Of the debt securities of £975 million for M&G at 31 December 2008, £959 million were rated AAA to A- by Standard and Poor's or Aaa rated by Moody's.
- iii M&G shareholder funds include those in respect of Prudential Capital, with the net reduction in the year primarily due to unrealised value movements of £190 million, on Prudential Capital's bond portfolio.
- iv Intra Group debt represented by operational borrowings at Group level
Operational borrowings for M&G are in respect of Prudential Capital's short-term fixed income security programme and comprise £1,269 million of commercial paper and £9 million of medium-term notes.
- v Consolidated investment funds
The M&G balance sheet shown above includes Prudential Capital together with investment funds which are managed on behalf of third-parties. In respect of the consolidated investment funds, the balance sheet includes cash and cash equivalents of £835 million, £345 million of other investments, £(115) million of other net assets and liabilities and the net asset value attributable to external unit holders of £1,065 million in respect of these funds, which are non-recourse to M&G and the Group.

Notes on the Group financial statements

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

continued

E2: Balance sheet for asset management operations continued

Reconciliation of movement in investments

A reconciliation of the total investments of asset management operations from the beginning of the year to the end of the year is as follows:

	Asset management operations			
	M&G £m	US £m	Asia £m	Total £m
At 1 January 2007				
Total investments	2,903	35	25	2,963
Less: Derivative liabilities	(142)	–	–	(142)
Directly held investments, net of derivative liabilities	2,761	35	25	2,821
Net cash inflow from operating activities	296	–	21	317
Realised gains in the year	8	–	–	8
Unrealised (losses) in the year	(22)	–	–	(22)
Foreign exchange translation differences	105	(1)	–	104
Movement in the year of directly held investments, net of derivative liabilities	387	(1)	21	407
At 31 December 2007/1 January 2008				
Total investments	3,334	34	46	3,414
Less: Derivative liabilities	(186)	–	–	(186)
Directly held investments, net of derivative liabilities	3,148	34	46	3,228
Net cash outflow from operating activities	(601)	–	(14)	(615)
Realised gains in the year	9	–	–	9
Unrealised (losses) in the year	(148)	(7)	(1)	(156)
Foreign exchange translation differences	516	13	16	545
Movement in the year of directly held investments, net of derivative liabilities	(224)	6	1	(217)
At 31 December 2008				
Total investments	3,216	40	47	3,303
Less: Derivative liabilities	(292)	–	–	(292)
Directly held investments, net of derivative liabilities	2,924	40	47	3,011

E3: Regulatory capital positions

Asset management operations in the UK, Hong Kong, Singapore, Vietnam and China are subject to regulatory requirements based on fixed operating expenses and other operating considerations. The movement in the year of the surplus regulatory capital position of these operations, combined with the movement in the IFRS basis shareholders' funds for other asset management operations, is as follows:

	Asset management operations				2007 £m
	2008 £m			Total	
	M&G	US	Asia	Total	Total
Capital surplus position					
Beginning of year	99	81	92	272	243
Exchange movement	(3)	39	31	67	(1)
Movement in capital requirement	(28)	–	25	(3)	(9)
Gains during the year	89	1	46	136	189
Distributions made	–	(8)	(34)	(42)	(150)
End of year	157	113	160	430	272

The movement in the year reflects changes in regulatory requirements whilst gains are driven by profits generated during the year. Distributions consist of dividends paid up to the parent company.

The M&G figures include those for Prudential Capital.

E4: Sensitivity of profit and equity to market and other financial risk

i Currency translation

Consistent with the Group's accounting policies, the profits of the Asia and PPM America asset management operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2008, the rates for the most significant operations are given in note B4.

A 10 per cent increase in these rates and those of other Asian operations would have reduced reported profit before tax attributable to shareholders and shareholders' equity, excluding goodwill attributable to Asia and PPM America asset management operations, by £5 million (2007: £7 million) and £26 million (2007: £18 million) respectively.

ii Other sensitivities to other financial risks for asset management operations

The principal sensitivities to other financial risk of asset management operations are credit risk on the bridging loan portfolio (as described in note E2) of M&G's Prudential Capital operation and the indirect effect of changes to market values of funds under management. Due to the nature of the asset management operations there is limited direct sensitivity to movements in interest rates. Total debt securities held at 31 December 2008 by asset management operations were £991 million (2007: £882 million), the majority of which are held by the Prudential Capital operation of M&G. Debt securities held by M&G are in general variable rate bonds and so market value is limited in sensitivity to interest rate movements and consequently any change in interest rates would not have a material impact on profit or shareholder's equity. Asset management operations do not hold significant investments in property or equities.

E5: Other operations

Other operations consist of unallocated corporate activities relating to Group Head Office and the Asia regional head office, with net income and expenditure for the year of negative £260 million (2007: negative £260 million) as detailed in note B1. An analysis of the assets and liabilities of other operations is shown in note B6.

Notes on the Group financial statements

F: Income statement notes

F1: Segmental information

The Group's primary and secondary segments are described in detail in note B6.

Primary segment information

The segment results for the years ended 31 December 2008 and 2007 are as follows:

	2008 £m	2007 £m
Revenue		
Insurance operations	(10,798)	31,555
Asset management	664	1,397
Unallocated corporate	157	186
Intra group revenue eliminated on consolidation	(290)	(268)
Total revenue, net of reinsurance, per income statement^{note i}	(10,267)	32,870
Analysed as:		
Investment returns ^{note iii}	(30,202)	12,225
Other items	19,935	20,645
	(10,267)	32,870
Charges (before income tax attributable to policyholders and unallocated surplus of long-term insurance funds)		
Insurance operations, including post-tax transfers from (to) unallocated surplus of with-profits funds	8,980	(30,533)
Asset management	(524)	(1,053)
Unallocated corporate	(553)	(494)
Intra group charges eliminated on consolidation	290	268
Total charges, net of reinsurance, per income statement^{note i}	8,193	(31,812)
Segment results – revenue less charges (continuing operations)		
Insurance operations	(1,818)	1,022
Asset management	140	344
Unallocated corporate	(396)	(308)
(Loss) profit before tax (<i>being tax attributable to shareholders' and policyholders' returns</i>) ^{note ii}	(2,074)	1,058
Tax attributable to policyholders' returns	1,624	5
(Loss) profit before tax attributable to shareholders ^{B1}	(450)	1,063
Tax attributable to shareholders' (loss) profit	59	(354)
(Loss) profit from continuing operations after tax	(391)	709
Segment results – discontinued operations		
Banking ¹⁹	–	241
(Loss) profit for the year	(391)	950

Notes

- i Total revenue for 2008 is negative £10,267 million whilst charges are a credit of £8,193 million. These abnormal effects arise from the basis of preparation whereby revenue includes investment appreciation, which is negative in 2008, and charges reflect the allocation, where appropriate, of investment return to policyholder benefits.
- ii The measure is the formal (loss) profit before tax measure under IFRS but is not the result attributable to shareholders.
- iii Investment return principally comprises
- Interest and dividends;
 - Realised and unrealised gains and losses on securities and derivatives classified as fair value through profit and loss under IAS 39; and
 - Realised gains and losses, including impairment losses, on securities classified as available-for-sale under IAS 39.

In its capacity as fund manager to fellow Prudential plc subsidiaries, M&G earns fees for asset management and related services. These services are charged at appropriate arm's length prices, typically priced as a percentage of funds under management.

Total charges include a credit of £25,419 million (2007: charge of £11,295 million) for non-cash expenses other than depreciation and amortisation mainly due to the impact of negative market returns experienced during the year on benefit claims and movement in unallocated surplus of with-profits funds.

Secondary segment information

Although the Company is UK registered, the Group manages its business on a global basis. The operations are based in three main geographical areas: UK, US and Asia.

	2008 £m	2007 £m
Revenue		
UK	(12,213)	17,890
US	915	8,271
Asia	1,321	6,977
Intra group revenue	(290)	(268)
Total revenue per income statement	(10,267)	32,870

F2: Revenue

	2008 £m	2007 £m
Long-term business premiums		
Insurance contract premiums	17,573	17,308
Investment contracts with discretionary participation feature premiums	964	874
Inwards reinsurance premiums	454	177
Less: reinsurance premiums ceded	(202)	(171)
Earned premiums, net of reinsurance	18,789	18,188
Realised and unrealised gains and losses on securities at fair value through profit and loss	(34,157)	2,634
Realised and unrealised gains and losses on derivatives at fair value through profit and loss	(5,261)	270
Realised gains and losses on available-for-sale securities, previously recognised directly in equity	(487)	13
Realised gains and losses on loans	210	47
Interest ^{note i}	6,739	5,857
Dividends	2,023	2,730
Other investment income	731	674
Investment income	(30,202)	12,225
Fee income from investment contract business and asset management ^{note ii}	1,109	1,039
Income from venture investments of the PAC with-profits funds ^{note iii}	37	1,418
Other income	1,146	2,457
Total revenue	(10,267)	32,870

Notes

- i Interest income includes £11 million (2007: £2 million) accrued in respect of impaired securities.
- ii Fee income includes £7 million (2007: £31 million) relating to financial instruments that are not held at fair value through profit and loss. These fees primarily related to prepayment fees, late fees and syndication fees.
- iii In November 2007 the Group sold PPM Capital and as a result the Group no longer controls venture fund investments managed by the sold entity and consequently has ceased to consolidate these operations from that date.

Notes on the Group financial statements

F: Income statement notes

continued

F3: Acquisition costs and other operating expenditure

	2008 £m	2007 £m
Acquisition costs ^{notes i,ii}	1,185	1,030
Staff and pension costs ⁱⁱ	913	1,402
Administrative and operating costs ^{note iv}	361	2,427
Total acquisition costs and other operating expenditure ^{notes iii,iv}	2,459	4,859

Notes

- i Acquisition costs in 2008 comprise amounts related to insurance contracts of £1,048 million (2007: £939 million), and investment contracts and asset management contracts of £137 million (2007: £91 million). These costs include amortisation of £520 million (2007: £410 million) and £15 million (2007: £3 million) respectively.
- ii Acquisition costs also include fee expenses relating to financial liabilities held at amortised costs of £nil (2007: £1 million).
- iii The total depreciation and amortisation expense is £618 million (2007: £523 million). Of this amount, £535 million (2007: £413 million) relates to amortisation of deferred acquisition costs of insurance contracts and asset management contracts, which is primarily borne by the long-term business segment. Of the remainder of the depreciation and amortisation charge of £83 million (2007: £110 million), £57 million (2007: £98 million) relates to long-term business, £10 million (2007: £8 million) to asset management and £16 million (2007: £4 million) to other operations.
- iv In November 2007, the Group sold PPM Capital and as a result, the Group no longer controls venture fund investments managed by the sold entity and consequently has ceased to consolidate these operations from that date with this resulting in a reduction of associated operating expenditure.

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

Finance costs consist of £161 million (2007: £158 million) interest on core debt of central companies and £11 million (2007: £10 million) on US operations' surplus notes.

F5: Tax

a Total tax credit (charge) by nature of expense

An analysis of the total tax benefit (expense) of continuing operations recognised in the income statement by nature of benefit (expense) is as follows:

	2008 £m	2007 £m
Current tax benefit (expense):		
Corporation tax	(225)	(806)
Adjustments in respect of prior years	359	185
Total current tax	134	(621)
Deferred tax arising from:		
Origination and reversal of temporary differences	1,629	222
(Expense) benefit in respect of a previously unrecognised tax loss, tax credit or temporary difference from a prior period	(77)	50
Write down or reversal of a previous write down of a deferred tax asset	(3)	–
Total deferred tax credit	1,549	272
Total tax credit (charge)	1,683	(349)

The total tax benefit (expense) arises as follows:

	2008 £m	2007 £m
Current tax benefit (expense):		
UK	280	(377)
Foreign	(146)	(244)
	134	(621)
Deferred tax credit:		
UK	1,478	349
Foreign	71	(77)
	1,549	272
Total	1,683	(349)

The total tax credit of £1,683 million for 2008 (2007: charge of £349 million) comprises a credit of £1,758 million (2007: charge of £28 million) for UK tax and a charge of £75 million (2007: £321 million) for overseas tax. This tax credit comprises tax attributable to policyholders and unallocated surplus of with-profits funds, unit-linked policies and shareholders. The tax credit attributable to shareholders of £59 million for 2008 (2007: charge of £354 million) comprises a credit of £95 million (2007: charge of £148 million) for UK tax and a charge of £36 million (2007: £206 million) for overseas tax.

The prior year adjustments primarily relate to the settlement of issues with HM Revenue Customs (HMRC) at an amount below previously provided, the reduction in amounts previously provided on outstanding issues with HMRC and the routine revision of tax returns.

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

	2008 £m	2007 £m
Unrealised gains and losses on investments	1,521	225
Short-term timing differences	(29)	(10)
Capital allowances	2	4
Balances relating to investment and insurance contracts	(239)	41
Unused tax losses	294	12
Deferred tax credit (charge)	1,549	272

In April 2008 the standard corporation tax rate for the UK changed from 30% to 28%. Deferred tax at the end of 2007 for UK operations had been provided at the new rate of 28 per cent on the basis that materially all of the temporary differences are expected to reverse once the new rate took effect. The effect on the deferred tax assets and liabilities at 31 December 2007 was £20 million.

In 2008, a deferred tax credit of £637 million (2007: £54 million) has been taken directly to reserves. Other movements in deferred tax totalling a £21 million credit is mainly comprised of foreign exchange movements. When these amounts are taken with the deferred tax credit shown above the result is a decrease of £2.2 billion (or £2.1 billion taking into account the restated 2007 comparative deferred tax as a result of the interpretation of IFRIC 14) in the Group's net deferred tax liability (2007 decrease of £419 million).

The tax credit related to discontinued banking operations in 2007 which was all attributable to shareholders, amounted to £19 million.

b Reconciliation of effective tax rate

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

i Summary of pre-tax (loss) profit and tax credit (charge)

The income statement includes the following items:

	2008 £m	2007 £m
(Loss) profit before tax	(2,074)	1,058
Tax attributable to policyholders' returns	1,624	5
(Loss) profit before tax attributable to shareholders	(450)	1,063
Tax attributable to shareholders' (losses) profits:		
Tax credit (charge)	1,683	(349)
Less: tax attributable to policyholders' returns	(1,624)	(5)
Tax attributable to shareholders' (losses) profits	59	(354)
(Loss) profit from continuing operations after tax	(391)	709

Notes on the Group financial statements

F: Income statement notes

continued

F5: Tax continued

ii Overview

For the purposes of explaining the relationship between tax expense and accounting profit, it is appropriate to consider the sources of profit and tax by reference to those that are attributable to shareholders and policyholders, as follows:

	2008 £m			2007 £m		
	Attributable to shareholders	Attributable to policyholders*	Total	Attributable to shareholders	Attributable to policyholders*	Total
(Loss) profit before tax	(450)	(1,624)	(2,074)	1,063	(5)	1,058
Taxation charge:						
Expected tax rate	41%	100%	87%	31%	100%	30%
Expected tax charge	187	1,624	1,811	(327)	5	(322)
Variance from expected tax charge (note v(ii))	(128)	–	(128)	(27)	–	(27)
Actual tax credit (charge)	59	1,624	1,683	(354)	5	(349)
Average effective tax rate	13%	100%	81%	33%	100%	33%

* For the column entitled 'Attributable to policyholders', the profit before tax represents income, net of post-tax transfers to unallocated surplus of with-profits funds, before tax attributable to policyholders and unallocated surplus of with-profits funds and unit-linked policies.

Due to the requirements of the financial reporting standards IAS 1 and IAS 12, the profit before tax and tax charge reflect the aggregate of amounts that are attributable to shareholders and policyholders.

Profit before tax comprises profit attributable to shareholders and pre-tax profit attributable to policyholders of linked and with-profits funds and unallocated surplus of with-profits funds.

The total tax charge for linked and with-profits business includes tax expense on unit-linked and with-profits funds attributable to policyholders, the unallocated surplus of with-profits funds and the shareholders' profits. This feature arises from the basis of taxation applied to life and pension business, principally in the UK, but with similar bases applying in certain Asian operations, and is explained in note (iii) below.

Furthermore, the basis of preparation of Prudential's financial statements incorporates the additional feature that, as permitted under IFRS 4, the residual equity of the Group's with-profits funds, i.e. unallocated surplus, is recorded as a liability with transfers to and from that liability reflected in pre-tax profits. This gives rise to anomalous effective tax rates for profits attributable to policyholders (as described in note (iv) below).

In meeting the reconciliation requirements set out in paragraph 811 of IAS 12, the presentation shown in this disclosure note seeks to ensure that the explanation of the relationship between tax expense and accounting profit draw properly the distinction between the elements of the profit and tax charge that are attributable to policyholders and shareholders as explained below in notes (iv) and (v) respectively. Due to the nature of the basis of taxation of UK life and pension business (as described in note (iii) below), and the significance of the results of the business to the Group, it is inappropriate to seek to explain the effective tax rate on profit before tax by traditional approach that would apply for other industries.

The shareholder elements are the components of the profit and tax charge that are of most direct relevance to investors, and it is this aspect that the IAS 12 requirement is seeking to explain for companies that do not need to account for both with-profits and unit-linked funds, where tax is borne by the Company on the policyholders' behalf and which is not contemplated by IFRS requirement.

iii Basis of taxation for UK life and pension business

Different rules apply under UK tax law for taxing pension business and life insurance business and there are detailed rules for apportioning the investment return and profits of the fund between the types of business.

The investment return referable to pension business, and some other less significant classes of business, is exempt from taxation, but tax is charged on the profit that shareholders derive from writing such business at the corporate rate of tax. The rules for taxing life insurance business are more complex. Initially, the UK regime seeks to tax the regulatory basis investment return less management expenses (I-E) on this business as it arises. However, in determining the actual tax charge, a calculation of the shareholder profits for taxation purposes from writing life insurance business also has to be made and compared with the I-E profit.

If the shareholder profit is higher than the I-E amount, extra income is attributable to the I-E calculation until the I-E profit equals the shareholder profit. If on the other hand, the I-E profit is the greater, then an amount equal to the shareholder profit is taxed at the corporate rate of tax, with the remainder of the I-E profit being taxed at the lower policyholder rate of tax.

The purpose of this approach is to ensure that the Company is always as a minimum taxed on the profit, as defined for taxation purposes by reference to the Company's regulatory returns (rather than IFRS basis results), that it has earned. The shareholders' portion of the long-term business is taxed at the shareholders' rate, with the remaining portion taxed at rates applicable to the policyholders.

It is to be noted that the calculations described are determined using data from the regulatory basis returns rather than the IFRS basis results. The differences between the regulatory and accounting bases are very significant and extremely complex rendering any explanation in general purpose financial statements to be of little if any use to users.

iv Profits attributable to policyholders and related tax

As noted above, it is necessary under IFRS requirements to include the total tax charge of the Company (both policyholder and shareholder elements) in the tax charge disclosed in the income statement.

For with-profits business, total pre-tax profits reflect the aggregate of profits attributable to policyholders and shareholders. However, amounts attributable to the equity of with-profits funds are carried in the liability for unallocated surplus. Also, as described in note (iii), UK with-profits business is taxed on a basis that affects policyholders' unallocated surplus of with-profits funds and shareholders. For the PAC with-profits sub-fund, transfers to and from unallocated surplus are recorded in the income statement, so that after charging the total tax borne by the fund, the net balance reflects the statutory transfer from the fund for the year. The statutory transfer represents 10 per cent of the actuarially determined surplus for the year that is attributable to shareholders.

For SAIF similar transfers are made. However, in the case of SAIF, a net nil balance is derived, reflecting the lack of shareholder interest in the financial performance of the fund (other than through asset management arrangements).

The accounting anomaly that arises under IFRS is that due to the fact that the net of tax profit attributable to with-profits policyholders is zero, the Company's presentation of pre-tax profit attributable to policyholders reflects an amount that is the mirror image of the tax charge attributable to policyholders.

For unit-linked business, pre-tax profits also reflect the aggregate of profits attributable to policyholders and shareholders. The pre-tax profits attributable to policyholders represent fees earned that are used to pay tax borne by the Company on policyholders' behalf. The net of tax profit attributable to policyholders for unit-linked business is thus zero.

The combined effect of these features is such that providing a reconciliation of the tax charge attributable to policyholders to an expected charge based on the standard corporate rate of tax on IFRS basis profits attributable to policyholders is not relevant.

In summary, for accounting purposes, in all cases and for all reporting periods, the apparent effective rate for profit attributable to policyholders and unallocated surplus is 100 per cent. However, it is to be noted that the 100 per cent rate does not reflect a rate paid on the profits attributable to policyholders. It instead reflects the basis of accounting for unallocated surplus coupled with the distinction made for performance reporting between sources of profit attributable to shareholders, policyholders and unallocated surplus and IFRS requirements in respect of reporting of all pre-tax profits and all tax charges irrespective of policyholder or shareholder economic interest.

Notes on the Group financial statements

F: Income statement notes

continued

F5: Tax continued

v Reconciliation of tax charge on profits attributable to shareholders

	2008 £m				Total
	Asian insurance operations	US insurance operations	UK insurance operations	Other operations	
Profit before tax attributable to shareholders:					
Operating profit based on longer-term investment returns ^{note iii}	295	406	535	111	1,347
Short-term fluctuations in investment returns	(200)	(1,058)	(212)	(313)	(1,783)
Shareholders' share of actuarial gains and losses on defined benefit pension schemes	(3)	–	–	(11)	(14)
Total	92	(652)	323	(213)	(450)
Expected tax rate: ^{note i}					
Operating profit based on longer-term investment returns ^{note iii}	24%	35%	28%	23%	29%
Short-term fluctuations in investment returns	27%	35%	28%	28%	32%
Shareholders' share of actuarial gains and losses on defined benefit pension schemes	25%	–	–	28%	27%
Expected tax credit (charge) based on expected tax rates:					
Operating profit based on longer-term investment returns ^{note iii}	(70)	(142)	(150)	(26)	(388)
Short-term fluctuations in investment returns	54	370	59	88	571
Shareholders' share of actuarial gains and losses on defined benefit pension schemes	1	–	–	3	4
Total	(15)	228	(91)	65	187
Variance from expected tax charge: ^{note ii}					
Operating profit based on longer-term investment returns ^{note iii}	(35)	17	57	57	96
Short-term fluctuations in investment returns	(23)	(173)	(8)	(19)	(223)
Shareholders' share of actuarial gains and losses on defined benefit pension schemes	–	–	–	(1)	(1)
Total	(58)	(156)	49	37	(128)
Actual tax credit (charge):					
Operating profit based on longer-term investment returns ^{note iii}	(105)	(125)	(93)	31	(292)
Short-term fluctuations in investment returns	31	197	51	69	348
Shareholders' share of actuarial gains and losses on defined benefit pension schemes	1	–	–	2	3
Total	(73)	72	(42)	102	59
Actual tax rate: Operating profit based on longer-term investment returns	36%	31%	17%	(28%)	22%
Total	79%	11%	13%	48%	13%

Notes

- i Expected tax rates for profit attributable to shareholders:
The expected tax rate for Other operations is lower than 2007. The tax rate of 23% reflects the mix of business between UK and overseas operations, which are taxed at a variety of rates. The rate will fluctuate from year to year dependent on the mix of profits between jurisdictions.
- ii For 2008, the principal variances arise from differences between the standard corporation tax rate and actual rates due to a number of factors, including:
 - a For Asian long-term operations, tax losses in several jurisdictions which are not expected to be available for relief against future profits, and losses on investments in jurisdictions which do not provide corresponding tax relief;
 - b For Jackson, the inability to fully recognise deferred tax assets on losses being carried forward which has partially been offset by the benefit of a deduction from taxable income of a proportion of dividends received attributable to the variable annuity business;
 - c For UK insurance operations, prior year adjustments arising from the routine revisions of tax returns, the settlement of outstanding issues with HMRC at an amount below that previously provided and the different tax bases of UK life business; and
 - d For Other operations, the settlement of issues with HMRC at amounts below those previously provided and a reduction in amounts previously provided on outstanding issues with HMRC which has been partially offset by the inability to recognise a deferred tax asset on various tax losses.
- iii Operating profit based on longer-term investment returns is net of attributable restructuring costs and development expenses.

	2007 £m				
	Asian insurance operations	US insurance operations	UK insurance operations	Other operations	Total
Profit before tax attributable to shareholders:					
Operating profit based on longer-term investment returns ^{note iii}	174	444	521	62	1,201
Short-term fluctuations in investment returns	(71)	(18)	(47)	(1)	(137)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	(1)	(1)
Total	103	426	474	60	1,063
Expected tax rate: ^{note i}					
Operating profit based on longer-term investment returns ^{note iii}	21%	35%	30%	28%	30%
Short-term fluctuations in investment returns	25%	35%	30%	28%	28%
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	20%	35%	30%	28%	28%
Total	18%	35%	30%	28%	31%
Expected tax credit (charge) based on expected tax rates:					
Operating profit based on longer-term investment returns ^{note iii}	(37)	(155)	(156)	(17)	(365)
Short-term fluctuations in investment returns	18	6	14	–	38
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	–	–
Total	(19)	(149)	(142)	(17)	(327)
Variance from expected tax charge: ^{note ii}					
Operating profit based on longer-term investment returns ^{note iii}	(12)	22	(25)	(1)	(16)
Short-term fluctuations in investment returns	(17)	1	(2)	6	(12)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	1	1
Total	(29)	23	(27)	6	(27)
Actual tax charge:					
Operating profit based on longer-term investment returns ^{note iii}	(49)	(133)	(181)	(18)	(381)
Short-term fluctuations in investment returns	1	7	12	6	26
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	1	1
Total	(48)	(126)	(169)	(11)	(354)
Actual tax rate: Operating profit based on					
longer-term investment returns	28%	30%	35%	29%	32%
Total	47%	30%	36%	18%	33%

Notes

- i Expected tax rates for profit attributable to shareholders:
Expected tax rates shown in the table above reflect the corporate tax rates generally applied to taxable profits of the relevant country jurisdictions. For Asian operations the expected tax rates reflect the corporate tax rates weighted by reference to the source of profits of the operations contributing to the aggregate business result.
Expected rates for 2007 for Asia are lower than 2006 due to an increased proportion of profits in low tax jurisdictions. The expected rate for other operations is lower than 2006. The tax rate of 28 per cent reflects the mix of business between UK and overseas operations which are taxed at a variety of rates. The rates will fluctuate year on year dependent on the mix of profits between jurisdictions.
- ii Variances from expected tax charge for results attributable to shareholders:
For 2007, the principal variances arise from differences between the standard corporation tax rate and actual rates due to a number of factors, including:
- For UK insurance operations, disallowed expenses and prior year adjustments arising from routine revisions of tax returns;
 - For Jackson, the benefit of a deduction from taxable income of a proportion of dividends received attributable to the variable annuity business;
 - For Asian long-term operations, tax losses in several jurisdictions which are not expected to be available for relief against future profits, and losses on investments in jurisdictions which do not provide corresponding tax relief; and
 - For other operations, the availability of capital losses brought forward on which no deferred tax had previously been recognised, which have been used against capital gains in the period.
- iii Operating profit based on longer-term investment returns is net of attributable restructuring costs and development expenses.

Notes on the Group financial statements

G: Financial assets and liabilities

G1: Financial instruments - designation and fair values

The Group designates all financial assets as either fair value through profit and loss, available-for-sale, or as loans and receivables. Financial liabilities are designated as either fair value through profit and loss or amortised cost, or as investment contracts with discretionary participating features accounted for under IFRS 4 as described in note A4.

	2008 £m				Fair value
	Fair value through profit and loss	Available-for-sale	Loans and receivables	Total carrying value	
Financial assets					
Cash and cash equivalents	–	–	5,955	5,955	5,955
Deposits	–	–	7,294	7,294	7,294
Equity securities and portfolio holdings in unit trusts	62,122	–	–	62,122	62,122
Debt securities ^{note i}	71,225	23,999	–	95,224	95,224
Loans ^{note ii}	–	–	10,491	10,491	10,043
Other investments ^{note iii}	6,301	–	–	6,301	6,301
Accrued investment income	–	–	2,513	2,513	2,513
Other debtors	–	–	1,232	1,232	1,232
	139,648	23,999	27,485	191,132	

	2008 £m				Fair value
	Fair value through profit and loss	Amortised cost	IFRS 4 basis value	Total carrying value	
Financial liabilities					
Core structural borrowings of shareholder-financed operations ^{notes i, H13}	–	2,958	–	2,958	2,137
Operational borrowings attributable to shareholder-financed operations ^{H13}	–	1,977	–	1,977	1,977
Borrowings attributable to with-profits funds ^{H13}	158	1,150	–	1,308	1,320
Obligations under funding, securities lending and sale and repurchase agreements	–	5,572	–	5,572	5,676
Net asset value attributable to unit holders of consolidated unit trust and similar funds	3,843	–	–	3,843	3,843
Investment contracts with discretionary participating features ^{note iv}	–	–	23,446	23,446	–
Investment contracts without discretionary participating features	11,616	2,885	–	14,501	14,568
Other creditors	–	1,496	–	1,496	1,496
Derivative liabilities	4,832	–	–	4,832	4,832
Other liabilities	–	890	–	890	890
	20,449	16,928	23,446	60,823	

	2007 £m				Fair value
	Fair value through profit and loss	Available-for-sale	Loans and receivables	Total carrying value	
Financial assets					
Cash and cash equivalents	–	–	4,951	4,951	4,951
Deposits	–	–	7,889	7,889	7,889
Equity securities and portfolio holdings in unit trusts	86,157	–	–	86,157	86,157
Debt securities ^{note i}	65,349	18,635	–	83,984	83,984
Loans ^{note ii}	–	–	7,924	7,924	8,105
Other investments ^{note iii}	4,396	–	–	4,396	4,396
Accrued investment income	–	–	2,023	2,023	2,023
Other debtors	–	–	909	909	909
	155,902	18,635	23,696	198,233	

	2007 £m				Fair value
	Fair value through profit and loss	Amortised cost	IFRS 4 basis value	Total carrying value	
Financial liabilities					
Core structural borrowings of shareholder-financed operations ^{notes i, H13}	–	2,492	–	2,492	2,476
Operational borrowings attributable to shareholder-financed operations ^{H13}	–	3,081	–	3,081	3,081
Borrowings attributable to with-profits funds ^{H13}	204	783	–	987	1,006
Obligations under funding, securities lending and sale and repurchase agreements	–	4,081	–	4,081	4,100
Net asset value attributable to unit holders of consolidated unit trust and similar funds	3,556	–	–	3,556	3,556
Investment contracts with discretionary participating features ^{note iv}	–	–	29,550	29,550	–
Investment contracts without discretionary participating features	12,110	1,922	–	14,032	14,034
Other creditors	–	1,020	–	1,020	1,020
Derivative liabilities	1,080	–	–	1,080	1,080
Other liabilities	1	790	–	791	791
	16,951	14,169	29,550	60,670	

Notes

- i As at 31 December 2008, £620 million (2007: £722 million) of convertible bonds were included in debt securities and £363 million (2007: £278 million) were included in borrowings.
- ii Loans and receivables are reported net of allowance for loan losses of £27 million (2007: £13 million).
- iii See note G3 for details of the derivative assets included. The balance also contains the PAC with-profits fund's participation in various investment funds and limited liability property partnerships.
- iv It is impractical to determine the fair value of investment contracts with discretionary participation features due to the lack of a reliable basis to measure such features.
- v For financial liabilities designated as fair value through profit and loss there was no impact on profit from movements in credit risk during 2008 and 2007.

Determination of fair value

The fair values of the financial assets and liabilities as shown on the table above have been determined on the following bases.

The fair values of the 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 fair values of the financial instruments are established by using valuation techniques. These include financial investments which are not quoted on active markets and financial investments for which markets are no longer active as a result of market conditions e.g. market illiquidity. The valuation techniques used include comparison to recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option adjusted spread models and, if applicable, enterprise valuation. These techniques may include a number of assumptions relating to variables such as credit risk and interest rates. Changes in assumptions relating to these variables could positively or negatively impact the reported fair value of these

Notes on the Group financial statements

G: Financial assets and liabilities

continued

G1: Financial instruments - designation and fair values continued

instruments. The source of pricing for the financial investments valued using valuation techniques could be from using quotations from independent third-parties, such as brokers and pricing services or by using valuation techniques modelled internally by the Group. Priority is given to publicly available prices from independent sources, when available but overall, the source of pricing is chosen with the objective of arriving at a fair value measurement which reflects the price at which an orderly transaction would take place between market participants on the measurement date.

The fair value estimates are made at a specific point in time, based upon available market information and judgements about the financial instruments, including estimates of the timing and amount of expected future cash flows and the credit standing of counterparties. Such estimates do not reflect any premium or discount that could result from offering for sale at one time the Group's entire holdings of a particular financial instrument, nor do they consider the tax impact of the realisation of unrealised gains or losses. 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. Illiquid market conditions have resulted in inactive markets for certain of the Group's financial instruments. As a result, there is generally no or limited observable market information for these instruments. Fair value estimates for financial instruments deemed to be in an illiquid market are based on judgements regarding current economic conditions, liquidity discounts, currency, credit and interest rate risks, loss experience and other factors. These fair values are estimates and involve considerable uncertainty and variability as a result of the inputs selected and may differ significantly from the values that would have been used had the ready market existed, and the differences could be material.

The loans and receivables have been shown net of provisions for impairment. The fair value of loans has been estimated from discounted cash flows expected to be received. The rate of discount used was the market rate of interest.

The estimated fair value of derivative financial instruments reflects the estimated amount the Group would receive or pay in an arm's length transaction. This amount is determined using 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.

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

Section A4 provides details of the determination of fair value for investment contracts without fixed and guaranteed terms (notably UK unit-linked policies). For investment contracts in the US with fixed and guaranteed terms the fair value is determined based on the present value of future cash flows discounted at current interest rates.

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

Use of valuation techniques

The carrying value of financial investments (including derivative liabilities) on the balance sheet of the Group which are not quoted on active markets and for which fair value is determined using internal valuation techniques, or is provided by brokers or pricing services, where the specific securities have been valued using valuation techniques by these third-party providers are as follows:

	2008 £m				
	Shareholder-backed business				Total
	UK with-profits fund	UK insurance operations	US insurance operations	Other operations	
Debt securities	12,341	685	24,246	47	37,319
Equity securities	661	–	235	–	896
Other investments (including derivative assets)	2,189	257	1,215	324	3,985
	15,191	942	25,696	371	42,200
Derivative liabilities	(496)	(238)	(863)	(351)	(1,948)
Net of derivative liabilities	14,695	704	24,833	20	40,252

	2007 £m				
	Shareholder-backed business				Total
	UK with-profits fund	UK insurance operations	US insurance operations	Other operations	
Debt securities	10,640	509	18,996	–	30,145
Equity securities	683	–	166	–	849
Other investments (including derivative assets)	2,425	103	744	73	3,345
	13,748	612	19,906	73	34,339
Derivative liabilities	(168)	(53)	(158)	(138)	(517)
Net of derivative liabilities	13,580	559	19,748	(65)	33,822

* Including SAIF

The majority of the financial investments valued using valuation techniques were debt securities.

The debt securities shown above 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 market standard practices. The majority of the debt securities 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 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.

Debt securities valued using valuation techniques held for UK insurance operations were £13,026 million (2007: £11,149 million) and of this amount £12,341 million (2007: £10,640 million) related to securities held by with-profits operations and £685 million (2007: £509 million) related to securities held by the UK shareholder-backed business.

Of the debt securities valued using valuation techniques held by the UK with-profits fund of £12,341 million at 31 December 2008 (2007: £10,640 million), £8,647 million (2007: £7,638 million) have been priced by independent third-parties and £3,694 million (2007: £3,002 million) determined using internal valuation techniques.

The debt securities held by the UK with-profits fund at 31 December 2008 of £12,341 million include US securities managed by PPM America with a value of £8,773 million. This amount comprises £8,738 million in respect of securities for which the fair value has been measured using valuation techniques for which all inputs significant to the measurement are based on observable market data. This categorisation corresponds to 'Level 2' assets under amendments to IFRS 7. £35 million is in respect of securities for which the fair value has been measured using valuation techniques that include any input significant to the measurement that is not based on observable market data i.e. 'Level 3' securities.

For the 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 fund managers involved in the day-to-day trading in these assets.

Of the debt securities valued using valuation techniques of £37,319 million (2007: £30,145 million) at 31 December 2008, debt securities with a fair value of £24,246 million (2007: £18,996 million) were held by the US insurance operations. The £24,246 million value at 31 December 2008 comprises 'Level 2' and 'Level 3' securities with values of £20,564 million and £3,681 million, respectively. Typical inputs used in pricing these debt securities include, but are not limited to, reported trades, benchmark yields, credit spreads, liquidity premiums, and/or estimated cash flows based on default and prepayment assumptions.

The majority of the debt securities of the US insurance operations are priced by independent pricing services and included as 'Level 2' securities. As a result of typical trading volumes and the lack of quoted market prices for most debt securities, independent pricing services will normally derive the security prices through recently reported trades for identical or similar securities, making adjustments through the reporting date based upon available market observable information. If there are no reported trades, the independent pricing services and brokers may use matrix or pricing model processes to develop a security price where future cash flow expectations are developed based upon collateral performance and discounted at relevant market rates.

Debt securities of US insurance operations valued using internally derived valuation techniques in 2008 include certain asset-backed securities which had previously been valued using prices provided by a pricing service or brokers in the context of active markets. The current market dislocations have caused a reassessment of the valuation process for these asset-backed securities. In particular, beginning at the end of the third-quarter of 2008, the external prices obtained for certain asset-backed securities were deemed to be inappropriate in the current market conditions. For the valuations at 31 December 2008, the US operations have therefore utilised internal valuation models, provided by PPM America, to derive fair values for all non-agency residential mortgage-backed securities and asset-backed securities and certain commercial mortgage-backed securities. Details of these asset-backed securities are provided in notes B6 and D3. The techniques used by PPM America include cash flow models based on spreads and, when available, market indices. The models used begin with current spread levels of similarly-rated securities to determine the market discount rate for the security. Additional risk premiums for illiquidity and non-performance are incorporated, if warranted, and included in the discount rate. Cash flows, as estimated by PPM America using issuer-specific default statistics and prepayment assumptions, are discounted to determine an estimated fair value. The use of internal valuation models has resulted in a fair value of these securities that was higher than those provided from pricing services and brokers of £760 million on a total amortised cost of £3.5 billion.

The equity securities and other investments which included property and other partnerships in investment pools, venture investments and derivative assets and derivative liabilities as shown on 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.

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 2008 was a gain of £355 million (2007: gain of £288 million) for the with-profits fund investments. The gain in 2008 reflects an underlying loss which is more than offset by the exchange gains of the foreign currency denominated investments of the with-profits fund. 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.

Notes on the Group financial statements

G: Financial assets and liabilities

continued

G1: Financial instruments - designation and fair values continued

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 2008 and which was attributable to shareholders, was a loss of £685 million (2007: gain of £116 million).

The 2007 comparatives shown above differ from the previously published information for the inclusion of the financial investments for which prices have been provided by independent third-parties, such as pricing services and brokers, and for which the prices have been derived using valuation techniques by these providers. The previously published 2007 information included only the financial investments valued internally using valuation techniques.

Interest income and expense

The interest income on financial assets not at fair value through profit and loss for the year ended 31 December 2008 from continuing operations was £2,532 million (2007: £2,016 million).

The interest expense on financial liabilities not at fair value through profit and loss for the year ended 31 December 2008 from continuing operations was £645 million (2007: £699 million).

G2: Market risk

Interest rate risk

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

	2008 £m			Total
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	
Financial assets				
Cash and cash equivalents	–	–	5,955	5,955
Deposits	1,126	6,084	84	7,294
Debt securities	89,353	5,532	339	95,224
Loans	6,979	3,485	27	10,491
Other investments (including derivatives)	1,539	686	4,076	6,301
	98,997	15,787	10,481	125,265
Financial liabilities				
Core structural borrowings of shareholder-financed operations	2,958	–	–	2,958
Operational borrowings attributable to shareholder-financed operations	1,520	454	3	1,977
Borrowings attributable to with-profits funds	729	482	97	1,308
Obligations under funding, securities lending and sale and repurchase agreements	889	4,683	–	5,572
Investment contracts without discretionary participation features	2,885	–	11,616	14,501
Derivative liabilities	1,185	785	2,862	4,832
Other liabilities	218	105	567	890
	10,384	6,509	15,145	32,038

	2007 £m			Total
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	
Financial assets				
Cash and cash equivalents	–	–	4,951	4,951
Deposits	678	7,211	–	7,889
Debt securities	76,481	7,503	–	83,984
Loans	4,319	3,605	–	7,924
Other investments (including derivatives)	664	285	3,447	4,396
	82,142	18,604	8,398	109,144
Financial liabilities				
Core structural borrowings of shareholder-financed operations	2,492	–	–	2,492
Operational borrowings attributable to shareholder-financed operations	2,743	331	7	3,081
Borrowings attributable to with-profits funds	451	441	95	987
Obligations under funding, securities lending and sale and repurchase agreements	594	3,487	–	4,081
Investment contracts without discretionary participation features	1,922	–	12,110	14,032
Derivative liabilities	244	145	691	1,080
Other liabilities	178	98	515	791
	8,624	4,502	13,418	26,544

Liquidity analysis

	2008 £m							Total carrying value
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	No stated maturity	
Financial liabilities								
Core structural borrowings of shareholder-financed operations ^{H13}	249	–	–	801	–	849	1,059	2,958
Operational borrowings attributable to shareholder-financed operations ^{H13}	1,584	339	–	–	–	54	–	1,977
Borrowings attributable to with-profits funds ^{H13}	272	580	278	–	–	78	100	1,308
Obligations under funding, securities lending and sale and repurchase agreements	5,572	–	–	–	–	–	–	5,572
Derivative liabilities	3,066	448	266	408	156	488	–	4,832
Other liabilities	646	11	5	–	–	–	228	890
	11,389	1,378	549	1,209	156	1,469	1,387	17,537

	2007 £m							Total carrying value
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	No stated maturity	
Financial liabilities								
Core structural borrowings of shareholder-financed operations ^{H13}	–	248	–	366	315	801	762	2,492
Operational borrowings attributable to shareholder-financed operations ^{H13}	2,618	51	355	–	–	57	–	3,081
Borrowings attributable to with-profits funds ^{H13}	103	232	265	–	–	83	304	987
Obligations under funding, securities lending and sale and repurchase agreements	4,081	–	–	–	–	–	–	4,081
Derivative liabilities	684	174	10	33	6	173	–	1,080
Other liabilities (including derivatives)	630	7	2	–	–	–	152	791
	8,116	712	632	399	321	1,114	1,218	12,512

Notes on the Group financial statements

G: Financial assets and liabilities

continued

G2: Market risk continued

The table below shows the maturity profile for investment contracts on an undiscounted basis to the nearest billion. This maturity profile has been based on the cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results.

	2008 £bn						Total undiscounted value
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	
Life assurance investment contracts	3	18	12	12	9	13	67

	2007 £bn						Total undiscounted value
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	
Life assurance investment contracts	3	12	16	16	15	25	87

The maturity profile above excludes certain corporate unit-linked business with gross policyholder liabilities of £8 billion (2007: £8 billion) which has no stated maturity.

This table has been prepared on an undiscounted basis and accordingly the amounts shown for life assurance investment contracts differ from those disclosed on the balance sheet. Durations of long-term business contracts, covering insurance and investment contracts, on a discounted basis are included in section D.

Credit risk

Of the total loans and receivables held £21 million (2007: £5 million) are past their due date but have not been impaired. Of the total past due but not impaired, £21 million (2007: £5 million) are less than one year past their due date. The Group expects full recovery of these loans and receivables. Financial assets that would have been past due or impaired had the terms not been renegotiated amounted to £1 million (2007: £nil).

There was no collateral held against loans that are past due and impaired or that are past due but not impaired at 31 December 2008 (2007: £nil).

In addition, during the year the Group took possession of £66 million (2007: £7 million) of other collateral held as security, which mainly consists of assets that could be readily convertible into cash.

Currency risk

As at 31 December 2008, the Group held 20 per cent (2007: 19 per cent) and 13 per cent (2007: 13 per cent) of its financial assets and financial liabilities respectively, in currencies, mainly US dollar and Euro, other than the functional currency of the relevant business unit.

The financial assets, of which 77 per cent (2007: 86 per cent) are held by the PAC with-profits fund, allow the PAC with-profits fund to obtain exposure to foreign equity markets.

The financial liabilities, of which 38 per cent (2007: 19 per cent) are held by the PAC with-profits fund, mainly relate to foreign currency borrowings.

The exchange risks inherent in these exposures are mitigated through the use of derivatives, mainly forward currency contracts (note G3 below).

The amount of exchange gains recognised in the income statement in 2008, except for those arising on financial instruments measured at fair value through profit and loss, is £638 million (2007: £102 million). This constitutes £32 million (2007: £109 million) gains on Medium Term Notes (MTN) liabilities and £606 million of net gains (2007: £7 million net losses), mainly arising on investments of the PAC with-profits fund. The gains on MTN liabilities are fully offset by value movements on cross-currency swaps, which are measured at fair value through profit and loss.

G3: Derivatives and hedging

Derivatives

The Group enters into a variety of exchange traded and over-the-counter derivative financial instruments, including futures, options, forward currency contracts and swaps such as interest rate swaps, cross-currency swaps, swaptions and credit default swaps.

All over-the-counter derivative transactions are conducted under standardised ISDA (International Swaps and Derivatives Association Inc) master agreements and the Group has collateral agreements between the individual Group entities and relevant counterparties in place under each of these market master agreements.

The total fair value balances of derivative assets and liabilities as at 31 December 2008 were as follows:

	2008 £m					
	UK insurance operations	US insurance operations	Asian insurance operations	Asset management	Unallocated to a segment	Group total
Derivative assets	1,326	675	15	74	280	2,370
Derivative liabilities	(3,401)	(863)	(32)	(292)	(244)	(4,832)
	(2,075)	(188)	(17)	(218)	36	(2,462)

	2007 £m					
	UK insurance operations	US insurance operations	Asian insurance operations	Asset management	Unallocated to a segment	Group total
Derivative assets	571	390	15	118	3	1,097
Derivative liabilities	(689)	(158)	(2)	(186)	(45)	(1,080)
	(118)	232	13	(68)	(42)	17

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

The notional amount of the derivatives, distinguishing between UK insurance and US operations, was as follows:

As at 31 December 2008	2008 £m			
	UK insurance operations Notional amount on which future payments are based		US insurance operations Notional amount on which future payments are based	
	Asset	Liability	Asset	Liability
Cross-currency swaps*	838	1,014	448	218
Equity index call options	17	32	–	–
Swaptions	980	980	28,863	–
Futures	3,286	4,055	–	460
Forwards*	14,315	16,489	–	–
Inflation swaps	2,559	2,482	–	–
Credit default swaps	123	14	–	–
Single stock options	1	1	–	–
Credit derivatives	–	–	31	177
Put options	–	–	6,573	–
Equity options	2	4	3,785	5
Total return swaps	479	514	–	313
Interest rate swaps*	5,074	5,245	1,704	4,514

* In addition, the other operations, including the Group Treasury function and the Asian operations, have cross-currency swap assets and liabilities with notional amounts of £1,503 million (2007: £730 million) and £605 million (2007: £1,401 million) respectively, forward currency contracts assets and liabilities with notional amounts of £1,419 million (2007: £983 million) and £2,310 million (2007: £773 million) respectively, interest rate swaps assets and liabilities of £1,407 million (2007: £2,799 million) and of £2,316 million (2007: £1,563 million), respectively, and cliquet options assets of £1,525 million (2007: £nil).

Notes on the Group financial statements

G: Financial assets and liabilities

continued

G3: Derivatives and hedging continued

As at 31 December 2007	2007 £m			
	UK insurance operations Notional amount on which future payments are based		US insurance operations Notional amount on which future payments are based	
	Asset	Liability	Asset	Liability
Cross-currency swaps*	658	648	602	–
Equity index call options	–	23	–	–
Swaptions	1,125	–	25,620	1,005
Futures	1,905	2,176	–	371
Forwards*	17,243	17,635	–	–
Inflation swaps	1,758	1,319	–	–
Credit default swaps	4,181	59	–	–
Single stock options	–	–	–	–
Credit derivatives	–	–	3	20
Put options	–	–	3,642	–
Equity options	–	–	5,545	11
Total return swaps	956	955	226	–
Interest rate swaps*	4,335	4,663	1,708	3,587

* In addition, the other operations, including the Group Treasury function and the Asian operations, have cross-currency swap assets and liabilities with notional amounts of £1,503 million (2007: £730 million) and £605 million (2007: £1,401 million) respectively, forward currency contracts assets and liabilities with notional amounts of £1,419 million (2007: £983 million) and £2,310 million (2007: £773 million) respectively, interest rate swaps assets and liabilities of £1,407 million (2007: £2,799 million) and of £2,316 million (2007: £1,563 million), respectively, and cliquet options assets of £1,525 million (2007: £nil).

These derivatives are used for efficient portfolio management to obtain cost effective and efficient exposure to various markets in accordance with the Group's investment strategies and to manage exposure to interest rate, currency, credit and other business risks. See also note D3 for use of derivatives by the Group's US operations.

The Group uses various interest rate derivative instruments such as interest rate swaps to reduce exposure to interest rate volatility.

The UK insurance operations use various currency derivatives in order to limit volatility due to foreign currency exchange rate fluctuations arising on securities denominated in currencies other than sterling. See also note G2 above. In addition, total return swaps and interest rate swaps are held for efficient portfolio management.

As part of the efficient portfolio management of the PAC with-profits fund, the fund may, from time to time, invest in cash-settled forward contracts over Prudential plc shares, which are accounted for consistently with other derivatives. This is in order to avoid a mismatch of the with-profits investment portfolio with the investment benchmarks set for its equity-based investment funds. The contracts will form part of the long-term investments of the with-profits fund. These contracts are subject to a number of limitations for legal and regulatory reasons.

Some of the Group's products, especially those sold in the US, have certain guarantee features linked to equity indexes. A mismatch between product liabilities and the performance of the underlying assets backing them, exposes the Group to equity index risk. In order to mitigate this risk, the relevant business units purchase swaptions, equity options and futures to match asset performance with liabilities under equity-indexed products.

The US operations and some of the UK operations hold large amounts of interest-rate sensitive investments that contain credit risks on which a certain level of defaults is expected. These entities have purchased some swaptions in order to manage the default risk on certain underlying assets and hence reduce the amount of regulatory capital held to support the assets.

Hedging

The Group has formally assessed and documented the effectiveness of the following hedges under IAS 39.

Fair value hedges

The Group uses interest rate derivatives to hedge the interest exposures on its US\$1 billion, 6.5 per cent perpetual subordinated capital securities and US\$300 million, 6.5 per cent perpetual subordinated capital securities. Where the hedge relationship is de-designated and re-designated, the fair value adjustment to the hedged item up to the point of de-designation continues to be reported as part of the basis of the hedged item and is amortised to the income statement based on a recalculated effective interest rate over the residual period to the first break clause date of the perpetual subordinated capital securities.

In addition, Jackson had a common stock equity collar hedge entered into in March 2005. This was to protect Jackson's unrealised gain of US\$5.9 million on an equity investment. The hedge expired in March 2008.

The fair value of the derivatives designated as fair value hedges above at 31 December 2008, were an asset of £17 million and liabilities of £nil (2007: asset of £5 million and liabilities of £25 million). Movements in the fair value of the hedging instruments of a net loss of £4 million (2007: net gain of £6 million) and the hedged items of a net gain of £7 million (2007: net loss of £4 million) are recorded in the income statement in respect of the fair value hedges above.

Cash flow hedges

Following the sale of Egg in 2007, the Group has no cash flow hedges in place.

Net investment hedges

The Group has entered into a series of one to three-month period forward currency transactions which together form a US\$2 billion net investment hedge of the currency exposure of the net investments in the US operations. The forward currency contracts were renewed throughout 2008 and 2007. The forward currency contracts in place at 31 December 2008 expire in January 2009. In December 2008, the Group de-designated the US\$2 billion forward currency contract and re-designated only US\$600 million of the forward currency contract as a partial net investment hedge of the currency exposure of the net investments in the US operations. The change reflected consideration of the direct US dollar exposure for accounting purposes, and the indirect offsetting exposure within the Group's IGD solvency reporting. The fair value of the forward currency contracts at 31 December 2008 was a liability of £56 million (2007: a liability of £44 million), of which £17 million (2007: a liability of £44 million) was designated as a net investment hedge of the currency exposure of the net investments in the US operations.

In addition, the Group has designated perpetual subordinated capital securities totalling US\$1.55 billion as a net investment hedge to hedge the currency risks related to the net investment in Jackson. The carrying value of the subordinated capital securities was £1,059 million (2007: £763 million) as at 31 December 2008. The foreign exchange loss of £299 million (2007: gain of £13 million) on translation of the borrowings to pounds sterling at the balance sheet date is recognised in the translation reserve in shareholders' equity.

The net investment hedges were 100 per cent effective.

G4: Derecognition and collateral

Securities lending and reverse repurchase agreements

The Group has entered into securities lending (including repurchase agreements) whereby blocks of securities are loaned to third-parties, primarily major brokerage firms. The amounts above the fair value of the loaned securities required to be held as collateral by the agreements depend on the quality of the collateral, calculated on a daily basis. The loaned securities are not removed from the Group's consolidated balance sheet, rather they are retained within the appropriate investment classification. Collateral typically consists of cash, debt securities, equity securities and letters of credit. At 31 December 2008, the Group had lent £12,617 million (2007: £17,172 million) (of which £9,701 million (2007: £11,461 million) was lent by the PAC with-profits fund) of securities and held collateral under such agreements of £13,497 million (2007: £18,125 million) (of which £9,924 million (2007: £12,105 million) was held by the PAC with-profits fund).

At 31 December 2008, the Group had entered into reverse repurchase transactions under which it purchased securities and had taken on the obligation to resell the securities for the purchase price of £588 million (2007: £1,361 million), together with accrued interest.

Collateral and pledges under derivative transactions

At 31 December 2008, the Group had pledged £1,154 million (2007: £260 million) for liabilities and held collateral of £829 million (2007: £292 million) in respect of over-the-counter derivative transactions.

Notes on the Group financial statements

G: Financial assets and liabilities

continued

G5: Impairment of financial assets

In accordance with the Group's accounting policy set out in note A4, impairment reviews were performed for available-for-sale securities and loans and receivables. In addition, impairment reviews were undertaken for the reinsurers' share of insurance contract liabilities.

During the year ended 31 December 2008, impairment losses of £525 million (2007: £184 million) were recognised for available-for-sale securities and loans and receivables. These were £497 million (2007: £35 million) in respect of available-for-sale securities held by Jackson and £28 million (2007: £149 million) in respect of loans and receivables. The 2008 impairment charge for loans and receivables of £28 million relates primarily to loans held by the UK with-profits fund. The 2007 impairment charge of £149 million related to loans and advances to customers in the discontinued banking operations during the period of ownership.

Impairment losses recognised on available-for-sale securities amounted to £497 million (2007: £35 million). Of this amount, 8 per cent (2007: 14 per cent) has been recorded on structured asset-backed securities, primarily due to reduced cash flow expectations on such securities that are collateralised by diversified pools of primarily below investment grade securities. Of the losses related to the impairment of fixed maturity securities the top five individual corporate issuers made up 27 per cent (2007: 57 per cent), reflecting a deteriorating business outlook of the companies concerned.

The impairment losses have been recorded in 'investment income' in the income statement.

In 2008, the Group realised gross losses on sales of available-for-sale securities of £184 million (2007: £86 million) with 55 per cent (2007: 46 per cent) of these losses related to the disposal of fixed maturity securities of six (2007: six) individual issuers, which were disposed of to rebalance the portfolio in the US operations in response to the unstable mortgage lending

The effect of those reasonably likely changes in the key assumptions underlying the estimates that underpin the assessment of whether impairment has taken place depends on the factors described in note A3. A key indicator of whether such impairment may arise in future, and the potential amounts at risk, is the profile of gross unrealised losses for fixed maturity securities accounted for on an available-for-sale basis by reference to the time periods by which the securities have been held continuously in an unrealised loss position and by reference to the maturity date of the securities concerned.

For 2008 the amounts of gross unrealised losses for fixed maturity securities classified as available-for-sale under IFRS in an unrealised loss position was £3,178 million (2007: £439 million). Notes B1 and D3 provide further details on the impairment charges and unrealised losses of Jackson's available-for-sale securities.

H: Other information on balance sheet items

H1: Intangible assets attributable to shareholders

a Goodwill

	2008 £m	2007 £m
Cost		
At 1 January and 31 December	1,461	1,461
Aggregate impairment		
At 1 January and 31 December	(120)	(120)
Net book amount at 31 December	1,341	1,341

Impairment testing

Goodwill does not generate cash flows independently of other groups of assets and thus is assigned to cash generating units (CGUs) for the purposes of impairment testing. These CGUs are based upon how management monitors the business and represent the lowest level to which goodwill can be allocated on a reasonable basis. An allocation to CGUs of the Group's goodwill attributable to shareholders is shown below:

	2008 £m	2007 £m
M&G	1,153	1,153
Other	188	188
	1,341	1,341

'Other' represents goodwill amounts allocated across CGUs in Asia and US operations. These goodwill amounts are not individually material.

Assessment of whether goodwill may be impaired

With the exception of M&G, the goodwill attributable to shareholders in the balance sheet mainly relates to acquired life businesses. The Company routinely compares the aggregate of net asset value and acquired goodwill on an IFRS basis of acquired life business with the value of the business as determined using the EEV methodology, as described in note D1. Any excess of IFRS over EEV carrying value is then compared with EEV basis value of current and projected future new business to determine whether there is any indication that the goodwill in the IFRS balance sheet may be impaired.

Goodwill is tested for impairment by comparing the CGUs carrying amount, excluding any goodwill, with its recoverable amount.

M&G

The recoverable amount for the M&G CGU has been determined by calculating its value in use. This has been calculated by aggregating the present value of future cash flows expected to be derived from the component businesses of M&G (based upon management projections).

The discounted cash flow valuation has been based on a five-year plan prepared by M&G, and approved by management, and cash flow projections for later years.

The value in use is particularly sensitive to a number of key assumptions as follows:

- i The set of economic, market and business assumptions used to derive the five-year plan. The direct and secondary effects of recent developments, e.g. the fall in global equity markets, are considered in arriving at the expectations for the financial projections for the plan.
- ii The assumed growth rate on forecast cash flows beyond the terminal year of the budget. A growth rate of 2.5 per cent has been used to extrapolate beyond the plan period.
- iii The risk discount rate. Differing discount rates have been applied in accordance with the nature of the individual component businesses. For retail and institutional business a risk discount rate of 12 per cent has been applied to post-tax cash flows. This represents an average implied discount rate for comparable UK listed asset managers calculated by reference to risk-free rates, equity risk premiums of five per cent and an average 'beta' factor for relative market risk of comparable UK listed asset managers. A similar approach has been applied for the other component businesses of M&G.
- iv That asset management contracts continue on similar terms.

Management believes that any reasonable change in the key assumptions would not cause the carrying amount of M&G to exceed its recoverable amount.

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H1: Intangible assets attributable to shareholders continued

Japanese life company

The aggregate goodwill impairment of £120 million at 31 December 2008 and 2007 relates to the goodwill held in relation to the Japanese life operation which was impaired in 2005.

b Deferred acquisition costs and other intangible assets

Deferred acquisition costs and other intangible assets in the Group consolidated balance sheet attributable to shareholders consist of:

	2008 £m	2007 £m
Deferred acquisition costs (DAC) related to insurance contracts as classified under IFRS 4	5,097	2,644
Deferred acquisition costs related to investment management contracts, including life assurance contracts classified as financial instruments and investment management contracts under IFRS 4	108	113
	5,205	2,757
Present value of acquired in-force policies for insurance contracts as classified under IFRS 4	64	59
Present value of future profits of acquired investment management contracts, including life assurance contracts classified as financial instruments and investment management contracts under IFRS 4	1	4
Distribution rights	79	16
	144	79
Total of deferred acquisition costs and other intangible assets	5,349	2,836
Arising in:		
UK insurance operations	134	157
US insurance operations	3,962	1,928
Asian insurance operations	1,247	745
Asset management operations	6	6
	5,349	2,836

The movement in the year comprises:

	2008 £m	2007 £m
Balance at 1 January	2,836	2,497
Additions	959	717
Amortisation to income statement	(551)	(424)
Exchange differences	1,035	(42)
Change in shadow DAC (note D3(i))	1,070	88
Balance at 31 December	5,349	2,836

Deferred acquisition costs related to insurance contracts attributable to shareholders

The movement in deferred acquisition costs relating to insurance contracts attributable to shareholders is as follows:

	2008 £m	2007 £m
Deferred acquisition costs at 1 January	2,644	2,315
Additions	887	694
Amortisation	(520)	(410)
Exchange differences	1,016	(44)
Change in shadow DAC	1,070	89
Deferred acquisition costs at 31 December	5,097	2,644

Deferred acquisition costs related to investment management contracts attributable to shareholders

Incremental costs associated with the origination of investment management contracts written by the Group's insurance and asset management businesses are capitalised and amortised as the related revenue is recognised. Deferred acquisition costs related to investment management contracts are all internally generated.

Amortisation of this intangible asset is included in the 'acquisition costs and other operating expenditure' line in the income statement.

	2008 £m	2007 £m
At 1 January		
Gross amount	136	130
Accumulated amortisation	(23)	(20)
Net book amount	113	110
Additions (through internal development)	12	7
Amortisation	(17)	(3)
Other charges	–	(1)
At 31 December	108	113
Comprising:		
Gross amount	148	136
Accumulated amortisation	(40)	(23)
Net book amount	108	113

Present value of acquired in-force business of long-term business contracts attributable to shareholders

Prior to the adoption of IFRS 4, the present value of acquired in-force business (PVAIF) was accounted for under UK GAAP.

On 1 January 2005, following the adoption of IFRS 4, PVAIF relating to investment contracts without discretionary participation features, which was previously included within long-term business, is removed and replaced by an asset representing the present value of the future profits of the asset management component of these contracts, where applicable. These contracts are accounted for under the provisions of IAS 18. The remainder of the PVAIF balance relates to insurance contracts and is accounted for under UK GAAP as permitted by IFRS 4.

The present value of future profits of acquired asset management contracts relates to unit-linked contracts acquired as part of the M&G acquisition in 1999.

Amortisation is charged to the 'acquisition costs and other operating expenditure' line in the income statement over the period of provision of asset management services as those profits emerge.

	2008 £m		2007 £m	
	Insurance contracts	Investment management	Insurance contracts	Investment management
At 1 January				
Cost	161	12	220	12
Accumulated amortisation	(102)	(8)	(154)	(6)
Net book amount	59	4	66	6
Exchange differences	14	–	2	–
Amortisation charge	(9)	(3)	(9)	(2)
At 31 December	64	1	59	4
Comprising:				
Cost	184	12	161	12
Accumulated amortisation	(120)	(11)	(102)	(8)
Net book amount	64	1	59	4

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H1: Intangible assets attributable to shareholders continued

Distribution rights attributable to the Asian insurance operations

Distribution rights relate to facilitation fees paid in respect of the bancassurance partnership arrangements in Asia for the bank distribution of Prudential's insurance products for a fixed period of time. The distribution rights amounts are amortised over the term of the distribution contracts.

	2008 £m	2007 £m
At 1 January		
Gross amount	16	–
Accumulated amortisation	0	–
	16	–
Additions	62	16
Amortisation charge	(4)	–
Exchange differences	5	–
At 31 December	79	16
Comprising:		
Gross amount	84	16
Accumulated amortisation	(5)	–
	79	16

H2: Intangible assets attributable to with-profits funds

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

	2008 £m
Goodwill	
Carrying value at 1 January 2008	192
Amortisation charge	–
Impairment	(18)
At 31 December 2008	174

All the goodwill relates to the UK and the insurance operations segments.

Following the sale by the Group of PPM Capital in November 2007, the only venture fund investment consolidated by the Group relates to an investment by PAC with-profits fund managed by M&G. The goodwill shown in the table above relates to this venture fund investment. Goodwill is tested for impairment for this investment by comparing the investment's carrying value with its recoverable amount. The recoverable amount of the investment was determined by calculating its fair value less costs to sell. At 31 December 2008, following the impairment testing carried out, £18 million of the goodwill was deemed to be impaired and written off accordingly.

The impairment charge of £18 million is recorded under 'acquisition costs and other operating expenditure' but is also taken account of in determining the charge/credit in the income statement for the transfer to the liability for unallocated surplus of with-profits funds.

b Deferred acquisition costs and other intangible assets

Other intangible assets in the Group consolidated balance sheet attributable to with-profit funds consist of:

	2008 £m	2007 £m
Deferred acquisition costs related to insurance contracts attributable to the PAC with-profit fund	13	19
Distribution rights attributable to with-profit funds of the Asian insurance operations	113	–
	126	19

Deferred acquisition costs related to insurance contracts attributable to the PAC with-profit fund

The movement in deferred acquisition costs relating to insurance contracts attributable to the PAC with-profit fund is as follows:

	2008 £m	2007 £m
At 1 January	19	31
Additions	–	1
Amortisation charge	(6)	(13)
At 31 December	13	19

The above costs relate to non-participating business written by the PAC with-profits sub-fund.

No deferred acquisition costs are established for the participating business.

Distribution rights attributable to with-profit funds of the Asian insurance operations

Distribution rights relate to facilitation fees paid in relation to the bancassurance partnership arrangements in Asia for the bank distribution of Prudential's insurance products for a fixed period of time. The distribution rights amounts are amortised over the term of the distribution contracts.

	2008 £m
Gross amount	–
Accumulated amortisation	–
	–
Additions	115
Amortisation charge	(2)
Exchange differences	–
At 31 December	113
Comprising:	
Gross amount	115
Accumulated amortisation	(2)
	113

H3: Reinsurers' share of insurance contract liabilities

	2008 £m	2007 £m
Insurance contract liabilities	1,176	724
Claims outstanding	64	59
	1,240	783

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

	2008 £m	2007 £m
At 1 January	724	878
Movement in the year	243	(147)
Foreign exchange translation differences	209	(7)
At 31 December	1,176	724

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H4: Tax assets and liabilities

Assets

Of the £657 million (2007: £285 million) current tax recoverable, the majority is expected to be recovered in one year or less.

Deferred tax asset

	2008 £m	2007 £m
Unrealised losses on investments	1,267	129
Balances relating to investment and insurance contracts	12	2
Short-term timing differences	1,282	770
Capital allowances	16	20
Unused deferred tax losses	309	30
Total	2,886	951

The deferred tax asset at 31 December 2008 and 2007 arises in the following parts of the Group.

	2008 £m	2007 £m
UK insurance operations:		
SAIF	7	1
PAC with-profits fund (including PAL)	272	93
Other	234	11
US insurance operations	1,969	657
Asian insurance operations	101	73
Other operations	303	116
	2,886	951

Deferred tax assets are recognised to the extent that they are regarded as recoverable, that is to the extent that, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable taxable profits from which the future reversal of the underlying temporary differences can be deducted. The significant increases in 2008 reflect the incidence of unrealised losses on the fixed income securities of US insurance operations, for which there is the intent and ability to hold for the longer term. In addition, deferred tax balances to UK shareholder-backed insurance business has increased reflecting losses carried forward on the tax basis which reflects the regulatory basis.

The UK taxation regime applies separate rules to trading and capital profits and losses. The distinction between temporary differences that arise from items of either a trading or capital nature may affect the recognition of deferred tax assets. Accordingly, for the 2008 results and balance sheet position at 31 December 2008, the possible tax benefit of approximately £211 million (2007: £280 million), which may arise from capital losses valued at approximately £1 billion (2007: £1.4 billion), is sufficiently uncertain that it has not been recognised. In addition, a potential deferred tax asset of £678 million (2007: £112 million), which may arise from tax losses and other potential temporary differences totalling £2.2 billion (2007: £350 million) is sufficiently uncertain that it has not been recognised. Forecasts as to when the tax losses and other temporary differences are likely to be utilised indicate that they may not be utilised in the short term.

Liabilities

Of the £842 million (2007: £1,237 million) current tax liability, it is not practicable to estimate how much is expected to be settled in one year or less due to the uncertainty over when outstanding issues will be agreed with HM Revenue & Customs.

Deferred tax liability

	2008 £m	2007 £m
Unrealised gains on investments	765	2,098
Balances relating to investment and insurance contracts	968	599
Short-term timing differences	1,490	693
Capital allowances	6	12
	3,229	3,402

Unprovided deferred income tax liabilities on temporary differences associated with investments in subsidiaries, associates and interests in joint ventures are considered to be insignificant due to the availability of various UK tax exemptions and reliefs.

Discounting

Deferred tax asset and liability balances have not been discounted.

H5: Accrued investment income and other debtors

	2008 £m	2007 £m
Accrued investment income		
Interest receivable	1,775	1,434
Other	738	589
Total	2,513	2,023
Other debtors		
Premiums receivable:		
From policyholders	194	154
From intermediaries	17	13
From reinsurers	253	104
Other	768	638
Total	1,232	909
Total accrued investment income and other debtors	3,745	2,932

Of the £3,745 million (2007: £2,932 million) of accrued investment income and other debtors, £114 million (2007: £64 million) is expected to be settled after one year or more.

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H6: Property, plant and equipment

Property, plant and equipment comprise Group occupied properties, development property and tangible assets. A reconciliation of the carrying amount of these items from the beginning of the year to the end of the year is as follows:

	Group occupied property £m	Development property £m	Tangible assets £m	Continuing operations £m	Discontinued operations £m	Total £m
At 1 January 2007						
Cost	225	479	917	1,621	226	1,847
Accumulated depreciation	(33)	–	(518)	(551)	(163)	(714)
Net book amount	192	479	399	1,070	63	1,133
Year ended 31 December 2007						
Opening net book amount	192	479	399	1,070	63	1,133
Exchange differences	2	–	1	3	–	3
Depreciation charge	(48)	–	(50)	(98)	(9)	(107)
Additions	71	48	109	228	3	231
Arising on acquisition of subsidiaries	5	–	33	38	–	38
Disposal of subsidiaries	–	–	–	–	(57)	(57)
Deconsolidated venture fund investments ¹⁶	(69)	–	(261)	(330)	–	(330)
Disposals	(2)	–	(25)	(27)	–	(27)
Reclassification from held for investment	–	120	–	120	–	120
Reclassification from held for sale	–	8	–	8	–	8
Closing net book amount	151	655	206	1,012	–	1,012
At 1 January 2008						
Cost	172	655	612	1,439	–	1,439
Accumulated depreciation	(21)	–	(406)	(427)	–	(427)
Net book amount	151	655	206	1,012	–	1,012
Year ended 31 December 2008						
Opening net book amount	151	655	206	1,012	–	1,012
Exchange differences	45	–	40	85	–	85
Depreciation charge	(3)	–	(67)	(70)	–	(70)
Additions	3	152	85	240	–	240
Disposals	(1)	–	(23)	(24)	–	(24)
Reclassification from (to) held for investment	68	(676)	–	(608)	–	(608)
Closing net book amount	263	131	241	635	–	635
At 31 December 2008						
Cost	292	131	717	1,140	–	1,140
Accumulated depreciation	(29)	–	(476)	(505)	–	(505)
Net book amount	263	131	241	635	–	635

All additions arising on acquisition of subsidiaries in 2007 related to acquisitions of venture investment subsidiaries of the PAC with-profits fund.

Capital expenditure: property, plant and equipment by primary segment

	2008 £m	2007 £m
Insurance operations	212	206
Asset management	13	11
Unallocated corporate	16	11
Continuing operations	241	228
Discontinued banking operations	–	3
Total	241	231

Capital expenditure: property, plant and equipment by secondary segment

	2008 £m	2007 £m
UK	173	145
US	20	33
Asia	48	50
Continuing operations	241	228
Discontinued banking operations	–	3
Total	241	231

H7: Investment properties

Investment properties principally relate to the PAC with-profits fund and are carried at fair value. A reconciliation of the carrying amount of investment properties at the beginning and end of the year is set out below:

	2008 £m	2007 £m
At 1 January	13,688	14,491
Additions:		
Resulting from acquisitions	1,414	1,707
Resulting from expenditure capitalised	218	128
Resulting from acquisitions through business combinations	463	–
Disposals	(1,010)	(1,378)
Net loss from fair value adjustments	(3,784)	(1,128)
Net foreign exchange differences	395	14
Transfers to held for sale assets	–	(25)
Transfers from (to) development properties	676	(121)
Transfers to owner occupied properties	(68)	–
At 31 December	11,992	13,688

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

	2008 £m	2007 £m
Rental income from investment properties	726	670
Direct operating expenses (including repairs and maintenance expenses) arising from investment properties:		
That generated rental income during the year	109	117
That did not generate rental income during the year	1	–
Total direct operating expenses	110	117

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H7: Investment properties continued

Investment properties of £3,559 million (2007: £3,665 million) are held under finance leases. A reconciliation between the total of future minimum lease payments at the balance sheet date, and their present value is shown below:

	2008 £m	2007 £m
Future minimum lease payments at 31 December	963	979
Future finance charges on finance leases	(863)	(877)
Present value of minimum lease payments	100	102
Future minimum lease payments are due as follows:		
Less than 1 year	5	5
1 to 5 years	22	22
Over 5 years	936	952
Total	963	979
The present values of these minimum lease payments are:		
Less than 1 year	5	5
1 to 5 years	22	22
Over 5 years	73	75
Total	100	102

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future value of a factor that changes other than with the passage of time. Contingent rent recognised as an expense in 2008 amounted to £nil (2007: £14 million). Contingent rents recognised as income in the year amounted to £nil (2007: £26 million).

The Group's policy is to rent investment properties to tenants through operating leases. Minimum future rentals to be received on non-cancellable operating leases are receivable in the following periods:

	2008 £m	2007 £m
Less than 1 year	742	679
1 to 5 years	2,599	2,464
Over 5 years	9,106	8,266
Total	12,447	11,409

The total minimum future rentals to be received on non-cancellable sub-leases for land and buildings at 31 December 2008 are £3,730 million (2007: £2,746 million).

H8: Investments in associates and joint ventures

Investments in associates

The Group had four associates at 31 December 2008 (2007: four) that are accounted for using the equity method. The Group's associates are a 30 per cent interest in The Nam Khang, a Vietnamese property developer, a 30 per cent interest in Apollo Education and Training Organisation Vietnam, a 25 per cent interest in OYO Developments Limited, and a 26.8 per cent interest in IFonline Group Limited (IFonline).

The Group also has investments in associates which meet the IAS 28 criteria for measurement at fair value through profit and loss in accordance with IAS 39.

Associates accounted for using the equity method

Equity accounting is applied to IFonline based on its reporting period of the year to 30 November and is adjusted for material changes up to 31 December. Accordingly, the information is deemed to cover the same period as that of the Group.

A summary of the movements in investments in associates accounted for using the equity method in 2008 and 2007 is set out below:

	Share of capital £m	Share of reserves £m	Share of net assets £m	Goodwill £m	Total carrying value £m
Balance at 1 January 2007	4	(5)	(1)	7	6
Acquisitions	5	–	5	1	6
Share of profit for the year after tax	–	–	–	–	–
Balance at 31 December 2007	9	(5)	4	8	12
Impairment of goodwill	–	–	–	(6)	(6)
Exchange translation and other movements	3	1	4	–	4
Share of loss for the year after tax	–	–	–	–	–
Balance at 31 December 2008	12	(4)	8	2	10

There have been no changes recognised directly in the equity of associates that would also be recognised directly in equity by the Group.

The Group's share of the assets, liabilities, revenues and profit and loss of associates accounted for using the equity method at 31 December 2008 and 2007 is as follows:

	2008 £m	2007 £m
Financial position		
Total assets (excluding goodwill)	12	7
Total liabilities	(4)	(3)
Net assets	8	4
Results of operations		
Revenue	3	5
Profit in the year	–	–

Associates carried at fair value through profit and loss

The Group's associates that are carried at fair value through profit and loss comprise investments in OEICs, unit trusts, funds holding collateralised debt obligations, property unit trusts, and venture capital investments of the PAC with-profits fund where the Group has significant influence. These investments are incorporated both in the UK and overseas, and some have year ends which are non-coterminous with that of the Group. In these instances, the investments are recorded at fair value at 31 December 2008 based on valuations or pricing information at that specific date. The aggregate fair value of associates carried at fair value through profit and loss where there are published price quotations is approximately £4 billion (2007: £2 billion) at 31 December 2008.

The aggregate assets of these associates are approximately £8 billion (2007: £9 billion). Aggregate liabilities, excluding liabilities to unit holders and shareholders for unit trusts and OEICs, are approximately £2 billion (2007: £2 billion). Fund revenues, with revenue arising in unit trusts and OEICs deemed to constitute the investment return for these vehicles, were approximately £0.8 billion (2007: £0.5 billion) and net loss in the year, excluding unit trusts and OEICs where all investment returns accrue to unit holders or shareholders respectively, was approximately £0.3 billion (2007: profit of £0.2 billion).

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H8: Investments in associates and joint ventures continued

Investments in joint ventures

Joint ventures represent activities over which the Group exercises joint control through contractual agreement with one or more parties. The Group's significant joint ventures, which are accounted for using proportionate consolidation, comprise various joint ventures relating to property investments where the Group has a 50 per cent interest as well as the following interests:

Investment	% held	Principal activity	Country
ICICI Prudential Life Insurance Company Limited	26	Life assurance	India
BOCI – Prudential Asset Management Limited	36	Pensions	China
PruHealth	50	Private medical insurance	UK
CITIC – Prudential Life Insurance Company Limited	50	Life assurance	China
CITIC Prudential Fund Management Company Limited	49	Asset management	China
Prudential ICICI Asset Management Company Limited	49	Asset management	India
Prudential BSN Takaful Berhad	49	General and life insurance	Malaysia

In August 2007, the Group increased its stake in CITIC Prudential Fund Management Company Limited from 33 per cent to 49 per cent.

On 29 September 2007, following expiry of the previous management agreement, a revised arrangement was put in place in respect of CITIC – Prudential Life Insurance Company Limited following which the Group's investment has been accounted for as a joint venture. Prior to the change in management agreement CITIC – Prudential Life Insurance Company Limited was accounted for as a subsidiary undertaking. Whilst the management agreement has been revised there has been no change in the Group's level of holding.

The investments noted in the table above have the same accounting year end as the Group, except for ICICI Prudential Life Insurance Company Limited and Prudential ICICI Asset Management Company Limited. Although these investments have reporting periods ending 31 March, 12 months of financial information up to 31 December is recorded. Accordingly, the information is deemed to cover the same period as that of the Group.

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

	2008 £m	2007 £m
Financial position		
Current assets	250	1,277
Non-current assets	1,212	173
Total assets	1,462	1,450
Current liabilities	(159)	(115)
Non-current liabilities	(1,063)	(1,121)
Total liabilities	(1,222)	(1,236)
Net equity	240	214
Results of operations		
Revenues	656	500
Expenses	(649)	(546)
Net profit (loss)	7	(46)

There are several minor service agreements in place between the joint ventures and the Group. During 2008, the aggregate amount of the transactions was £15.9 million (2007: £5.4 million) and the balance outstanding as at 31 December 2008 was £22.5 million (2007: £4.7 million).

The joint ventures have no significant contingent liabilities to which the Group is exposed nor does the Group have any significant contingent liabilities in relation to its interest in the joint ventures.

H9: Assets held for sale

Assets held for sale in 2007 of £30 million comprised investment property of the PAC with-profits fund.

Investment properties are classified as held for sale when contracts have been exchanged but the sale has not been completed at the period end. There were no assets held for sale at 31 December 2008.

Gains on disposal of held for sale assets are recorded in 'investment income' within the income statement.

H10: Cash and cash equivalents

Cash and cash equivalents consist of cash at bank and in hand, deposits held at call with banks, treasury bills and other short-term highly liquid investments with less than 90 days maturity from the date of acquisition. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts:

	2008 £m	2007 £m
Cash	5,362	4,528
Cash equivalents	593	423
Total cash and cash equivalents	5,955	4,951

Cash and cash equivalents held centrally are considered to be available for general use by the Group. These funds amount to £165 million and £394 million at 31 December 2008 and 2007, respectively. The remaining funds are considered not to be available for general use by the Group, and include funds held for the benefit of policyholders.

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

	2008 £m	2007 £m
Share capital and share premium		
Share capital	125	123
Share premium	1,840	1,828
Reserves		
Retained earnings	3,604	4,301
Translation reserve	638	(112)
Available-for-sale reserve	(1,149)	(78)
Total shareholders' equity	5,058	6,062

The authorised share capital of the Company is £220 million (2007: £220 million) (divided into 4,000,000,000 (2007: 4,000,000,000) ordinary shares of 5 pence each and 2,000,000,000 sterling preference shares of 1 pence each) and US\$20 million (divided into 2,000,000,000 US dollar preference shares of 1 cent each) and Euros 20 million (divided into 2,000,000,000 Euro preference shares of 1 cent each). None of the preference shares have been issued. A summary of the ordinary shares in issue is set out below:

Notes on the Group financial statements

H: Other information on balance sheet items

continued

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

Share capital and share premium

	2007		
	Number of ordinary shares	Share capital £m	Share premium £m
Issued shares of 5p each fully paid:			
At the beginning of the year	2,444,312,425	122	1,822
Shares issued under share option schemes	803,818	–	6
Shares issued in lieu of cash dividends	24,900,997	1	175
Transfer to retained earnings in respect of shares issued in lieu of cash dividends	–	–	(175)
At end of the year	2,470,017,240	123	1,828
	2008		
Issued shares of 5p each fully paid:			
At the beginning of the year	2,470,017,240	123	1,828
Shares issued under share option schemes	2,307,469	–	12
Shares issued in lieu of cash dividends	24,622,979	2	156
Transfer to retained earnings in respect of shares issued in lieu of cash dividends	–	–	(156)
At end of the year	2,496,947,688	125	1,840

Amounts recorded in share capital represent the nominal value of the shares issued. The difference between the proceeds received on issue of shares, net of issue costs, and the nominal value of shares issued is credited to the share premium account.

At 31 December 2008, there were options outstanding under Save As You Earn schemes to subscribe for 6,825,343 (2007: 9,017,442) shares at prices ranging from 266 pence to 617 pence (2007: 266 pence to 695 pence) and exercisable by the year 2015 (2014). In addition, there are 967,652 (2007: 2,037,220) conditional options outstanding under the RSP and 4,906,234 (2007: 3,485,617) under the GPSP exercisable at nil cost within a 10-year period.

The cost of own shares of £75 million as at 31 December 2008 (2007: £60 million) is deducted from retained earnings. The Company has established trusts to facilitate the delivery of shares under employee incentive plans and savings-related share option schemes. At 31 December 2008, 6.4 million (2007: 6.6 million) Prudential plc shares with a market value of £27 million (2007: £47 million) were held in such trusts. Of this total, 6.0 million (2007: 5.1 million) shares were held in trusts under employee incentive plans. In 2008, the Company purchased 5.4 million (2007: 1.2 million) shares in respect of employee incentive plans at a cost of £27 million (2007: £9 million). The maximum number of shares held in the year was 6.6 million which was at the beginning of the year.

Of the total shares held in trust, 0.4 million (2007: 1.5 million) shares were held by a qualifying employee share ownership trust. These shares are expected to be fully distributed in the future on maturity of savings-related share option schemes.

The Group has consolidated a number of authorised investment funds where it is deemed to control these funds under IFRS. Certain of these funds hold shares in Prudential plc. The total number of shares held by these funds at 31 December 2008 was 9.2 million (2007: 4.1 million) and the cost of acquiring these shares of £47 million (2007: £22 million) is included in the cost of own shares. The market value of these shares as at 31 December 2008 was £37 million (2007: £29 million).

Reserves

The translation reserve represents cumulative foreign exchange translation differences taken directly to equity in accordance with IFRS, net of related tax. In accordance with IFRS 1, cumulative translation differences are deemed to be zero at 1 January 2004, the date of transition to IFRS.

The available-for-sale reserve represents gains or losses arising from changes in the fair value of available-for-sale securities of Jackson, net of the related change in amortisation of deferred income and acquisition costs and of the related tax.

H12: Insurance contract liabilities and unallocated surplus of with-profits funds

Movement in year

	Insurance contract liabilities £m	Unallocated surplus of with-profits funds £m
At 1 January 2007	123,339	13,425
Income and expense included in the income statement	9,604	541
Foreign exchange translation differences	(167)	(7)
At 31 December 2007	132,776	13,959
At 1 January 2008	132,776	13,959
Income and expense included in the income statement	(12,760)	(5,815)
Foreign exchange translation differences	16,014	270
At 31 December 2008	136,030	8,414

Note B6 provides further analysis of the movement in the year of the Group's policyholder liabilities and unallocated surplus of the with-profits funds.

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H13: Borrowings

Core structural borrowings of shareholder-financed operations

	Innovative Tier 1*	Lower Tier 2*	Senior†	2008 £m	2007 £m
				Total	Total
Parent company					
Subordinated debt:					
€500m 5.75% Subordinated Notes 2021 ^{note i}		482		482	365
€20m Medium-Term Subordinated Notes 2023 ^{note ii}		19		19	15
£435m 6.125% Subordinated Notes 2031		427		427	427
US\$1,000m 6.5% Perpetual Subordinated Capital Securities ^{note iii}	696			696	485
US\$250m 6.75% Perpetual Subordinated Capital Securities ^{note iv}	173			173	124
US\$300m 6.5% Perpetual Subordinated Capital Securities ^{notes ivv}	190			190	154
	1,059	928	–	1,987	1,570
Senior debt:‡					
£249m 5.5% Bonds 2009			249	249	248
£300m 6.875% Bonds 2023			300	300	300
£250m 5.875% Bonds 2029			249	249	249
	–	–	798	798	797
Total parent company†	1,059	928	798	2,785	2,367
Jackson					
US\$250m 8.15% Surplus Notes 2027 ^{note vi}		173		173	125
Total^{note vii}	1,059	1,101	798	2,958	2,492

* These debt classifications are consistent with the treatment of capital for regulatory purposes, as defined in the FSA Handbook.

† Including central finance subsidiaries.

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

Notes

- i The €500 million 5.75 per cent borrowings have been swapped into borrowings of £333 million with interest payable at six month £Libor plus 0.962 per cent.
- ii The €20 million Medium-Term Subordinated Notes were issued at 20-year Euro Constant Maturity Swap (capped at 6.5 per cent). These have been swapped into borrowings of £14 million with interest payable at three month £Libor plus 1.2 per cent.
- iii Interest on the US\$1,000 million 6.5 per cent borrowings was swapped into floating rate payments at three month US\$Libor plus 0.80 per cent. In January 2009, this swap was cancelled.
- iv The US\$250 million 6.75 per cent borrowings and the US\$300 million 6.5 per cent borrowings can be converted, in whole or in part, at the Company's option and subject to certain conditions, on any interest payment date falling on or after 23 March 2010 and 23 March 2011 respectively, into one or more series of Prudential preference shares.
- v Interest on the US\$300 million 6.5 per cent borrowings was swapped into floating rate payments at three month US\$Libor plus 0.0225 per cent. In January 2008, this was swapped back into fixed rate payments at 6.5 per cent.
- vi The Surplus Notes are unsecured and subordinated to all present and future indebtedness, policy claims and other creditor claims of Jackson.
- vii Maturity analysis

The following table sets out the maturity analysis of the Group's core structural borrowings:

	2008 £m	2007 £m
Less than 1 year	249	–
1 to 2 years	–	248
2 to 3 years	–	–
3 to 4 years	–	–
4 to 5 years	–	–
Over 5 years	2,709	2,244
Total	2,958	2,492

Operational borrowings attributable to shareholder-financed operations

	2008 £m	2007 £m
Borrowings in respect of short-term fixed income securities programmes		
Commercial paper	1,269	2,422
Medium-Term Notes 2008	–	48
Medium-Term Notes 2010	9	7
	1,278	2,477
Non-recourse borrowings of US operations^{note i}		
Jackson ^{note ii}	104	126
Investment subsidiaries	23	9
Piedmont and CDO funds ^{note iii}	384	456
	511	591
Other borrowings		
Bank loans and overdrafts ^{note iv}	185	6
Obligations under finance leases	3	7
	188	13
Total^{note vi}	1,977	3,081

Notes

- i In all instances the holders of the debt instruments issued by these subsidiaries and funds do not have recourse beyond the assets of those subsidiaries and funds.
- ii This represents senior debt issued through the Federal Home Loan Bank of Indianapolis and is secured on collateral posted with FHLB by Jackson. The interest rate on this debt is variable based on a market rate and was 0.47 per cent at 31 December 2008.
- iii Piedmont is an investment trust investing in certain asset-backed and mortgage-backed securities in the US. These borrowings pertain to debt instruments issued to external parties.
- iv Bank loans and overdrafts include a short-term loan of £130 million in Asian operations (2007: £nil).
- v In addition to the operational borrowings shown in the table above, in October 2008 Prudential plc issued £200 million Floating Rate Notes 2009, which were wholly subscribed to by a Group subsidiary. These borrowings have been eliminated on consolidation.
- vi Maturity analysis
The following table sets out the maturity analysis of the Group's operational borrowings attributable to shareholder-financed operations:

	2008 £m	2007 £m
Less than 1 year	1,584	2,618
1 to 2 years	9	–
2 to 3 years	38	7
3 to 4 years	52	44
4 to 5 years	240	54
Over 5 years	54	358
Total	1,977	3,081

Borrowings attributable to with-profits funds

	2008 £m	2007 £m
Non-recourse borrowings of consolidated investment funds ^{note i}	1,161	789
£100m 8.5% Undated Subordinated Guaranteed Bonds of Scottish Amicable Finance plc ^{note ii}	100	100
Other borrowings (predominantly obligations under finance leases)	47	98
Total^{note iii}	1,308	987

Notes

- i In all instances the holders of the debt instruments issued by these funds do not have recourse beyond the assets of those funds.
- ii The interests of the holders of the bonds issued by Scottish Amicable Finance plc, a subsidiary of the Scottish Amicable Insurance Fund, are subordinate to the entitlements of the policyholders of that fund.

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H13: Borrowings continued

iii Maturity analysis

The following table sets out the maturity analysis of the Group's borrowings attributable to with-profits funds:

	2008 £m	2007 £m
Less than 1 year	272	103
1 to 2 years	12	16
2 to 3 years	150	62
3 to 4 years	418	-
4 to 5 years	-	154
Over 5 years	456	652
Total	1,308	987

H14: Provisions and contingencies

Provisions

	2008 £m	2007 £m
Provision in respect of defined benefit pension schemes: ⁱⁱ		
Deficit, gross of deferred tax, based on scheme assets held, including investments in Prudential insurance policies:		
Attributable to PAC with-profits fund (i.e. absorbed by the liability for unallocated surplus)	67	98
Attributable to shareholder-financed operations (i.e. to shareholders' equity)	82	85
	149	183
Add back: Investments in Prudential insurance policies	157	172
Provision after elimination of investments in Prudential insurance policies and matching policyholder liability from Group balance sheet	306	355
Other provisions (see below)	155	220
Total provisions	461	575

Analysis of other provisions:

	2008 £m	2007 £m
At 1 January	220	238
Charged to income statement:		
Additional provisions	48	116
Unused amounts released	(24)	(23)
Used during the year	(101)	(112)
Exchange differences	12	1
At 31 December	155	220
Comprising:		
Legal provisions	23	19
Restructuring provisions	21	35
Other provisions	111	166
Total	155	220

Of the other provisions balance of £155 million (2007: £220 million), £90 million (2007: £77 million) is expected to be settled within one year. Employer contributions expected to be paid into defined benefit pension schemes within one year are shown in note I1.

Legal provisions

The legal provisions of £23 million (2007: £19 million) relate predominantly to Jackson. Jackson has been named in civil proceedings, which appear to be substantially similar to other class action litigation brought against many life insurers in the US, alleging misconduct in the sale of insurance products. During 2008, £2 million was paid.

Restructuring provisions

Restructuring provisions of £21 million (2007: £35 million) relate to restructuring activities of UK insurance operations.

In 2004 and 2005, UK insurance operations implemented restructurings relating to document management review, streamlining operations, and the relocation of activities to an offshore base in India. In December 2005, the Group announced an initiative for UK insurance operations to work more closely with M&G and in the process facilitate the realisation of substantial annualised pre-tax cost savings and opportunities for revenue synergies.

On 28 November 2007 UK insurance operations announced it had entered into a partnership agreement with Capita Group Plc (Capita) to outsource a large proportion of its in-force and new business policy administration. Under the terms of the proposed agreement, Capita will provide customer servicing, policy administration, new business processing, claims activity and related IT support.

At 1 January 2007, a provision of £72 million was brought forward, and during 2007 an additional £21 million was provided, £14 million of unused provision was released, and £44 million was paid.

During 2008, an additional provision of £4 million was provided, £7 million of unused provision was released, and £11 million was paid.

Other provisions

Other provisions of £111 million (2007: £166 million) include provisions of £95 million (2007: £155 million) relating to staff benefit schemes. During 2008, another £37 million was provided (including exchange movements of £6 million), £15 million of unused provision was released and £82 million was paid. In 2007, a provision of £134 million was brought forward, an additional £78 million was provided, £3 million of unused provision was released and £54 million was paid. Other provisions also include £16 million (2007: £11 million) relating to various onerous contracts where, in 2008, an additional £10 million was provided and £5 million was used. In 2007, £18 million was brought forward, £2 million was provided and £1 million was released and £8 million was paid.

Contingencies and related obligations

Litigation

In addition to the legal proceedings relating to Jackson mentioned above, the Group is involved in other litigation and regulatory issues. Whilst the outcome of such matters cannot be predicted with certainty, the directors believe that the ultimate outcome of such litigation and regulatory issues will not have a material adverse effect on the Group's financial condition, results of operations, or cash flows.

Pension mis-selling review

In 1988, the UK government introduced new pensions legislation intended to encourage more individuals to make their own arrangements for their pensions. During the period from April 1988 to June 1994, many individuals were advised by insurance companies, Independent Financial Advisers and other intermediaries to not join, to transfer from or to opt out of their occupational pension schemes in favour of private pension products introduced under the UK Income and Corporation Taxes Act 1988. The UK insurance regulator (previously the Personal Investment Authority, now the FSA), subsequently determined that many individuals were incorrectly advised and would have been better off not purchasing the private pension products sold to them. Industry participants are responsible for compensating the persons to whom private pensions were mis-sold. As a result, the FSA required that all UK life insurance companies review their potential cases of pension mis-selling and pay compensation to policyholders where necessary and, as a consequence, record a provision for the estimated costs. The Group met the requirement of the FSA to issue offers to all cases by 30 June 2002.

The table below summarises the change in the pension mis-selling provision for the years ended 31 December 2008 and 2007. The change in the provision is included in benefits and claims in the income statement and the movement in unallocated surplus of with-profits funds has been determined accordingly.

	2008 £m	2007 £m
Balance at beginning of year	448	401
Changes to actuarial assumptions and method of calculation	(75)	71
Discount unwind	20	22
Redress to policyholders	(46)	(41)
Payment of administrative costs	(2)	(5)
Balance at end of year	345	448

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H14: Provisions and contingencies continued

The pension mis-selling provision is included within the liabilities in respect of investment contracts with discretionary participation features under IFRS 4.

The pension mis-selling provision at 31 December 2008 set out above of £345 million is stochastically determined on a discounted basis. The average discount rate implied in the movement in the year is 4.0 per cent. The undiscounted amounts at 31 December 2008 expected to be paid in each of the years ending 31 December are as follows:

	2008 £m
Year ended 31 December	
2009	17
2010	8
2011	9
2012	13
2013	12
Thereafter	572
Total undiscounted amount	631
Aggregate discount	(286)
Discounted pension mis-selling provision at 31 December 2008	345

The liability accounting for the contracts which are the subject of the mis-selling provision is reflected in two elements, namely the core policyholder liability determined on the basis applied for other contract liabilities and the mis-selling provision. The overall liability for these contracts remains appropriate in the context of the accounting for policyholder liabilities that determines the calculation of both elements. However, the constituent elements are reallocated and remeasured for the changes arising from the application of the realistic Peak 2 basis of liabilities for the core policyholder liability, as reflected in the IFRS policy improvement to apply the UK GAAP standard FRS 27 as described in section A4.

The FSA periodically updates the actuarial assumptions to be used in calculating the provision, including interest rates and mortality assumptions. The pension mis-selling provision represents the discounted value of future expected payments, including benefit payments and all internal and external legal and administrative costs of adjudicating, processing and settling those claims. To the extent that amounts have not been paid, the provision increases each year reflecting the shorter period of discount.

The directors believe that, based on current information, the provision, together with future investment return on the assets backing the provision, will be adequate to cover the costs of pension mis-selling as well as the costs and expenses of the Group's pension review unit established to identify and settle such cases. Such provision represents the best estimate of probable costs and expenses. However, there can be no assurance that the current provision level will not need to be increased.

The costs associated with the pension mis-selling review have been met from the inherited estate (see below). Accordingly, these costs have not been charged to the asset shares used in the determination of policyholder bonus rates. Hence policyholders' pay-out values have been unaffected by pension mis-selling.

In 1998, Prudential stated that deducting mis-selling costs from the inherited estate would not impact its bonus or investment policy and it gave an assurance that if this unlikely event were to occur, it would make available support to the fund from shareholder resources for as long as the situation continued, so as to ensure that policyholders were not disadvantaged. The assurance was designed to protect both existing policyholders at the date it was announced, and policyholders who subsequently purchased policies while the pension mis-selling review was continuing.

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

The bonus and investment policy for each type of with-profits policy is the same irrespective of whether or not the assurance applies and this is expected to continue for the foreseeable future. Hence removal of the assurance for new business has had no impact on policyholder returns.

In February 2009, the FSA issued a revised consultation paper 09/09 proposing that future payments of compensation and redress for events occurring after 31 July 2009 may only be paid from assets attributable to shareholders.

Mortgage endowment products review

In common with several other UK insurance companies, the Group used to sell low-cost endowment products related to repayment of residential mortgages. At sale, the initial sum assured is set at a level such that the projected benefits, including an estimate of the annual bonus receivable over the life of the policy, will equal or exceed the mortgage debt. Because of a decrease in expected future investment returns since these products were sold, the FSA is concerned that the maturity value of some of these products will be less than the mortgage debt. The FSA has worked with insurance companies to devise a programme whereby the companies write to customers indicating whether they may have a possible shortfall and outline the actions that the customers can take to prevent this possibility.

The Group is exposed to mortgage endowment products in respect of policies issued by Scottish Amicable Life plc (SAL) and policies issued by Scottish Amicable Life Assurance Society (SALAS) which were transferred into SAIF. At 31 December 2008, provisions of £5 million (2007: £5 million) in SAL and £40 million (2007: £43 million) in SAIF were held to cover potential compensation in respect of mortgage endowment product mis-selling claims. As SAIF is a separate sub-fund of the Prudential Assurance long-term business fund, this provision has no impact on shareholders.

In addition, in the year ended 31 December 2008 Prudential Assurance's main with-profits fund paid compensation of £1 million (2007: £5 million) in respect of mortgage endowment products mis-selling claims and at 31 December 2008 held a provision of £54 million (2007: £55 million) in respect of further compensation. The movement in this provision has no impact on the Group's profit before tax.

In May 2006, the Group introduced a deadline for both Prudential and Scottish Amicable mortgage endowment complaints. Impacted customers have three years to lodge a mis-selling complaint in line with the time limit prescribed by the FSA and the ABI.

Guaranteed annuities

Prudential Assurance used to sell guaranteed annuity products in the UK and at 31 December 2008 held a provision of £42 million (2007: £45 million) within the main with-profits fund to honour guarantees on these products. The Group's main exposure to guaranteed annuities in the UK is through SAIF and at 31 December 2008 a provision of £391 million (2007: £563 million) was held in SAIF to honour the guarantees. As SAIF is a separate sub-fund of the Prudential Assurance long-term business fund, the movement in this provision has no impact on shareholders.

Other matters

Inherited estate of the PAC long-term fund

The assets of the with-profits sub-fund (WPSF) within the long-term fund of The Prudential Assurance Company Limited (PAC) comprise the amounts that it expects to pay out to meet its obligations to existing policyholders and an additional amount used as working capital. The amount payable over time to policyholders from the WPSF is equal to the policyholders' accumulated asset shares plus any additional payments that may be required by way of smoothing or to meet guarantees. The balance of the assets of the WPSF is called the 'inherited estate' and has accumulated over many years from various sources.

The inherited estate, as working capital, enables PAC to support with-profits business by providing the benefits associated with smoothing and guarantees, by providing investment flexibility for the fund's assets, by meeting the regulatory capital requirements that demonstrate solvency and by absorbing the costs of significant events or fundamental changes in its long-term business without affecting the bonus and investment policies. The size of the inherited estate fluctuates from year to year depending on the investment return and the extent to which it has been required to meet smoothing costs, guarantees and other events.

Prudential announced in March 2006 that it had begun a process to determine whether it could achieve greater clarity as to the status of the inherited estate through reattribution. In June 2008 Prudential announced that it did not believe that it was in the interests of current or future policyholders or shareholders to continue the reattribution process. This announcement reflects Prudential's overriding priority which is to maintain the long-term financial security of the WPSF and to continue delivering strong performance for the benefit of its policyholders.

Support for long-term business funds by shareholders' funds

As a proprietary insurance company, Prudential Assurance is liable to meet its obligations to policyholders even if the assets of the long-term funds are insufficient to do so. The assets, represented by the unallocated surplus of with-profits funds, in excess of amounts expected to be paid for future terminal bonuses and related shareholder transfers ('the excess assets') in the long-term funds could be materially depleted over time by, for example, a significant or sustained equity market downturn, costs of significant fundamental strategic change or a material increase in the pension mis-selling provision. In the unlikely circumstance that the depletion of the excess assets within the long-term fund was such that the Group's ability to satisfy policyholders' reasonable expectations was adversely affected, it might become necessary to restrict the annual distribution to shareholders or to contribute shareholders' funds to the long-term funds to provide financial support.

In 1997, the business of SALAS, a mutual society, was transferred to Prudential Assurance. In effecting the transfer, a separate sub-fund, SAIF, was established within Prudential Assurance's long-term business fund. This sub-fund contains all the with-profits business and all other pension business that was transferred. No new business has been or will be written in the sub-fund and the sub-fund is managed to ensure that all the invested assets are distributed to SAIF policyholders over the lifetime of SAIF

Notes on the Group financial statements

H: Other information on balance sheet items

continued

H14: Provisions and contingencies continued

policies. With the exception of certain amounts in respect of the unitised with-profits life business, all future earnings arising in SAIF are retained for SAIF policyholders. Any excess (deficiency) of revenue over expense within SAIF during a period is offset by a transfer to (from) the SAIF unallocated surplus. Shareholders have no interest in the profits of SAIF but are entitled to the asset management fees paid on this business. With the exception of certain guaranteed annuity products mentioned earlier in this note, and certain products which include a minimum guaranteed rate of accumulation, the majority of SAIF with-profits policies do not guarantee minimum rates of return to policyholders.

Should the assets of SAIF be inadequate to meet the guaranteed benefit obligations to the policyholders of SAIF, the Prudential Assurance long-term fund would be liable to cover any such deficiency. Due to the quality and diversity of the assets in SAIF and the ability of SAIF to revise guaranteed benefits in the event of an asset shortfall, the directors believe that the probability of either the Prudential Assurance long-term fund or the Group's shareholders' funds having to contribute to SAIF is remote.

Guarantees and commitments

Guarantee funds in both the UK and the US provide for payments to be made to policyholders on behalf of insolvent life insurance companies. These guarantee funds are financed by payments assessed on solvent insurance companies based on location, volume and types of business. The Group estimated its reserve for future guarantee fund assessments for Jackson to be £18 million at 31 December 2008 (2007: £9 million). Similar assessments for the UK businesses were not significant. The directors believe that the reserve is adequate for all anticipated payments for known insolvencies.

At 31 December 2008, Jackson has unfunded commitments of £400 million (2007: £181 million) related to its investments in limited partnerships and of £24 million (2007: £104 million) related to commercial mortgage loans. These commitments were entered into in the normal course of business and the directors do not expect a material adverse impact on the operations to arise from them.

Jackson owns debt instruments issued by two separate securitisation trusts managed by PPM America which are consolidated into the Group accounts, SERVES 2001-6 (SERVES 2) and SERVES 2004-1 (SERVES 3). Jackson has a £50 million debt interest in SERVES 2 and a £33 million debt interest in SERVES 3. The creditors of the entities have no recourse to the general credit of Jackson. During 2008, Jackson entered into 'Option Put and Forbearance Agreements' with the counterparty to these two entities in exchange for the counterparty forbearing its right to initiate forced liquidations of the entities under certain market value triggers. The support provided by the agreements could potentially expose Jackson to maximum losses of £118 million and £103 million for SERVES 2 and SERVES 3, respectively, if circumstances allowed the forbearance period to cease. Jackson believes that, so long as the forbearance period continues, the risk of loss under the agreements is remote.

The Group has provided other guarantees and commitments to third-parties entered into in the normal course of business but the directors do not consider that the amounts involved are significant.

H15: Other liabilities

	2008 £m	2007 £m
Creditors arising from direct insurance and reinsurance operations	552	538
Interest payable	139	76
Other items	199	177
Total	890	791

I: Other notes

II: Staff and pension plans

a Staff and employment costs

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

	2008	2007
Business operations:		
UK operations	6,231	7,732
US operations	3,298	3,123
Asian operations	20,154	16,807
Venture fund investment subsidiaries of the PAC with-profits fund (see below)	–	21,184
Continuing operations	29,683	48,846
Discontinued banking operations	–	770
Total	29,683	49,616

The costs of employment for continuing operations were:

	2008 £m	2007 £m
Business operations:		
Wages and salaries	791	819
Social security costs	54	62
Other pension costs (see below)	78	96
Pension actuarial and other (gains) losses charged to income statement	(10)	2
	68	98
Venture fund investment subsidiaries of the PAC with-profits fund (see below)	–	423
Total for continuing operations	913	1,402
Discontinued banking operations	–	21
Total	913	1,423

Other pension costs comprises £47 million (2007: £68 million) relating to defined benefit schemes and £31 million (2007: £28 million) relating to defined contribution schemes of continuing operations. Of the defined contribution scheme costs, £21 million (2007: £19 million) related to overseas defined contribution schemes. The £47 million (2007: £68 million) comprises a charge of £29 million (2007: £41 million) relating to PSPS and a charge of £18 million (2007: £27 million) for other schemes.

Consistent with the derecognition of the Company's interest in the underlying IAS 19 surplus of PSPS as described in note (b)(i)1 below, the £29 million (2007: £41 million) for PSPS represents the cash cost of contributions for ongoing service of active members and the unwind of discount on the opening provision for deficit funding for PSPS. The charge of £18 million (2007: £27 million) for other schemes comprises a £7 million (2007: £17 million) charge on an economic basis, reflecting the total assets of the schemes, and a further £11 million (2007: £10 million) charge to adjust for amounts invested in Prudential insurance policies to arrive at the IAS 19 basis charge.

The gains of £10 million (2007: loss of £2 million) for actuarial and other gains comprises a loss of £21 million (2007: loss of £7 million) for actuarial and other losses on an economic basis and £31 million actuarial gains (2007: gain of £5 million) to adjust for amounts invested in Prudential insurance policies. The derivation of these amounts is shown in note (b)(i)7 below.

Of the £423 million costs of employment for venture fund investment subsidiaries in 2007, £349 million related to wages and salaries, £70 million related to social security costs and £4 million related to pension costs. Following the change of control arrangements put in place at the same time as the sale by the Group of PPM Capital in November 2007, the Group no longer controls those venture fund investment subsidiaries managed by the sold entity and consequently ceased to consolidate these operations subsequent to this, with the average number of staff employed and costs of employment for 2007 detailed above reflecting the period prior to disposal.

Of the £21 million costs of employment for discontinued banking operations in 2007, £18 million related to wages and salaries, £2 million related to social security costs and £1 million related to pension costs.

b Pension plans

i Defined benefit plans

1 Summary and the effects of the adoption of IFRIC 14

The Group business operations operate a number of pension schemes. The specific features of these plans vary in accordance with the regulations of the country in which the employees are located, although they are, in general, funded wholly by the Group and based either on a cash balance formula or on years of service and salary earned in the last year or years of employment. The largest defined benefit scheme is the principal UK scheme, namely the Prudential Staff Pension Scheme (PSPS), 87 per cent (2007: 87 per cent) of the underlying scheme liabilities of the Group defined benefit schemes are accounted for within PSPS.

Notes on the Group financial statements

I: Other notes

continued

II: Staff and pension plans continued

The Group also operates two smaller defined benefit schemes for UK employees in respect of Scottish Amicable and M&G activities. For all three schemes the projected unit method was used for the most recent full actuarial valuations. There is also a small defined benefit scheme in Taiwan.

Defined benefit schemes in the UK are generally required to be subject to full actuarial valuation every three years in order to assess the appropriate level of funding for schemes in relation to their commitments. These valuations include assessments of the likely rate of return on the assets held within the separate trustee administered funds. PSPS was last actuarially valued as at 5 April 2005. This valuation demonstrated the scheme to be 94 per cent funded, with a shortfall of actuarially determined assets to liabilities of six per cent, representing a deficit of £243 million.

As a result, changes were made to the basis of funding for the scheme with effect from that date. Based on that valuation, deficit funding amounts designed to eliminate the actuarial deficit over a 10 year period have been and are being made. Total contributions to the Scheme for deficit funding and employer's contributions for ongoing service for current employees are expected to be of the order of £70-75 million per annum subject to a reassessment when the subsequent valuation is completed. In 2008, total contributions for the year including expenses and augmentations were £79 million (2007: £82 million). Deficit funding for PSPS is apportioned in the ratio of 70/30 between the PAC life fund and shareholder-backed operations following detailed consideration in 2005 of the sourcing of previous contributions. Employer contributions for ongoing service of current employees are apportioned in the ratio relevant to current activity. The PSPS valuation as at 5 April 2008 is currently being finalised.

The deficit of the Scottish Amicable Pension Scheme of £44 million (2007: £54 million) has been allocated 50 per cent to the PAC with-profits fund and 50 per cent to the PAC shareholders fund.

The adoption of IFRIC 14

As mentioned in notes A2 and A5, the Group has adopted IFRIC 14 for pension schemes in 2008. The adoption of IFRIC 14, which gives guidance on assessing the limit in IAS 19 on the amount of surplus in a defined benefit pension scheme that can be recognised as an asset thereby providing reliable and more relevant information. The recognition of an asset is restricted to those that are demonstrably recoverable, either by refund or reduction in future contributions. It also addresses when a minimum funding requirement might give rise to a liability. The assessment of recoverability and any additional liability is made by reference to the terms of the Trust Deed of pension schemes and, unless substantively enacted or contractually agreed, with no account taken of potential changes to current funding arrangements.

This adoption of the principles of IFRIC 14 has had an effect on the Group's interest in the financial position of the Group's main UK defined benefit pension scheme, PSPS. The change relates solely to the accounting measurement of the Group's interest in the financial position of PSPS. Adoption of the principles of IFRIC 14 does not affect the Group's interest in the Group's other defined benefit pension schemes.

Under the terms of the Trust Deed, the Group has no unconditional right of refund to any surplus in PSPS. Also, the Group has no ability under the guidance in IFRIC 14 to anticipate a reduction in the level of future contributions for ongoing services from those currently being paid. In addition, the Group currently has a committed five-year deficit funding arrangement in place as agreed with the Trustees of the PSPS following the last triennial valuation of PSPS as at 5 April 2005.

The asset and liabilities of PSPS are unaffected by the impact of the adoption of IFRIC 14. PSPS is managed on an economic basis for the longer-term benefit of its current and deferred pensioners and active members. The surplus in PSPS is available to absorb future adverse asset value movements and, if required, strengthening in mortality assumptions. The fluctuating nature of the surplus is demonstrated by the increase in the underlying gross surplus from £528m at 31 December 2007 to £728m at 31 December 2008.

The summary effect of the adoption of IFRIC 14

In respect of the position at 31 December 2008, the Group has not recognised the underlying PSPS pension surplus of £728 million (£615 million net of deferred tax), reflecting the difference between the market value of the scheme assets and the discounted value of the liabilities, which would have otherwise been recognised as an asset on its balance sheet under the previous policy. In addition, the Group has recognised a liability for deficit funding to 5 April 2010 of £65 million (£55 million net of deferred tax) in respect of PSPS. Of these, the amounts attributable to shareholders are £223 million (£160 million net of deferred tax) for the surplus not recognised as an asset and £20 million (£15 million net of deferred tax) for the additional liability for deficit funding. In total the impact on shareholders' equity at 31 December 2008 is a reduction of £175 million as shown below.

The 2007 comparative figures in these consolidated financial statements have been adjusted accordingly for the adoption of IFRIC 14.

The effect of the change on the consolidated income statement, earnings per share and consolidated balance sheet are as follows:

	2008	2007
	Adjustments incorporated in the results	Adjustments made to the previously published results
Consolidated income statement		
	Increase (decrease) in profit (£m)	
Investment return	47	4
Benefit and claims and movement in unallocated surplus of with-profits funds	66	205
Other operating expenditure	(173)	(336)
Profit (loss) before tax (<i>being tax attributable to shareholders' and the policyholders' returns</i>)	(60)	(127)
Tax attributable to policyholders' returns	11	24
Profits (loss) before tax attributable to shareholders	(49)	(103)
Tax attributable to shareholders' (loss) profit	13	28
Profit (loss) from continuing operations after tax/profit (loss) for the year	(36)	(75)

	Increase (decrease) in earnings per share (in pence)	
Earnings per share		
Basic and diluted based on profit (loss) from continuing operations attributable to equity holders of the company	(1.5)p	(3.1)p

	Increase (decrease) in shareholders' equity (£m)	
Consolidated balance sheet		
Deferred tax assets	10	26
Other debtors	(625)	(388)
Policyholders' liability – contract liabilities (including amounts in respect of contracts classified as investment contracts under IFRS 4)	(103)	(140)
Unallocated surplus of with-profits funds	495	392
Deferred tax liabilities	113	73
Provisions	(65)	(102)
Shareholders' equity	(175)	(139)

Effect on the Group's supplementary analysis of profit and movements in shareholders' equity

	2008 £m			2007 £m		
	Previous basis	Effect of adoption of IFRIC 14	Revised basis	As previously published	Effect of adoption of IFRIC 14	After change
Operating profit based on longer-term investment returns	1,371	(24)	1,347	1,213	(12)	1,201
Short-term fluctuations in investment returns on shareholder-backed business	(1,783)	–	(1,783)	(137)	–	(137)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	11	(25)	(14)	90	(91)	(1)
(Loss) profit before tax	(401)	(49)	(450)	1,166	(103)	1,063
Tax	46	13	59	(382)	28	(354)
(Loss) profit after tax	(355)	(36)	(391)	784	(75)	709
Profits from discontinued operations	–	–	–	241	–	241
Less minority interests	(5)	–	(5)	(3)	–	(3)
(Loss) profit for the year	(360)	(36)	(396)	1,022	(75)	947
Other movements in reserves	(608)	–	(608)	(309)	–	(309)
Shareholders' equity at the beginning of the year	6,201	(139)	6,062	5,488	(64)	5,424
Shareholders' equity at the end of the year	5,233	(175)	5,058	6,201	(139)	6,062

Notes on the Group financial statements

I: Other notes

continued

II: Staff and pension plans continued

As at 31 December 2008, after the effect of the adoption of IFRIC 14, the shareholders' share of the pension liability for PSPS deficit funding obligation and the deficits of the defined benefit pension schemes amounted to a £61 million liability net of related tax relief (2007: £63 million). These amounts are determined after including amounts invested by the M&G scheme in Prudential policies as explained later in this note.

On the economic basis (including investments of the M&G scheme in Prudential policies as assets) for 2008, a £26 million (2007: £35 million) pre-tax shareholder charge to operating results based on longer-term returns arises. In addition, outside the operating result but included in total profits is a pre-tax shareholder loss of £14 million (2007: £1 million).

In addition, also on the economic basis, the PAC with-profits sub-fund was charged £10 million (2007: charge of £23 million) for its share of the pension charge of PSPS and Scottish Amicable and charged with £7 million (2007: £6 million) for its share of net actuarial and other losses on the scheme assets and liabilities. As shareholder profits for the PAC with-profits sub-fund reflects the surplus for distribution, these amounts are effectively absorbed by an increased charge in the income statement for the transfer to the liability for unallocated surplus.

At 31 December 2008, after the effect of the adoption of IFRIC 14, the total share of the liability for deficit funding on PSPS and the deficit on the smaller Scottish Amicable Scheme attributable to the PAC with-profits fund amounted to a liability of £60 million (2007: £88 million) net of related tax relief.

2 Corporate governance

The rules of the Group's largest pension arrangement, the defined benefit section of PSPS, a final salary scheme, specify that, in exercising its investment powers, the Trustee's objective is to achieve the best overall investment return consistent with the security of the assets of the scheme. In doing this, regard is had to the nature and duration of the scheme's liabilities. The Trustee sets the benchmark for the asset mix, following analysis of the liabilities by the Scheme's Actuary and, having taken advice from the Investment Managers, then selects benchmark indices for each asset type in order to measure investment performance against a benchmark return.

The Trustee reviews strategy, the asset mix benchmark and the Investment Managers' objectives every three years, to coincide with the Actuarial Valuation, or earlier if the Scheme Actuary recommends. Interim reviews are conducted annually based on changing economic circumstances and financial market levels.

The Trustee sets the general investment policy and specifies any restrictions on types of investment and the degrees of divergence permitted from the benchmark, but delegates the responsibility for selection and realisation of specific investments to the Investment Managers. In carrying out this responsibility, the Investment Managers are required by the Pensions Act 1995 to have regard to the need for diversification and suitability of investments. Subject to a number of restrictions contained within the relevant asset management agreements, the Investment Managers are authorised to invest in any class of investment asset. However, the Investment Managers will not invest in any new class of investment asset without prior consultation with the Trustee.

The Trustee consults the Principal Employer, the Prudential Assurance Company, on these investment principles, but the ultimate responsibility for the investment of the assets of the scheme lies with the Trustee.

The investment policies and strategies for the other two UK defined benefit schemes, the M&G Group Pension Scheme and the Scottish Amicable Staff Pension Scheme, which are both final salary schemes, follow similar principles, but have different target allocations reflecting the particular requirements of the schemes.

3 Assumptions

The actuarial assumptions used in determining benefit obligations and the net periodic benefit costs for the years ended 31 December were as follows:

	2008 %	2007 %
Discount rate*	6.1	5.9
Rate of increase in salaries	5.0	5.3
Rate of inflation	3.0	3.3
Rate of increase of pensions in payment for inflation:		
Guaranteed (maximum 5%)	3.0	3.3
Guaranteed (maximum 2.5%) [†]	2.5	2.5
Discretionary [†]	2.5	2.5
Expected returns on plan assets	6.2	5.9

* The discount rate of 6.1% has been determined by reference to an 'AA' corporate bond index adjusted to allow for the difference in duration between the index and the pension liabilities.

[†] The rates of 2.5 per cent shown are those for PSPS. Assumed rates of increase of pensions in payment for inflation for all other schemes are 3.0 per cent in 2008 (2007: 3.3 per cent).

The calculations are based on current actuarially calculated mortality estimates with a specific allowance made for future improvements in mortality, which is broadly in line with that adopted for the 92 series of mortality tables prepared by the Continuous Mortality Investigation Bureau of the Institute and Faculty of Actuaries. In 2007, the mortality assumptions were strengthened by including a floor to the medium cohort improvements.

The tables used for PSPS at 31 December 2008 were:

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

The assumed life expectancies on retirement at age 60, based on the mortality table used was:

	2008 years		2007 years	
	Male	Female	Male	Female
Retiring today	26.4	28.4	26.2	28.3
Retiring in 15 years' time	28.9	29.8	28.7	29.3

The mean term of the current PSPS liabilities is around 18 years.

Using external actuarial advice provided by Watson Wyatt Partners for the valuation of PSPS and by Aon Limited for the M&G scheme, and Hazell Carr for the Scottish Amicable scheme, the most recent full valuations have been updated to 31 December 2008, applying the principles prescribed by IAS 19.

4 Summary financial position

The Group liability in respect of defined benefit pension schemes is as follows:

	2008 £m	2007 £m
Economic position:		
Deficit, gross of deferred tax, based on scheme assets held, including investments in Prudential insurance policies:		
Attributable to the PAC with-profits fund (i.e. absorbed by the liability for unallocated surplus)	(67)	(98)
Attributable to shareholder-financed operations (i.e. to shareholders' equity)	(82)	(85)
Economic deficit – as explained in note 5 below	(149)	(183)
Add back: investments in Prudential insurance policies (offset on consolidation in the Group financial statements against insurance liabilities)	(157)	(172)
Deficit included in balance sheet under IAS 19 – as explained in note 7 below	(306)	(355)

The following disclosures explain the economic position and IAS 19 basis of accounting after eliminating investment in Prudential insurance policies on consolidation.

5 Group economic financial position

The economic financial position of the defined benefit pension schemes reflects the total assets of the schemes including investments in Prudential policies. This is to be contrasted with the IAS 19 basis assets of the M&G schemes, as consolidated into the Group balance sheet, which exclude investments in Prudential insurance policies which on the financial statement presentation are offset against policyholder liabilities.

The M&G pension scheme has invested £157 million at 31 December 2008 (2007: £172 million) in Prudential insurance policies. As required by IFRS, this amount of scheme asset is eliminated against the policyholder liability and hence, for the purposes of preparing the consolidated balance sheet, the IAS 19 basis net pension liability is £157 million (2007: £172 million) lower than the 'economic basis' deficit of £149 million (2007: 'economic basis' deficit of £183 million). Additionally, the PSPS scheme has invested £103 million at 31 December 2008 (2007: £140 million) in Prudential insurance policies. However, these assets are not recognised due to the effects of the change in accounting policy for the adoption of IFRIC 14 as described in note 1 above.

Notes on the Group financial statements

I: Other notes

continued

II: Staff and pension plans continued

On the 'economic basis', after including the underlying assets represented by the investments in Prudential insurance policies as scheme assets, the underlying balance sheets of the schemes at 31 December were:

	2008 £m				2007 £m			
	PSPS	Other schemes note iii	Total	%	PSPS	Other schemes note iii	Total	%
Equities	823	213	1,036	19	1,278	265	1,543	28
Bonds	2,430	277	2,707	51	1,134	249	1,383	25
Properties	283	18	301	6	545	54	599	11
Cash-like investments ^{note i}	1,267	6	1,273	24	1,932	5	1,937	36
Total value of assets	4,803	514	5,317	100	4,889	573	5,462	100
Present value of benefit obligations	(4,075)	(598)	(4,673)		(4,361)	(654)	(5,015)	
	728	(84)	644		528	(81)	447	
Effect of the adoption of IFRIC 14 for pension schemes:								
Derecognition of PSPS surplus	(728)	–	(728)		(528)	–	(528)	
Set up obligation for deficit funding for PSPS until 5 April 2010	(65)	–	(65)		(102)	–	(102)	
Pre-tax deficit ^{note ii}	(65)	(84)	(149)		(102)	(81)	(183)	

Notes

- i 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 2008, the nominal value of the interest and inflation-linked swaps amounted to £1.2 billion (2007: £1.2 billion) and £0.3 billion (2007: £0.7 billion) respectively.
- ii The resulting scheme deficit arising from the excess of liabilities over assets at 31 December 2008 of £149 million comprised a deficit of £67 million (2007: deficit of £98 million) attributable to the PAC with-profits fund and deficit of £82 million (2007: deficit of £85 million) attributable to shareholder operations.
- iii In addition to PSPS, there are two smaller schemes in the UK, the Scottish Amicable Pension Scheme, and the M&G Pension Scheme, with a combined deficit at 31 December 2008 of £67 million (2007: £71 million), gross of tax. There is also a small scheme in Taiwan, which at 31 December 2008 had a deficit of £17 million (2007: £10 million), gross of tax.

The movements in the deficit on the 'economic basis' between scheme assets and liabilities were:

	2008 %	2007 %
Current service cost	(19)	(19)
Curtailment credit	14	–
Other finance income	(2)	2
Cash costs and unwind of discount on opening provision for deficit funding for PSPS	(29)	(41)
Contributions	95	101
Actuarial and other gains and losses	(21)	(7)
Exchange translation difference	(4)	–
Net increase in deficit	34	36

Estimated pension scheme deficit attributable to shareholder operations – economic basis

Movements on the pension scheme deficit (determined on the 'economic basis'), to the extent attributable to shareholder operations are as follows:

	2008 £m					At end of year
	At beginning of year	Charge to operating results (based on longer-term investment returns) note i	Actuarial and other gains (losses) attributable to shareholders note ii	Contributions paid by shareholder operations	Exchange translation difference	
Gross of tax deficit	(85)	(26)	(14)	47	(4)	(82)
Related deferred tax	22	7	5	(13)	–	21
Net of tax deficit	(63)	(19)	(9)	34	(4)	(61)

	2007 £m					At end of year
	At beginning of year	Charge to operating results (based on longer-term investment returns) note i	Actuarial and other gains (losses) attributable to shareholders note ii	Contributions paid by shareholder operations	Exchange translation difference	
Gross of tax deficit	(99)	(35)	(1)	50	–	(85)
Related deferred tax	27	8	1	(14)	–	22
Net of tax deficit	(72)	(27)	–	36	–	(63)

Notes

- i Charge to operating results (based on longer-term investment returns)
This comprises:

	2008 £m	2007 £m
Current service cost	(19)	(19)
Curtailement credit	14	–
Finance income (expense):		
Interest on pension scheme liabilities	(39)	(31)
Expected return on pension scheme assets	37	33
	(2)	2
Total credit net of finance income	(7)	(17)
Cash cost and unwind of discount on opening provision for deficit funding for PSPS*	(29)	(41)
Less: amount attributable to PAC with-profits fund	10	23
Charge to operating results, based on longer-term investment returns, attributable to shareholders	(26)	(35)

* Consistent with the derecognition of the Company's interest in the underlying IAS 19 surplus of PSPS, the effect of the accounting policy change on the operating results, based on longer-term investment returns, is to replace the usual IAS 19 pension charges and credits with the cash cost of contributions for ongoing service of active members. In addition, the charge to the operating results also includes a charge for the unwind of discount on the opening provision for deficit funding for PSPS.

Notes on the Group financial statements

I: Other notes

continued

II: Staff and pension plans continued

Notes continued

- ii Actuarial and other gains and losses
This comprises:

	2008 £m	2007 £m
Actuarial gains and losses:		
Actual less expected return on pension scheme assets	(97)	4
Experience gains (losses) on scheme liabilities	18	(4)
Changes in assumptions underlying the present value of scheme liabilities ^a	71	(7)
Total actuarial losses	(8)	(7)
Less: amount attributable to PAC with-profits fund	(2)	6
	(10)	(1)
Other gains and losses:		
Change in the provision for deficit funding for PSPS ^b	(13)	–
Less: amount attributable to PAC with-profits fund	9	–
	(4)	–
Actuarial gains and losses attributable to shareholders, excluded from operating results based on longer-term investment returns, but included in profit before tax attributable to shareholders ^b	(14)	(1)

a The gains of £71 million relating to changes in assumptions comprise the gains due to the effect of an increase in the risk discount rate combined with the effect of decreases in inflation rates.

b The amounts of actuarial gains and losses shown in the table above relate to Scottish Amicable, M&G and a small Taiwan defined benefit pension scheme. Consistent with the derecognition of the underlying IAS 19 surplus of PSPS, the amounts do not include actuarial gains and losses for PSPS. In addition, as a result of the adoption of IFRIC 14, the Group has recognised a provision for deficit funding to 5 April 2010 in respect of PSPS. The change in the period in relation to this provision is recognised above as other gains and losses on defined benefit pension schemes.

Since shareholder profits in respect of the PAC with-profits fund are a function of the actuarially determined surplus for distribution, the overall income statement result is not directly affected by the level of pension cost or other expenses attributable to the fund.

Estimated pension scheme deficit attributable to PAC with-profits fund – economic basis

Movements on the pension scheme deficit determined on the 'economic basis' are as follows:

	2008 £m				At end of year
	At beginning of year	Pension charge (credit) note i above	Actuarial and other gains (losses) note ii above	Contributions paid by PAC with-profits fund	
Gross of tax deficit	(98)	(10)	(7)	48	(67)
Related deferred tax	10	1	1	(5)	7
Net of tax deficit	(88)	(9)	(6)	43	(60)

	2007 £m				At end of year
	At beginning of year	Pension charge (credit) note i above	Actuarial and other gains (losses) note ii above	Contributions paid by PAC with-profits fund	
Gross of tax deficit	(120)	(23)	(6)	51	(98)
Related deferred tax	12	2	1	(5)	10
Net of tax deficit	(108)	(21)	(5)	46	(88)

The pension charges and credits which comprise service costs less net finance income for the Scottish Amicable Scheme and the cash costs and unwind of discount on pension provision for deficit funding for PSPS, and actuarial and other gains and losses are included within the income statement but also taken account of in determining the charge in the income statement for the transfer to the liability for unallocated surplus of with-profits funds.

6 Movement in IAS 19 basis financial position

The change in the present value of the benefit obligation and the change in fair value of the assets for the total of the PSPS, Scottish Amicable, M&G and Taiwan schemes over the period were as follows:

	2008 £m					Total
	PSPS	Other schemes				
	Provision for deficit funding	IAS 19 basis: change in fair value of plan assets	Investments in Prudential insurance policies	Economic basis: total assets	IAS 19 basis: change in present value of benefit obligations	Economic basis: net obligations
Fair value of plan assets, beginning of year		401	172	573		573
Present value of benefit obligation, beginning of year					(654)	(654)
Provision for deficit funding for PSPS	(102)					(102)
	(102)	401	172	573	(654)	(183)
Service cost – current charge only					(19)	(19)
Curtailment credit					14	14
Interest cost					(39)	(39)
Expected return on plan assets		26	11	37		37
Employee contributions			1	1	(1)	–
Employer contributions	79	7	9	16		95
Actuarial gains (losses)		(67)	(31)	(98)	90	(8)
Benefit payments		(10)	(5)	(15)	15	–
Cash costs and unwind of discount on the opening provision for deficit funding for PSPS	(29)					(29)
Movement in the provision for deficit funding for PSPS	(13)					(13)
Exchange translation difference					(4)	(4)
Fair value of plan assets, end of year		357	157	514		514
Present value of benefit obligation, end of year					(598)	(598)
Provision for deficit funding of PSPS	(65)					(65)
Economic basis deficit						(149)

Notes on the Group financial statements

I: Other notes

continued

II: Staff and pension plans continued

	2007 £m					Total
	PSPS	Other schemes				
	Provision for deficit funding	IAS 19 basis: change in fair value of plan assets	Investments in Prudential insurance policies	Economic basis: total assets	IAS 19 basis: change in present value of benefit obligations	Economic basis: net obligations
Fair value of plan assets, beginning of year		366	161	527		527
Present value of benefit obligation, beginning of year					(603)	(603)
Provision for deficit funding for PSPS	(143)					(143)
	(143)	366	161	527	(603)	(219)
Service cost – current charge only					(19)	(19)
Interest cost					(31)	(31)
Expected return on plan assets		23	10	33		33
Employee contributions			1	1	(1)	–
Employer contributions	82	10	9	19		101
Actuarial gains (losses)		9	(5)	4	(11)	(7)
Benefit payments		(7)	(4)	(11)	11	–
Cash costs and unwind of discount on the opening liability for deficit funding for PSPS	(41)					(41)
Fair value of plan assets, end of year		401	172	573		573
Present value of benefit obligation, end of year					(654)	(654)
Provision for deficit funding for PSPS	(102)					(102)
Economic basis deficit						(183)

7 IAS 19 basis financial position as consolidated

The IAS 19 basis pensions deficit can be summarised as follows:

	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Fair value of plan assets, end of year	5,057	5,150	4,988	4,622	4,092
Present value of funded benefit obligation	(4,493)	(4,826)	(5,023)	(5,228)	(4,777)
Funded status	564	324	(35)	(606)	(685)
Present value of unfunded obligations (M&G scheme)*	(180)	(189)	(187)	(190)	(140)
	384	135	(222)	(796)	(825)
Effect of the change in accounting policy for pension schemes:					
Derecognition of PSPS' surplus	(728)	(528)	(141)	–	–
Set up obligation for deficit funding for PSPS until 5 April 2010	(65)	(102)	(143)	–	–
Adjustment in respect of investment of PSPS in Prudential policies	103	140	126	–	–
Deficit recognised in the balance sheet	(306)	(355)	(380)	(796)	(825)

* The M&G pension scheme assets are invested in Prudential insurance policies. For IFRS accounting purposes, the M&G scheme is in effect unfunded. Please see above for more details.

	2008	2007
	£m	£m
Components of net periodic pension cost		
Current service cost	(45)	(58)
Curtailment credit	44	–
Interest cost	(289)	(265)
Expected return on assets – economic basis	336	309
Less: expected return on investments of scheme assets in Prudential insurance policies	(22)	(20)
Expected return on assets – IAS 19 basis [†]	314	289
	24	(34)
Effect of the adoption of IFRIC 14	(71)	(34)
Pension cost (as referred to in note 11a)	(47)	(68)
Actuarial gains and losses – economic basis	60	295
Less: actuarial losses on investments of scheme assets in Prudential insurance policies	79	1
	139	296
Effect of the adoption of IFRIC 14	(129)	(298)
Actuarial gains and losses – IAS 19 basis* (as referred to in note 11a)	10	(2)
Net periodic pension cost (included within acquisition and other operating expenditure in the income statement)	(37)	(70)

* Consistent with the derecognition of the Company's interest in the underlying IAS 19 surplus of PSPS, the effect on the net periodic pension cost for PSPS was to replace the usual IAS 19 pension charges and credits with the cash cost of contribution for ongoing services of active members and also not to report the actuarial gains and losses.

[†]In determining the expected return on scheme assets for 2008, the 5.9 per cent rate shown below has been applied to the opening assets.

The long-term expected rate of return has been taken to be the weighted average (by market value) of the long-term expected rates of return on each major asset class shown below:

	2008		2007		2006		2005		2004	
	£m	%	£m	%	£m	%	£m	%	£m	%
Scheme assets (IAS 19 basis before effect of adoption of IFRIC 14)										
Equity	875	17	1,332	26	1,432	29	2,376	51	2,516	61
Bonds	2,619	52	1,299	25	2,185	44	1,593	35	993	24
Properties	290	6	583	11	621	12	575	12	520	13
Cash-like investments	1,273	25	1,936	38	750	15	78	2	63	2
Total	5,057	100	5,150	100	4,988	100	4,622	100	4,092	100

	Prospectively for 2009 %	2008 %	2007 %
Long-term expected rate of return			
Equity	6.8	7.5	7.5
Bonds	4.8	5.4	4.8
Properties	6.05	6.75	6.8
Cash	2.0	5.5	5.0
Weighted average long-term expected rate of return	4.5	6.1	5.9

The expected rates of return have been determined by reference to long-term expectations, the carrying value of the assets and equity and other market conditions at the balance sheet date.

The actual return on scheme assets was a loss £20 million (2007: gain of £282 million) on an IAS 19 basis.

Notes on the Group financial statements

I: Other notes

continued

II: Staff and pension plans continued

None of the scheme assets included shares in Prudential plc or property occupied by the Prudential Group.

	2008 £m	2007 £m	2006 £m	2005 £m	2004 £m
Fair value of scheme assets, end of year (IAS 19 basis)	5,057	5,150	4,988	4,622	4,092
Present value of the benefit obligation, end of year	(4,673)	(5,015)	(5,210)	(5,418)	(4,917)
Underlying scheme assets in surplus (deficit) of benefit obligation, before the effect of the adoption of IFRIC 14	384	135	(222)	(796)	(825)
Experience adjustments on scheme	145	(14)	18	1	(17)
Percentage of scheme liabilities at 31 December	3.10%	0.28%	(0.35)%	(0.02)%	0.35%
Experience adjustments on scheme assets (IAS 19 basis)	(277)	(7)	140	527	112
Percentage of scheme assets at 31 December	(5.48)%	(0.14)%	2.81%	11.42%	2.74%

The experience adjustments on scheme liabilities in 2008 of a gain of £145 million relate mainly to the 'true up' reflecting improvements in data consequent upon the ongoing triennial valuation of PSPS.

Total employer contributions expected to be paid into the Group defined benefit schemes for the year ending 31 December 2009 amounts to £98 million (2008: £90 million), subject to a reassessment when the valuation at 5 April 2008 is completed.

8 Sensitivity of the financial position of the PSPS, Scottish Amicable and M&G pension schemes to key variables

The table below shows the sensitivity of the underlying PSPS, Scottish Amicable and M&G pension scheme liabilities at 31 December 2008 of £4,075 million, £398 million and £180 million respectively (2007: £4,361 million, £454 million and £189 million) to changes in discount rates and inflation rates.

2008			
Assumption	Change in assumption	Impact on scheme liabilities on IAS 19 basis	
Discount rate	Decrease by 0.2% from 6.1% to 5.9%	Increase in scheme liabilities by:	
		PSPS	3.3%
		Scottish Amicable	4.9%
Discount rate	Increase by 0.2% from 6.1% to 6.3%	Decrease in scheme liabilities by:	
		PSPS	3.1%
		Scottish Amicable	4.6%
Rate of inflation	Decrease by 0.2% from 3.0% to 2.8% with consequent reduction in salary increases	Decrease in scheme liabilities by:	
		PSPS	0.8%
		Scottish Amicable	4.5%
		M&G	3.8%

2007			
Assumption	Change in assumption	Impact on scheme liabilities on IAS 19 basis	
Discount rate	Decrease by 0.2% from 5.9% to 5.7%	Increase in scheme liabilities by:	
		PSPS	3.5%
		Scottish Amicable	5.3%
Discount rate	Increase by 0.2% from 5.9% to 6.1%	Decrease in scheme liabilities by:	
		PSPS	3.4%
		Scottish Amicable	5.1%
Rate of inflation	Decrease by 0.2% from 3.3% to 3.1% with consequent reduction in salary increases	Decrease in scheme liabilities by:	
		PSPS	1.3%
		Scottish Amicable	5.0%
		M&G	4.4%

9 Transfer value of PSPS scheme

At 31 December 2008, it is estimated that the assets of the scheme are broadly sufficient to cover the liabilities of PSPS on a 'buyout' basis including an allowance for expenses. The 'buyout' basis refers to a basis that might apply in the circumstance of a transfer to another appropriate financial institution. In making this assessment it has been assumed that a more conservative investment strategy applies together with a more prudent allowance for future mortality improvements and no allowance for discretionary pension increases.

ii Other pension plans

The Group operates various defined contribution pension schemes including schemes in Jackson and Asia. As noted earlier, the cost of the Group's contributions for continuing operations to these schemes in 2008 was £31 million (2007: £28 million).

I2: Share-based payments

The Group maintains 10 main share award and share option plans relating to Prudential plc shares, which are described below.

The Group Performance Share Plan (GPSP) is the incentive plan in which all executive directors and other senior executives within the Group can participate. This scheme was established as a replacement for the Restricted Share Plan (RSP) under which no further awards could be made after March 2006. Awards are granted either in the form of a nil cost option, conditional right over shares, or such other form that shall confer to the participant an equivalent economic benefit, with a vesting period of three years. The performance measure for the awards is that Prudential's Total Shareholder Return (TSR) outperforms an index comprising of peer companies. Vesting of the awards between each performance point is on a straight line sliding scale basis. Participants are entitled to the value of reinvested dividends that would have accrued on the shares that vest. Shares are currently purchased in the open market by a trust for the benefit of qualifying employees.

The RSP was, until March 2006, the Group's long-term incentive plan for executive directors and other senior executives designed to provide rewards linked to shareholder return. Each year participants were granted a conditional option to receive a number of shares. There was a deferment period of three years at the end of which the award vested to an extent that depended on the performance of the Group's shares including notional reinvested dividends and on the Group's underlying financial performance. After vesting, the option may be exercised at zero cost at any time, subject to closed period rules, in the balance of a 10-year period. Shares are purchased in the open market by a trust for the benefit of qualifying employees. The RSP replaced the Executive Share Option Scheme in 1995 and all options under this plan had been exercised at 31 December 2005.

No rights were granted in the RSP if the Company's TSR performance as ranked against the comparator group is below 50th percentile. For performance at 50th percentile, an option of 25 per cent of the maximum award is made. The maximum grant is made only if the TSR ranking of the Company is 20th percentile or above. Between these points, the size of the grant of option made is calculated on a straight line sliding scale.

The BUPP is an incentive plan created to provide a common framework under which awards would be made to senior employees and in the UK, Jackson and Asia include the Chief Executive Officers. Awards under this plan in 2007 and 2008 were based on growth in Shareholder Capital Value on the European Embedded Value (EEV) basis with performance measured over three years. Upon vesting, half of the vested award is released as shares and the other half released in cash. Participants are entitled to receive the value of reinvested dividends over the performance period for those shares that vest. The growth parameters for the awards are relevant to each region and vesting of the awards between each performance point is on a straight line sliding scale basis.

UK-based executive directors are eligible to participate in the Prudential HM Revenue & Customs (HMRC) approved UK Savings Related Share Option Scheme (SAYE scheme) and the Asia-based executive directors can participate in the equivalent International SAYE scheme. The schemes allow employees to save towards the exercise of options over Prudential plc shares, at an option price set at the beginning of the savings period at a discount of up to 20 per cent to the market price. Savings contracts may be up to £250 per month for three or five years, or additionally in the UK scheme seven years. On maturity at the end of the set term, participants may exercise their options within six months of the end of the savings period and purchase Prudential plc shares. If an option is not exercised within six months, participants are entitled to a refund of their cash contributions plus interest if applicable under the rules. Shares are issued to satisfy options that are exercised. No options may be granted under the schemes if the grant would cause the number of shares which have been issued, or which remain issuable pursuant to options granted in the preceding 10 years under the scheme and other share option schemes operated by the Company, or which have been issued under any other share incentive scheme of the Company, to exceed 10 per cent of the Company's ordinary share capital at the proposed date of grant.

UK-based executive directors are also eligible to participate in the Company's HMRC approved Share Incentive Plan which allows all UK-based employees to purchase shares of Prudential plc (partnership shares) on a monthly basis out of gross salary. For every four partnership shares bought, an additional matching share is awarded, purchased on the open market. Dividend shares accumulate while the employee participates in the plan. Partnership shares may be withdrawn from the scheme at any time. If the employee withdraws from the plan within five years, the matching shares are forfeit and if within three years, dividend shares are forfeit.

Notes on the Group financial statements

I: Other notes

continued

I2: Share-based payments continued

Jackson operates a performance-related share award which, subject to the prior approval of the Jackson Remuneration Committee, may grant share awards to eligible Jackson employees in the form of a contingent right to receive shares or a conditional allocation of shares. These share awards have vesting periods of four years and are at nil cost to the employee. Award holders do not have any right to dividends or voting rights attaching to the shares. The shares are held in the employee share trust in the form of American Depository Receipts which are tradable on the New York Stock Exchange.

The new Prudential Corporation Asia Long-Term Incentive Plan (PCA LTIP) is an incentive plan for senior employees and Chief Executive Officers replacing the Asia Business Unit Performance Plan (BUPP). Awards under the new PCA LTIP will vest after three years subject to the employee being in employment at the time of vesting without any performance conditions. Awards will be discretionary and on a year by year basis determined by Prudential's full year financial results and the employee's contribution to the business. All awards will be in Prudential shares except for countries where share awards are not feasible due to securities and/or tax reasons, where awards will be replaced by the cash value of the shares that would otherwise have been transferred.

Certain senior executives have annual incentive plans with awards paid in cash up to the target level of their plan. The portion of any award for above target performance is made in the form of awards of shares deferred for three years, with the release of shares subject to close periods. The shares are held in the employee share trust and shares equivalent to dividends otherwise payable will accumulate for the benefit of award holders during the deferral period up to the release date.

In addition, there are other share awards which included the 1,000 Day Long Term Incentive Plan (LTIP) and other arrangements.

The 1,000 Day LTIP plan was a UK insurance operations performance-based plan in which the UK Remuneration Committee could, at any time up to 5 October 2005, select employees at its absolute discretion, for participation in the plan. The performance period was 1,000 days and, based on the final performance level being at, or above, the threshold level, the committee shall grant participants 10 per cent of the allocated award in 2005, 20 per cent in 2006 and the remaining 70 per cent in 2007. There are no beneficial interests, or any rights to dividends until such time as the awards are released, at nil cost, to participants. There are no outstanding shares awarded through this scheme.

The other arrangements relate to various awards that have been made without performance conditions to individual employees, typically in order to secure their appointment or ensure retention.

Movements in share options outstanding under the Group's share-based compensation plans relating to Prudential plc shares during 2008 and 2007 were as follows:

	2008		2007	
	Number of options millions	Weighted average exercise price £	Number of options millions	Weighted average exercise price £
Options outstanding (including conditional options)				
Beginning of year:	14.5	2.57	16.5	2.47
Granted	6.9	3.28	4.0	2.69
Exercised	(3.5)	2.73	(1.9)	3.42
Forfeited	(1.5)	0.69	(1.4)	1.37
Expired	(3.7)	4.94	(2.7)	2.13
End of year	12.7	2.44	14.5	2.57
Options immediately exercisable, end of year	0.6	2.29	0.2	3.35

The weighted average share price of Prudential plc for the year ended 31 December 2008 was £5.46 compared to £7.15 for the year ended 31 December 2007.

Movements in share awards outstanding under the Group's share-based compensation plans relating to Prudential plc shares at 31 December 2008 and 2007 were as follows:

	2008	2007
	Number of awards millions	Number of awards millions
Awards outstanding		
Beginning of year:	8.0	6.6
Granted	3.5	3.8
Exercised	(1.7)	(1.3)
Forfeited	(0.9)	(1.1)
Expired	(0.3)	–
End of year	8.6	8.0

The following table provides a summary of the range of exercise prices for Prudential plc options (including conditional options) outstanding at 31 December 2008.

Range of exercise prices	Outstanding			Exercisable	
	Number outstanding millions	Weighted average remaining contractual life years	Weighted average exercise prices £	Number exercisable millions	Weighted average exercise prices £
Between £0 and £1	5.9	8.3	–	0.3	–
Between £1 and £2	–	–	–	–	–
Between £2 and £3	0.3	1.7	2.66	0.0	2.66
Between £3 and £4	0.5	1.4	3.56	0.0	3.65
Between £4 and £5	4.6	3.3	4.45	0.3	4.07
Between £5 and £6	1.4	2.8	5.59	–	–
Between £6 and £7	0.0	0.4	6.17	0.0	6.17
Between £7 and £8	–	–	–	–	–
	12.7	5.5	2.44	0.6	2.29

The following table provides a summary of the range of exercise prices for Prudential plc options (including conditional options) outstanding at 31 December 2007.

Range of exercise prices	Outstanding			Exercisable	
	Number outstanding millions	Weighted average remaining contractual life years	Weighted average exercise prices £	Number exercisable millions	Weighted average exercise prices £
Between £0 and £1	5.5	8.6	–	–	–
Between £1 and £2	–	–	–	–	–
Between £2 and £3	2.7	1.3	2.66	–	–
Between £3 and £4	1.2	1.7	3.62	0.2	3.37
Between £4 and £5	2.9	2.7	4.62	–	–
Between £5 and £6	2.2	3.5	5.62	–	–
Between £6 and £7	–	0.9	6.55	–	6.95
Between £7 and £8	–	–	–	–	–
	14.5	4.7	2.57	0.2	3.35

The years shown above for weighted average remaining contractual life include the time period from end of vesting period to expiration of contract.

The weighted average fair values of Prudential plc options and awards granted during the period are as follows:

	2008 £			2007 £		
	Weighted average fair value			Weighted average fair value		
	GPSP	Other options	Awards	RSP and GPSP	Other options	Awards
	4.16	2.14	5.69	4.78	2.55	7.33

The fair value amounts relating to all options including conditional nil cost options above were determined using the Black-Scholes and the Monte Carlo option-pricing models using the following assumptions:

	2008		2007	
	GPSP	Other options	RSP and GPSP	Other options
Dividend yield (%)	3.60	3.60	2.32	2.32
Expected volatility (%)	30.87	34.67	28.90	27.17
Risk-free interest rate (%)	4.23	4.46	5.46	5.25
Expected option life (years)	3.00	3.74	3.00	3.48
Weighted average exercise price (£)	–	4.74	–	5.62
Weighted average share price (£)	6.63	6.16	7.52	7.47

Notes on the Group financial statements

I: Other notes

continued

I2: Share-based payments continued

Under IFRS, compensation costs for all share-based compensation plans are determined using the Black-Scholes model and the Monte Carlo model. Share options and awards are valued using the share price at the date of grant. The compensation costs for all awards and options are recognised in net income over the plans' respective vesting periods. The Group uses the Black-Scholes model to value all options and awards other than the GPSP, for which the Group uses a Monte Carlo model in order to allow for the impact of the TSR performance conditions. These models are used to calculate fair values for share options and awards at the grant date based on the quoted market price of the stock at the measurement date, the amount, if any, that the employees are required to pay, the dividend yield, expected volatility, risk-free interest rates and exercise prices.

The expected volatility is measured as the standard deviation of expected share price returns based on statistical analysis of daily share prices over a period up to the grant date equal to the expected life of options. Risk-free interest rates are UK gilt rates with projections for three, five and seven year terms to match corresponding vesting periods. Dividend yield is determined as the average yield over the year of grant and expected dividends are not incorporated into the measurement of fair value. For the GPSP, volatility and correlation between Prudential and an index constructed from a simple average of the TSR growth of 11 companies is required. For grants in 2008, an average index volatility and correlation of 26 per cent and 82 per cent respectively, were used.

When options are granted or awards made to employees, an estimate is made of what percentage is more than likely to vest, be forfeited, lapse or cancelled based on historical information. Based on these estimates, compensation expense to be accrued at that date is calculated and amortised over the vesting period. For early exercises of options or release of awards due to redundancy, death or resignation, the compensation expense is immediately recognised and for forfeitures due to employees leaving the Group, any previously recognised expense is reversed. However, if an employee loses their award because of the Group's failure to meet the performance criteria, previously recognised expense is not reversed.

During the year, the Group granted share options to certain non-employee independent financial advisors. Those options were measured using the Black-Scholes option pricing model with assumptions consistent with those of other share options. These transactions were measured using an option model because the Group does not receive a separate and measurable benefit from those non-employees in exchange for the options granted. As such, the fair value of the options themselves is more readily determinable than the services received in return.

c Total share-based payment expense

Total expense recognised in the year in the consolidated financial statements related to share-based compensation is as follows:

	2008 £m	2007 £m
Share-based compensation expense	23	28
Amount accounted for as equity-settled	27	19
Carrying value at 31 December of liabilities arising from share-based payment transactions	12	18
Intrinsic value of above liabilities for which rights had vested at 31 December	4	4

I3: Key management remuneration

Key management constitutes the directors of Prudential plc as they have authority and responsibility for planning, directing and controlling the activities of the Group.

Total key management remuneration amounts to £18,122,000 (2007: £15,670,000). This comprises salaries and short-term benefits of £10,425,000 (2007: £9,496,000), post-employment benefits of £1,003,000 (2007: £967,000), leaving benefits of £507,000 (2007: £nil) and share-based payments of £6,187,000 (2007: £5,207,000).

Post-employment benefits comprise the change in the transfer value of the accrued benefit relating to directors' defined benefit pension schemes in the year and the total contributions made to directors' other pension arrangements.

The share-based payments charge is the sum of £4,624,000 (2007: £3,456,000), which is determined in accordance with IFRS 2, 'Share-Based Payments' (see note I2) and £1,563,000 (2007: £1,751,000) of deferred share awards.

Total key management remuneration includes total directors' emoluments of £12,683,000 (2006: £11,959,000) as shown in the directors' remuneration table and related footnotes in the directors' remuneration report, and additional amounts in respect of pensions and share-based payments. Further information on directors' remuneration is given in the directors' remuneration report.

I4: Fees payable to auditor

	2008 £m	2007 £m
Fees payable to the Company's auditor for the audit of the Company's annual accounts	1.6	1.8
Fees payable to the Company's auditor and its associates for other services:		
Audit of subsidiaries and associates pursuant to legislation	5.0	4.4
Other services supplied pursuant to legislation	2.4	2.9
Other services relating to taxation	0.6	0.4
Valuation and actuarial services	0.7	0.7
Services relating to corporate finance transactions	–	0.2
All other services	0.5	1.0
Total	10.8	11.4

In addition, there were fees incurred of £0.2 million (2007: £0.2 million) for the audit of pension schemes.

The Audit Committee regularly monitors the non-audit services provided to the Group by its auditor and has developed a formal Auditor Independence Policy which sets out the types of services that the auditor may provide, consistent with the guidance in Sir Robert Smith's report 'Audit Committees – Combined Code Guidance' and with the provisions of the US Sarbanes-Oxley Act.

The Audit Committee annually reviews the auditor's objectivity and independence. More information on these issues is given in the corporate governance report within this Annual Report.

I5: Related party transactions

Transactions between the Company and its subsidiaries are eliminated on consolidation.

In addition, the Company has transactions and outstanding balances with certain unit trusts, OEICs, collateralised debt obligations and similar entities which are not consolidated and where a Group company acts as manager. These entities are regarded as related parties for the purposes of IAS 24. The balances are included in the Group's balance sheet at fair value or amortised cost in accordance with their IAS 39 classifications. The transactions are included in the income statement and include amounts paid on issue of shares or units, amounts received on cancellation of shares or units and paid in respect of the periodic charge and administration fee. Further details of the aggregate assets, liabilities, revenues, profits or losses and reporting dates of entities considered to be associates under IFRS are disclosed in note H8.

Executive officers and directors of the Company may from time to time purchase insurance, asset management or annuity products marketed by Group companies in the ordinary course of business on substantially the same terms as those prevailing at the time for comparable transactions with other persons.

Apart from the transactions with directors referred to below, no director had interests in shares, transactions or arrangements that require disclosure, other than those given in the directors' remuneration report. Key management remuneration is disclosed in note I3.

In 2007, prior to disposal, three directors had credit cards with the discontinued banking operations. In 2008 and 2007, other transactions with directors were de-minimis both by virtue of their size and in the context of the directors' financial positions. As indicated above, all of these transactions are on terms broadly equivalent to those that prevail in arm's length transactions.

I6: Subsidiary undertakings

i Principal subsidiaries

The principal subsidiary undertakings of the Company at 31 December 2008, all wholly owned except PCA Life Assurance Company Limited, were:

	Main activity	Country of incorporation
The Prudential Assurance Company Limited	Insurance	England and Wales
Prudential Annuities Limited*	Insurance	England and Wales
Prudential Retirement Income Limited (PRIL)*	Insurance	Scotland
M&G Investment Management Limited*	Asset management	England and Wales
Jackson National Life Insurance Company*	Insurance	US
Prudential Assurance Company Singapore (Pte) Limited*	Insurance	Singapore
PCA Life Assurance Company Limited* (99% owned)	Insurance	Taiwan

* Owned by a subsidiary undertaking of the Company.

Notes on the Group financial statements

I: Other notes

continued

16: Subsidiary undertakings continued

Each subsidiary has one class of ordinary shares and operates mainly in its country of incorporation, except for PRL which operates mainly in England and Wales.

On 20 February 2009, the Company announced that it had entered into an agreement to transfer the assets and liabilities of its agency distribution business and its agency force in Taiwan to China Life Insurance Company Ltd of Taiwan. The business being transferred represents 94 per cent of its in-force liabilities in Taiwan. Further details are set out in note I10.

ii Dividend restrictions and minimum capital requirements

Certain Group subsidiaries are subject to restrictions on the amount of funds they may transfer in the form of cash dividends or otherwise to the parent company. UK insurance companies are required to maintain solvency margins which must be supported by capital reserves and other resources, including unrealised gains on investments. Jackson can pay dividends on its capital stock only out of earned surplus unless prior regulatory approval is obtained. Furthermore, without the prior regulatory approval, dividends cannot be distributed if all dividends made within the preceding 12 months exceed the greater of Jackson's statutory net gain from operations or 10 per cent of Jackson's statutory surplus for the prior year. In 2009, the maximum amount of dividends that can be paid by Jackson without prior regulatory approval is US\$290 million (£202 million) (in 2008: US\$490 million (£246 million)). The Group's Asian subsidiaries, mainly the Singapore and Malaysia businesses, may remit dividends to the Group, in general, provided the statutory insurance fund meets the capital adequacy standard required under local statutory regulations.

PAC and Jackson are the two principal insurance subsidiaries of the Group, which together comprise approximately 77 per cent (2007: 78 per cent) of total Group assets. At 31 December 2008, the PAC long-term fund's excess of available capital resources over its regulatory requirement (as per line 42 of Form 2 of the PAC FSA regulatory returns) was estimated to be £4.7 billion (2007: £10.5 billion) and the statutory capital and surplus of Jackson was US\$3 billion (£2 billion) (2007: US\$4.0 billion (£2.0 billion)). The Group capital position statement for life assurance businesses is set out in note D5.

iii Acquisition and disposal of subsidiaries

2007

On 1 May 2007, the Company completed the sale of Egg Banking plc to Citi. Additional details regarding the disposal are set out in note I9.

On 9 November 2007, the Company completed the sale of PPM Capital, its direct private equity business.

2008

There were no acquisitions or disposals of subsidiaries during the year. Subsequent to the year end, on 20 February 2009, the Company announced that it had entered into an agreement to transfer the assets and liabilities of its agency distribution business and its agency force in Taiwan to China Life Insurance Company Ltd of Taiwan, subject to regulatory approval. Additional details regarding this transfer are set out in note I10.

iv PAC with-profits fund acquisitions and disposals

The PAC with-profits fund acquired a number of venture capital holdings through PPM Capital and M&G. Prior to November 2007, the Group was deemed to have a controlling interest in these venture capital holdings, in aggregate with, if applicable, other holdings held by, for example, the Prudential Staff Pension Scheme. In November 2007, the Group disposed of PPM Capital following which the Group no longer had a controlling interest in venture fund investment subsidiaries that it managed and consequently ceased to consolidate these investments from that date. The Group continues to consolidate, where applicable, the venture capital holdings managed by M&G.

2007

The acquisitions made in 2007 were as follows:

- 71 per cent of the voting equity interest of Orizon AG, an employment hiring agency, which was managed by PPM Capital; and
- 78 per cent of the voting equity interest of Red Funnel, a ferry company, which was managed by M&G.

These acquisitions are considered individually immaterial and therefore all information relating to the acquisitions has been presented in aggregate in this note.

The results of the acquisitions have been included in the consolidated financial statements of the Group and contributed a loss of £8.3 million to earnings within the income statement.

The table below identifies the net assets of these acquisitions and minor business purchases by existing venture holdings and reconciles the net assets to the consideration paid:

	2007 £m
	Fair value on acquisition
Cash and cash equivalents	20
Other current assets	26
Property, plant and equipment	38
Intangible assets other than goodwill	1
Other non-current assets	3
Less liabilities, including current liabilities and borrowings	(304)
Net assets acquired	(216)
Goodwill	313
Cash consideration	97

Aggregate goodwill of £313 million was recognised for the excess of the cost over the Group's interest in the net fair value of the entities' assets, liabilities, and contingent liabilities acquired.

Following the disposal of PPM Capital, SUSPA, TJ Hughes, Sterigenics, Muller & Weygandt, TMF Group, JOST, Histoire D'or, Azzuri Communications, Paramount plc and Orizon AG ceased to be consolidated as subsidiary undertakings and goodwill and other intangible assets, net of amortisation, relating to these investments were derecognised accordingly.

2008

There were no new acquisitions or disposals of venture capital investments in 2008. However, during the year, the holding in the voting equity interest of Red Funnel increased from 78 per cent to 90 per cent.

17: Commitments

i Operating leases

The Group leases various offices to conduct its business. Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

	2008 £m	2007 £m
Future minimum lease payments for non-cancellable operating leases fall due during the following periods:		
Not later than 1 year	86	38
Later than 1 year and not later than 5 years	199	126
Later than 5 years	140	111

The total minimum future sublease rentals to be received on non-cancellable operating leases for land and buildings for the year ended 31 December 2008 was £0.2 million (2007: £0.4 million).

Minimum lease rental payments for the year ended 31 December 2008 of £84 million (2007: £50 million) are included in the consolidated income statement.

ii Capital commitments

The Group has provided, from time to time, certain guarantees and commitments to third-parties including funding the purchase or development of land and buildings and other related matters. At 31 December 2008, the aggregate amount of contractual obligations to purchase and develop investment properties amounted to £1 million (2007: £64 million).

Notes on the Group financial statements

I: Other notes

continued

18: Cash flows

Structural borrowings of shareholder-financed operations comprise core debt of the parent company and Jackson surplus notes. Core debt excludes borrowings to support short-term fixed income securities programmes and non-recourse borrowings of investment subsidiaries and consolidated investment funds of shareholder-financed operations and other borrowings. Cash flows in respect of these borrowings are included within cash flows from operating activities.

Structural borrowings of with-profits operations relate solely to the £100 million 8.5 per cent undated subordinated guaranteed bonds which contribute to the solvency base of SAIF. Cash flows in respect of other borrowings of with-profits funds, which principally relate to consolidated investment funds are also included within cash flows from operating activities.

Cash flows relating to discontinued operations in 2007, as detailed in note 19, are inflows of £157 million for the period of ownership in 2007. All of these related to cash flows from operating activities.

19: Discontinued banking operations

Discontinued banking operations in 2007 related entirely to UK banking operations following the sale on 1 May 2007 of Egg Banking plc to Citi. Consideration paid to the Company was, net of expenses, £527 million cash. Cash and cash equivalents disposed of in 2007 were £1,065 million. Accordingly, the cash outflow for the Group in 2007 arising from the disposal of Egg, as shown in the consolidated cash flow statement, was £538 million.

The profit included in the 2007 income statement in respect of discontinued banking operations for the period of ownership was as follows:

	2007 £m
Interest income	261
Interest expense	(148)
Net interest income	113
Fee and commission income	41
Fee and commission expense	(8)
Operating income	146
General administrative expenses	(56)
Impairment losses on loans and cash advances to customers	(149)
Other operating expenses	(9)
Operating loss based on longer-term investment returns	(68)
Profit on sale of Egg Banking plc	290
Profit before tax	222
Tax on operating loss based on longer-term investment returns	19
Tax on profit on sale of Egg Banking plc	0
Tax attributable to shareholders' profits	19
Profit for the year	241

The interest income on financial assets not at fair value through profit and loss for the period of ownership in 2007 was £241 million. The interest expense on financial liabilities not at fair value through profit and loss for the period of ownership in 2007 was £148 million.

Fee and commission income in 2007 includes £27 million relating to financial instruments held at amortised cost. These fees primarily related to balance transfer fees and late payment fees. Fee and commission expense in 2007 includes fee expenses relating to financial liabilities held at amortised cost of £4 million which related to treasury fees.

Of the loss for the period of ownership in 2007, no loss was attributable to minority interests in Egg.

I10: Post balance sheet events

i Intended sale of legacy agency book and agency force in Taiwan to China Life Insurance of Taiwan

On 20 February 2009, the Company announced that it had entered into an agreement to sell the assets and liabilities of its agency distribution business and its agency force in Taiwan to China Life Insurance Company Ltd of Taiwan ('China Life') for the nominal sum of NT\$1, subject to regulatory approval.

In addition, the Company will invest £45 million to purchase a 9.95 per cent stake in China Life through a share placement. The business to be transferred represents 94 per cent of Prudential's in-force liabilities in Taiwan and includes its legacy interest rate guaranteed products with IFRS basis gross assets at 31 December 2008 of £4.5 billion. After taking account of IFRS shareholders' funds of the business at 31 December 2008 and restructuring and other costs, the Group's IFRS shareholders' funds are expected to decrease by approximately £595 million. In addition, on completion there will be a net increase in the Company's Insurance Groups Directive surplus of approximately £800 million.

The movement in shareholders' IFRS equity of the total Taiwan life business for 2008 comprised:

	£m
Operating profit based on longer-term investment returns	60
Short-term fluctuations in investment returns	(65)
Shareholders share of actuarial and other gains and losses on defined benefit pension schemes	(3)
Loss before tax	(8)
Total tax	(8)
Loss for the financial year	(16)
Minority interests	–
Investments by Parent Company*	93
Exchange and other reserve movements	111
Net movement	188
Equity brought forward at 1 January 2008	289
Equity carried forward at 31 December 2008	477

* Comprising £66 million for solvency capital and £27 million for business development.

The carrying value of the IFRS equity reflects the application of 'grandfathered' US GAAP under IFRS. This does not, and is not designed to include the cost of holding economic capital, to support the legacy interest rate guaranteed products as recognised under the Company's supplementary reporting basis under European Embedded Value principles.

ii Insurance Groups Directive - Group solvency position

The IGD group solvency position as at 31 December 2008 will be submitted to the FSA by 30 April 2009. At the time of preparation of these financial statements the surplus capital, under the IGD test of capital adequacy, was estimated to be around £1.7 billion before allowing for the 2008 final dividend, giving a solvency ratio of 160 per cent. This is composed of the Group's IGD surplus at 31 December 2008 which is estimated at £1.4 billion and of an additional £0.3 billion which the FSA has, after the year end, allowed the Group to include in the Group's IGD surplus going forward as a result of an innovative structure the Group has developed. The £0.3 billion additional capital reflects the ability to realise a portion of the shareholders' economic interest in the future transfers from the PAC with-profits fund.