Notes on the Group financial statements
A: Background

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), M&G Investment Management Limited and, prior to disposal, Egg Banking plc. On 29 January 2007 the Company announced that it had entered into a binding agreement to sell its Egg banking business to Citi, as described in note I6. On 1 May 2007, the Company completed the sale.

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.

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 unitised 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 Principles (GAAP). These are presented on pages 290 to 299.

In 2007 the Group adopted IFRS 7, 'Financial Instruments: Disclosures', IAS 1 (as amended) and amendment to IFRS 4 Implementation Guidance.

The Group has applied all IFRS standards and interpretations adopted by the EU and effective at 31 December 2007.

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 International Accounting Standards Board (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.

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 for Jackson. 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.

A3: Critical accounting policies, estimates and judgements continued

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 2007 and 2006 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 2007 and 2006 results, options and guarantees are valued on a market consistent basis. The basis is described in note D2(e)(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:

A3: Critical accounting policies, estimates and judgements continued

- 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 being recorded as movements within shareholders' equity.

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

For shareholder-backed business, with the exception of debt securities held by Jackson and Egg (prior to its sale in 2007) 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.

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).

b Critical accounting estimates and judgements

Investments

Determining the fair value of unquoted investments

The Group holds certain financial investments which are not quoted on active markets. Their fair values are determined in full or in part by using valuation techniques. If the market for a financial investment of the Group is not active, the Group establishes fair value by using quotations from independent third parties, such as brokers or by using valuation techniques. The fair values of investments valued using a valuation technique at 31 December 2007 was £9,854 million (2006: £8,211 million). Of this amount £5,739 million (2006: £4,503 million) is held by with-profits operations, for which value movements do not affect directly shareholder results, and £4,115 million (2006: £3,708 million) is held by shareholder-backed operations. 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. Additional details are explained in note G1.

A3: Critical accounting policies, estimates and judgements continued

Determining impairments relating to financial assets

Available-for-sale securities

Financial investments carried on an available-for-sale basis are represented by Jackson's and, prior to the sale of Egg in May 2007, Egg's debt securities portfolio. These are considered to be impaired if there has been a significant or prolonged period of decline in fair value below amortised cost or if there is any other objective evidence of impairment. The consideration of this requires management's judgement. Among the factors considered is whether the decline in fair value results from a change in quality of the security itself, or from a downward movement in the market as a whole and the likelihood of recovering the carrying value based on the current and short-term prospects of the issuer.

Unrealised losses that are considered to be primarily the result of market conditions, such as increasing interest rates, 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. Prudential's review of fair value involves several criteria, including economic conditions, credit loss experience, other issuer-specific developments and future cash flows. These assessments are based on the best available information at the time. Factors such as market liquidity, the widening of bid/ask spreads and a change in cash flow assumptions can contribute to future price volatility. If actual experience differs negatively from the assumptions and other considerations used in the consolidated financial statements, unrealised losses currently in equity may be recognised in the income statement in future periods. Additional details are described in note 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.

The principal holdings of loans and receivables where credit risk was of particular significance were loans and advances to customers held by Egg. Egg was sold in May 2007. Egg had significant concentrations of credit risk in respect of its unsecured lending on credit cards, personal loans and mortgage lending secured on property in the UK. The table in note J5 details the movements in the allowance for losses on such loans and advances up to the date of sale.

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. 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.

A3: Critical accounting policies, estimates and judgements continued

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(e)(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 sensitivity relates to assumed future investment returns for the Taiwan life operation as described below.

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 life assurance 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.

A3: Critical accounting policies, estimates and judgements continued

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 2007 and 2006 was 8.4 per cent per annum determined using a mean reversion methodology. Likely changes to this percentage return are not expected to be significant.

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 two 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 £45 million a year.

The profits attaching to these contracts are particularly affected by the rates of return earned, and estimated to be earned on, the assets held to cover liabilities and on future investment income and contract cash flows. Under IFRS, the insurance contract liabilities of the Taiwan business are determined on the US GAAP basis as applied previously under UK GAAP. Under this basis the policy liabilities are calculated on sets of assumptions, which are locked-in at the point of policy inception, and a deferred acquisition cost 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. At 31 December 2007 and 2006 it has been assumed that the longer-term bond rate will be attained 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(h)(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.

A3: Critical accounting policies, estimates and judgements continued

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.

Asian operations

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

The sensitivity of the results for this operation, including the potential effect on write-offs of deferred acquisition costs, is significant and is 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 2007 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.

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.

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.

A4: Significant accounting policies continued

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

iii Loans and receivables – this comprises investments that have fixed or determinable payments and are not designated as fair value through profit and loss or available-for-sale. These investments include loans collateralised by mortgages, deposits, loans to policyholders and other unsecured loans and receivables. These investments are carried at amortised cost using the effective interest method.

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

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

Use of fair values

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

Impairments

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

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

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

Derivatives and hedge accounting

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

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

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

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

A4: Significant accounting policies continued

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. In addition, for 2006 and during 2007 to the date of disposal, the Group also entered into significant derivative transactions for its discontinued banking operations.

For the Group's continuing operations, hedge accounting under IAS 39 is not usually applied. The exceptions, where hedge accounting has been applied in 2007 and 2006, 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 and, prior to the sale of Egg in the first half of 2007, Egg. 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.

Securities lending including repurchase agreements

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

In cases where the Group takes possession of the collateral under its securities lending programme, the collateral, and corresponding obligation to return such collateral, are recognised in the consolidated 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.

A4: Significant accounting policies continued

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-certains).

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.

A4: Significant accounting policies continued

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.

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:

A4: Significant accounting policies continued

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 2007 and 2006, was 8.4 per cent per annum implemented using a mean reversion methodology. These returns affect the level of future expected profits through their effects on 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.

A4: Significant accounting policies continued

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 2007 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.

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.

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. 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 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.

A4: Significant accounting policies continued

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.

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.

A4: Significant accounting policies continued

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, long-term business, asset management and, prior to the sale of Egg in the first half of 2007, banking operations. 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.

A4: Significant accounting policies continued

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. Except as discussed below, in determining profit on this basis the following key elements are applied to the results of the Group's shareholder-financed operations.

i Debt securities and equity securities

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

ii Derivative value movements

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

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

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

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

— Unit-linked and US variable annuity business.

For such business the policyholder liabilities are directly reflective of the asset value movements. Accordingly all asset value movements are recorded in the operating results based on longer-term investment returns.

— Assets covering non-participating business liabilities that are interest rate sensitive.

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

— Participating business for which liabilities include policyholders' interest in investment appreciation and other surplus.

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

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

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

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

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

A5: New accounting pronouncements

The following standards, interpretations and amendments have either been effective and adopted in 2007 or have been issued but are not yet effective in 2007, 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 2007

IFRS 7, 'Financial Instruments: Disclosures'

IFRS 7 replaces IAS 30, 'Disclosures in the Financial Statements of Banks and Similar Financial Institutions', which dealt with disclosures for banking operations, and the disclosure requirements of IAS 32, 'Financial Instruments: Disclosure and Presentation'. The latter, therefore, becomes a standard dealing wholly with presentation of financial instruments. IFRS 7 is intended to complement the principles for recognising, measuring and presenting financial assets and financial liabilities in IAS 32 and IAS 39, 'Financial Instruments: Recognition and Measurement'. The objective of IFRS 7 is to require entities to provide disclosures in their financial statements to enable the users of financial statements to evaluate the significance of financial instruments for the entity's financial position and performance and the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks. Consequential amendments have been made to other standards as a result of the release of IFRS 7, notably IAS 1, 'Presentation of Financial Statements', and IFRS 4, 'Insurance Contracts'.

IFRS 7 was issued in August 2005 and became effective for annual periods beginning on or after 1 January 2007.

Amendment to IFRS 4 Implementation Guidance

Revised IFRS 4 implementation guidance was issued in December 2005 and is effective in conjunction with the adoption of IFRS 7 as discussed above. The revisions relate to disclosures around insurance contracts.

Amendment to IAS 1, 'Capital Disclosures'

As a result of the issue of IFRS 7, IAS 1 was amended in August 2005 to include a requirement to disclose information on the entity's objectives, policies and processes for managing capital. This amendment became effective for annual periods beginning on or after 1 January 2007.

The Group adopted IFRS 7, Revised IFRS 4, 'Implementation Guidance' and the Amendment to IAS 1 in 2007. There is no impact on the profit and shareholders' equity of the Group from the adoption of these accounting pronouncements as their provisions relate to disclosure.

The additional disclosures required by IFRS 7, revised IFRS 4 and amendment to IAS 1 are shown in the relevant sections of the notes on the Group financial statements. The adoption of these pronouncements represents a change in accounting policy and the comparative 2006 figures have been disclosed accordingly.

IFRIC 9, 'Reassessment of Embedded Derivatives'

IFRIC 9 requires assessment of whether embedded derivatives are required to be separated from the host contract and accounted for as derivatives when the Group first becomes a party to the contracts. Subsequent reassessment is prohibited unless there is a change in the terms of the contracts that significantly modifies the cash flows that otherwise would be required under the contracts, in which case a reassessment is required. This interpretation became effective for annual periods beginning on or after 1 June 2006.

The adoption of IFRIC 9 did not have a material impact on the financial statements of the Group.

SOP 05-1,'Accounting by Insurance Enterprise for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts'

As explained in note A3, the assets and liabilities of the insurance contracts of Jackson and certain Asian operations, where the local GAAP is not well established, are accounted for based on insurance accounting prescribed by US GAAP. This is permitted by IFRS 4, where the assets and liabilities of life assurance contracts classified as insurance contracts with discretionary participating features under this standard are accounted for under previously applied GAAP, which in the case of Jackson and these certain Asian operations is US GAAP.

In September 2005, the American Institute of Certified Public Accountants (AICPA) issued SOP 05-1 which affects the US GAAP insurance accounting. This SOP provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FAS 97, 'Accounting and Reporting by Insurance Enterprises for Certain Long-Duration and for Realised Gains and Losses from the Sale of Investments'. SOP 05-1 sets out conditions to determine whether contract modifications are considered as internal replacements and result in a replacement contract that is substantially changed from the replaced contract. SOP 05-1 then requires unamortised deferred acquisition costs, unearned revenue liabilities and deferred sales inducement assets from replaced contracts in an internal replacement transaction that results in a substantially changed contract not to be deferred in connection with the replacement contract.

A5: New accounting pronouncements continued

SOP 05-1 became effective and was adopted by Jackson and those certain Asian operations from January 2007. The adoption of the provisions of SOP 05-1 did not have a material impact on the financial statements of the Group.

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. 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.

IFRIC 14, 'IAS19 – 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. This interpretation is effective for accounting periods beginning on or after 1 January 2008.

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 accounting periods beginning on or after 1 January 2009.

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;
- recognition and measurement at fair value of contingent consideration at acquisition date with subsequent changes to income;
- adoption of full goodwill method to measure non-controlling interests.

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.

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 the aforementioned standards, interpretations and amendments on its financial statements. Apart from IFRS 8, all of the other aforementioned pronouncements have not been adopted for use in the EU at 31 December 2007.

Notes on the Group financial statements

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.

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

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 are based on expected long-term rates of return. 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(g), D3(g) and D4(f). In particular, the operating result for UK insurance operations for 2007 and 2006 benefited from credits of £34 million and £46 million respectively. The 2007 benefit of £34 million arose on annuity and pension business. The 2006 credit of £46 million arose from regulatory changes.

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.

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

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

Notes continued

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

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

	2007 £m	2006 £m
Asian operations	(71)	134
Jackson	(18)	53
UK insurance operations	(47)	(43)
Other	(1)	11
	(137)	155

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

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

The fluctuations for US operations for the year comprise of the following items:

	2007 £m	2006 £m
Debt security fluctuations		
Credit related		
Actual credit related losses in the year		
Bond writedowns	(35)	(32)
Losses on sales of impaired and deteriorating bonds	(51)	(3)
Recoveries/reversals	8	10
	(78)	(25)
Risk margin charge to operating profit based on longer-term investment returns	48	54
	(30)	29
Interest related		
Actual interest related realised gains (losses) in year	31	(15)
Amortisation of current and prior year interest related realised gains and losses to operating profit based on longer-term investment returns	(37)	(45)
	(6)	(60)
Related change to amortisation of deferred acquisition costs	9	6
Total fluctuations related to debt securities	(27)	(25)
Derivatives (other than equity related): Market value movement	(19)	34
Equity type movements: Actual less longer-term return	42	21
Other items	(14)	23
Total	(18)	53

In addition, for US operations, included within the movements in shareholders' equity is a net reduction in value of Jackson's debt securities of £244 million. This reduction reflects a combination of increases due to reduction in US interest rates offset by the impact of widened credit spreads in the US bond market. These movements do not reflect defaults or permanent impairments. Additional details on the values of the Jackson portfolio are described in note D3.

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

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

Notes continued

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

	2007 £m	2006 £m
Actuarial gains and losses		
Actual less expected return on scheme assets	(8)	156
Experience losses on liabilities	(14)	18
Gains on changes of assumptions for scheme liabilities	317	311
	295	485
Less: amount attributable to the PAC with-profits sub-fund	(205)	(318)
Total	90	167

Further details on the Group's defined benefit pension schemes 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 UK restructuring costs are allocated as follows:

	2007 £m	2006 £m
UK insurance operations	7	31
M&G	0	2
Unallocated corporate	12	5
	19	38

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.

	2007					
	Before tax B1 £m	Tax 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	1,213	(383)	(4)	826	33.8p	33.7p
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	90	(25)	–	65	2.6p	2.7p
Based on profit for the year from continuing operations	1,166	(382)	(3)	781	31.9p	31.9p
Adjustment for post-tax results of discontinued operations*	222	19	–	241	9.9p	9.8p
Based on profit for the year	1,388	(363)	(3)	1,022	41.8p	41.7p

B2: Earnings per share continued

	2006					
	Before tax B1 £m	Tax 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	1,050	(304)	(1)	745	30.9p	30.9p
Short-term fluctuations in investment returns on shareholder-backed business	155	(38)	(2)	115	4.8p	4.8p
Shareholders' share of actuarial gains and losses on defined benefit pension schemes	167	(50)	–	117	4.8p	4.8p
Based on profit for the year from continuing operations	1,372	(392)	(3)	977	40.5p	40.5p
Adjustment for post-tax results of discontinued operations*	(150)	45	2	(103)	(4.3)p	(4.3)p
Based on profit for the year	1,222	(347)	(1)	874	36.2p	36.2p

* Discontinued operations relate entirely to UK Banking operations following the sale on 1 May 2007 of Egg Banking plc to Citi. Note I6 provides details of the sale of Egg.

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:

	2007 millions	2006 millions
Weighted average shares for calculation of basic earnings per share	2,445	2,413
Shares under option at end of year	9	10
Number of shares that would have been issued at fair value on assumed option exercise	(6)	(7)
Weighted average shares for calculation of diluted earnings per share	2,448	2,416

B3: Dividends

	2007 £m	2006 £m
Dividends declared and paid in reporting period		
Parent company:		
Interim dividend (2007: 5.70p, 2006: 5.42p per share)	140	131
Final dividend for prior period (2006: 11.72p, 2005: 11.02p per share)	286	267
Subsidiary company payments to minority interests	5	1
Total	431	399

As a result of shares issued in lieu of dividends of £176 million (2006: £76 million), dividends paid in cash, as set out in the consolidated cash flow statement, were £255 million (2006: £323 million).

	2007 £m	2006 £m
Parent company dividends relating to reporting period:		
Interim dividend (2007: 5.70p, 2006: 5.42p per share)	140	131
Final dividend (2007: 12.30p, 2006: 11.72p per share)	304	287
Total	444	418

A final dividend of 12.30 pence per share was proposed by the directors on 13 March 2008. Subject to shareholders' approval, the dividend will be paid on 20 May 2008 to shareholders on the register at the close of business on 11 April 2008. The dividend will absorb an estimated £304 million of shareholders' funds. A scrip dividend alternative will be offered to shareholders.

B4: Exchange translation
Exchange movement recorded directly in equity

	2007 £m	2006 £m
Asian operations	16	(97)
US operations	(43)	(384)
Unallocated to a segment (Central funds)	38	257
	11	(224)

The movements reflect the application of year end exchange rates at balance sheet rates and average exchange rates to the income statement. The movement unallocated to a segment reflects the retranslation of currency borrowings which have been designated as a net investment hedge to hedge the currency risks related to the net investment in Jackson.

The exchange rates applied were:

Local currency: £	Closing rate at 31 Dec 2007	Average for 2007	Closing rate at 31 Dec 2006	Average for 2006	Opening rate at 1 Jan 2006
Hong Kong	15.52	15.62	15.22	14.32	13.31
Japan	222.38	235.64	233.20	214.34	202.63
Malaysia	6.58	6.88	6.90	6.76	6.49
Singapore	2.87	3.02	3.00	2.93	2.85
Taiwan	64.56	65.75	63.77	59.95	56.38
US	1.99	2.00	1.96	1.84	1.72

B5: New business
Insurance products and investment products (note i)

	Insurance products gross premiums		Investment products gross inflows note ii		Total	
	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m
Asian operations	2,944	1,921	38,954	20,408	41,898	22,329
US operations	6,534	5,981	60	–	6,594	5,981
UK operations	6,866	7,192	14,745	13,486	21,611	20,678
Group total	16,344	15,094	53,759	33,894	70,103	48,988

B5: New business continued

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

	Single		Regular		Annual premium and contribution equivalents	
	2007 £m	2006 £m	2007 £m	2006 £m	2007 £m	2006 £m
Asian operations						
China[note v]	72	27	40	36	47	39
Hong Kong	501	355	117	103	167	139
India (Group's 26% interest)	26	20	177	105	180	107
Indonesia	118	31	109	71	121	74
Japan	122	68	22	7	34	14
Korea	179	103	241	208	259	218
Malaysia	41	4	78	72	82	72
Singapore	593	357	67	72	126	108
Taiwan	132	92	218	139	231	148
Other	36	15	55	36	59	37
Total Asian operations	1,820	1,072	1,124	849	1,306	956
US operations						
Fixed annuities	573	688	–	–	57	69
Fixed index annuities	446	554	–	–	45	55
Variable annuities	4,554	3,819	–	–	455	382
Life	7	8	19	17	20	18
Guaranteed investment contracts	408	458	–	–	41	46
GIC – Medium Term Notes	527	437	–	–	53	44
Total US operations	6,515	5,964	19	17	671	614
UK operations						
Product summary						
Internal vesting annuities	1,399	1,341	–	–	140	134
Direct and partnership annuities	842	780	–	–	84	78
Intermediated annuities	589	592	–	–	59	59
Total individual annuities	2,830	2,713	–	–	283	271
Equity release	156	89	–	–	16	9
Individual pensions	38	21	1	–	5	2
Corporate pensions	283	318	84	66	112	98
Unit-linked bonds	243	388	–	–	24	39
With-profit bonds	297	139	–	–	30	14
Protection	–	11	5	9	5	10
Offshore products	434	540	4	–	47	54
Total retail retirement	4,281	4,219	94	75	522	497
Corporate pensions	198	261	115	100	135	126
Other products	190	232	25	26	44	49
DWP rebates	143	161	–	–	14	16
Total mature life and pensions	531	654	140	126	193	191
Total retail	4,812	4,873	234	201	715	688
Wholesale annuities[notes iii,iv]	1,799	1,431	–	–	180	143
Credit life	21	687	–	–	2	69
Total UK operations	6,632	6,991	234	201	897	900
Channel Summary						
Direct and partnership	2,385	2,543	209	174	448	428
Intermediated	2,284	2,169	25	27	253	244
Wholesale[notes iii,iv]	1,820	2,118	–	–	182	212
Sub-total	6,489	6,830	234	201	883	884
DWP rebates	143	161	–	–	14	16
Total UK operations	6,632	6,991	234	201	897	900
Group total	14,967	14,027	1,377	1,067	2,874	2,470

B5: New business continued
Investment products – funds under management (note ii)

	2007 £m				
	1 Jan 2007	Market gross inflows	Redemptions	Market and other movements	31 Dec 2007
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**

	2006 £m				
	1 Jan 2006	Market gross inflows	Redemptions	Market and other movements	31 Dec 2006
Asian operations	10,132	20,408	(17,876)	(411)	12,253
UK operations	36,196	13,486	(7,385)	2,649	44,946
Group total	46,328	33,894	(25,261)	2,238	57,199

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.

Annual premium and contribution equivalents 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 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. US investment products are no longer included in the table above as they are assets under administration rather than funds under management.

iii The tables 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 new business premium of £174 million.

iv The tables for 2006 above include a bulk annuity transaction with the Scottish Amicable Insurance Fund (SAIF) with a premium of £560 million. The transaction reflects the arrangement entered into in June 2006 for the reinsurance of non-profit immediate pension annuity liabilities of SAIF to Prudential Retirement Income Limited (PRIL), a shareholder-owned subsidiary of the Group. SAIF is a closed ring-fenced sub-fund of the PAC long-term fund established by a Court approved Scheme of Arrangement in October 1997, which is solely for the benefit of SAIF policyholders. Shareholders have no interest in the profits of this fund, although they are entitled to investment management fees on this business. The inclusion of the transaction between SAIF and PRIL as new business in the tables reflects the transfer from SAIF to Prudential shareholders' funds of longevity risk, the requirement to set aside supporting capital, and entitlement to surpluses arising on this block of business from the reinsurance arrangement. For Group reporting purposes the amounts recorded by SAIF and PRIL for the premium are eliminated on consolidation.

v 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 joint venture. Prior to this date CITIC–Prudential was consolidated as a subsidiary undertaking (see note H8). The totals above include 100 per cent of total premiums for CITIC-Prudential up to 29 September 2007 and 50 per cent thereafter, being the Group's share after this date.

B6: Group balance sheet

The Group's primary reporting segments are long-term business, 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:

Long-term business

This segment comprises long-term products that contain both a significant and insignificant element 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 managed by PPM Capital and other investment subsidiaries held for the purpose of supporting the Group's long-term business 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 advisor, 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.

Discontinued banking operations

This segment, prior to the sale of Egg in the first half of 2007, consisted of products provided by the Group's online banking subsidiary, Egg. The nature of these products and the managing of the business differed from the risks inherent in the other business segments, and the regulatory environment of the banking industry differed from that of the other business segments. Note I6 includes details of the disposal of Egg Banking plc in the first half of 2007.

	2007 £m				
	Long-term business	Asset management	Unallocated to a segment	Intra-group eliminations	Total
Consolidated total assets	213,323	7,011	4,909	(5,499)	219,744
Consolidated total liabilities	(207,850)	(5,282)	(5,808)	5,499	(213,441)
Segment assets by geographical segment					
UK					161,696
US					42,758
Asia					20,789
Intra-group eliminations					(5,499)
Total assets per balance sheet					219,744

	2006 £m						
	Long-term business	Asset management	Unallocated to a segment	Intra-group eliminations	Total continuing operations	Discontinued banking operations	Total
Consolidated total assets	201,936	5,565	3,672	(4,151)	207,022	9,498	216,520
Consolidated total liabilities	(196,650)	(3,923)	(5,272)	4,151	(201,694)	(9,206)	(210,900)
Segment assets by geographical segment							
UK							165,103
US							39,695
Asia							15,873
Intra-group eliminations							(4,151)
Total assets per balance sheet							216,520

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.

B6: Group balance sheet continued
This analysis is shown below for the Group balance sheet at 31 December 2007.

	2007 £m							
	Insurance operations							
	UK D2	US D3	Asia D4	Total insurance operations	Asset management E2	Unallocated to a segment	Intra group eliminations	Group total
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
Other non-investment and non-cash assets[H3-H6]	4,433	1,651	762	6,846	521	4,457	(5,499)	6,325
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[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	150,239	42,543	20,541	213,323	7,011	4,909	(5,499)	219,744

B6: Group balance sheet continued

	2007 £m							
	Insurance operations UK D2	US D3	Asia D4	Total insurance operations	Asset management E2	Unallocated to a segment	Intra group eliminations	Group total
Equity and liabilities								
Equity								
Shareholders' equity[H11]	1,364	2,690	1,369	5,423	1,677	(899)	–	6,201
Minority interests	42	1	7	50	52	–	–	102
Total equity	1,406	2,691	1,376	5,473	1,729	(899)	–	6,303
Liabilities								
Policyholder liabilities and unallocated surplus of with-profits funds:								
Insurance contract liabilities[H12]	82,798	32,926	16,912	132,636	–	–	–	132,636
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)[D2eii,H12]	14,205	–	146	14,351	–	–	–	14, 351
Total policyholder liabilities and unallocated surplus of with-profits funds	138,542	34,848	17,179	190,569	–	–	–	190,569
Core structural borrowings of shareholder-financed operations:[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]	12	591	–	603	1	2,477	–	3,081
Borrowings attributable to with-profits funds[G1,H13]	987	–	–	987	–	–	–	987
Other non-insurance liabilities[G1,H4,H9,H14,H15]	9,292	4,288	1,986	15,566	5,281	964	(5,499)	16,312
Total liabilities	148,833	39,852	19,165	207,850	5,282	5,808	(5,499)	213,441
Total equity and liabilities	150,239	42,543	20,541	213,323	7,011	4,909	(5,499)	219,744

B6: Group balance sheet continued
This analysis is shown below for the Group balance sheet at 31 December 2006.

	2006 £m									
	Insurance operations UK D2	US D3	Asia D4	Total insurance operations	Asset management E2	Unallocated to a segment	Intra group eliminations	Total continuing operations	Discontinued operations	Group total
Assets										
Intangible assets attributable to shareholders:										
Goodwill	–	–	111	111	1,230	–	–	1,341	–	1,341
Deferred acquisition costs and other intangible assets	167	1,712	612	2,491	6	–	–	2,497	–	2,497
Total[H1]	167	1,712	723	2,602	1,236	–	–	3,838	–	3,838
Intangible assets attributable to PAC with-profits fund:										
In respect of acquired subsidiaries for venture fund and other investment purposes	830	–	–	830	–	–	–	830	–	830
Deferred acquisition costs	31	–	–	31	–	–	–	31	–	31
Total[H2]	861	–	–	861	–	–	–	861	–	861
Total	1,028	1,712	723	3,463	1,236	–	–	4,699	–	4,699
Other non-investment and non-cash assets[G1,H3-H6]	4,733	1,588	602	6,923	415	2,917	(4,151)	6,104	342	6,446
Investment of long-term business and other operations:										
Investment properties	14,429	20	41	14,490	1	–	–	14,491	–	14,491
Investments accounted for using the equity method	–	–	–	–	–	6	–	6	–	6
Loans	1,128	3,254	904	5,286	2,181	94	–	7,561	6,193	13,754
Equity securities and portfolio holdings in unit trusts	60,246	11,710	6,894	78,850	13	29	–	78,892	–	78,892
Debt securities	53,461	20,146	5,391	78,998	678	67	–	79,743	1,976	81,719
Other investments	2,461	542	87	3,090	80	(28)	–	3,142	78	3,220
Deposits	6,812	457	408	7,677	10	72	–	7,759	–	7,759
Total investments[G1,H7,H8]	138,537	36,129	13,725	188,391	2,963	240	–	191,594	8,247	199,841
Held for sale assets[H9]	463	–	–	463	–	–	–	463	–	463
Cash and cash equivalents[H10]	1,979	99	618	2,696	951	515	–	4,162	909	5,071
Total assets	146,740	39,528	15,668	201,936	5,565	3,672	(4,151)	207,022	9,498	216,520

B6: Group balance sheet continued

	2006 £m									
	Insurance operations									
	UK D2	US D3	Asia D4	Total insurance operations	Asset management E2	Unallocated to a segment	Intra group eliminations	Total continuing operations	Discontinued operations	Group total
Equity and liabilities										
Equity										
Shareholders' equity[H11]	1,263	2,656	1,287	5,206	1,590	(1,600)	–	5,196	292	5,488
Minority interests	79	1	–	80	52	–	–	132	–	132
Total equity	1,342	2,657	1,287	5,286	1,642	(1,600)	–	5,328	292	5,620
Liabilities										
Banking customer accounts[G1]	–	–	–	–	–	–	–	–	5,554	5,554
Policyholder liabilities and unallocated surplus of with-profits funds:										
Insurance contract liabilities[H12]	80,323	30,184	12,706	123,213	–	–	–	123,213	–	123,213
Investment contract liabilities with discretionary participation features[G1]	28,665	–	68	28,733	–	–	–	28,733	–	28,733
Investment contract liabilities without discretionary participation features[G1]	11,453	1,562	27	13,042	–	–	–	13,042	–	13,042
Unallocated surplus of with-profits funds (reflecting application of 'realistic' basis provisions for UK regulated with-profits funds[D2(e)(ii),H12]	13,511	–	88	13,599	–	–	–	13,599	–	13,599
Total policyholder liabilities and unallocated surplus of with-profits funds	133,952	31,746	12,889	178,587	–	–	–	178,587	–	178,587
Core structural borrowings of shareholder-financed operations:[H13]										
Subordinated debt (other than Egg)	–	–	–	–	–	1,538	–	1,538	–	1,538
Other	–	127	–	127	–	947	–	1,074	–	1,074
	–	–	–	–	–	2,485	–	2,612	–	2,612
Egg subordinated debt[H13]	–	–	–	–	–	–	–	–	451	451
Total	–	–	–	–	–	2,485	–	2,612	451	3,063
Operational borrowings attributable to shareholder-financed operations[G1,H13]	11	743	–	754	4	2,032	–	2,790	2,819	5,609
Borrowings attributable to with-profits funds[G1,H13]	1,776	–	–	1,776	–	–	–	1,776	–	1,776
Other non-insurance liabilities[G1,H4,H9,H14,H15]	9,659	4,255	1,492	15,406	3,919	755	(4,151)	15,929	382	16,311
Total liabilities	145,398	36,871	14,381	196,650	3,923	5,272	(4,151)	201,694	9,206	210,900
Total equity and liabilities	146,740	39,528	15,668	201,936	5,565	3,672	(4,151)	207,022	9,498	216,520

B7: Internal funds under management

Internal funds under management analysed by business area at 31 December 2007 were as follows:

	2007 £m				2006 £m
	UK	US	Asia	Total	Total
Investment property	13,666	8	14	**13,688**	14,491
Equity securities	60,840	15,507	9,810	**86,157**	78,892
Debt securities	58,037	19,002	6,945	**83,984**	79,743
Loans	3,579	3,258	1,087	**7,924**	7,561
Other investments	10,809	1,054	434	**12,297**	10,907
Total continuing operations	146,931	38,829	18,290	**204,050**	191,594
Discontinued banking operations	–	–	–	**–**	8,247
Total internal funds under management	146,931	38,829	18,290	**204,050**	199,841

C: Group risk management

i 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 rissks, 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, Group Finance Director and the Group Risk function, working with counterparts in the business units in addition to other Group Head Office (GHO) oversight functions. 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 carry out a review of risks as part of the annual preparation of their three-year business plan. This involves an assessment of the impact and likelihood of key risks and of the effectiveness of controls in place to manage them, and is reviewed regularly throughout the year. In addition, business unit dialogue meetings involving Group and business unit executive management are held regularly to review opportunities and risks to business objectives. Any mitigation strategies involving large transactions (e.g. a material derivative transaction) would be subject to scrutiny at Group level before implementation.

Additional information on the Group's risk framework is included in the risk management section of the Group's operating and financial 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 as follows:

a Group risk appetite

The Group risk appetite framework sets out the Group's overall tolerance to risk exposures, approach to risk/return optimisation and management of risk. The Group risk appetite statements set out the Group's risk tolerance, or risk appetite, to 'shocks' to the key financial risk exposures (market, credit and insurance risk). Aggregate risk limits are defined in terms of earnings volatility and 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 and International Financial Reporting Standards (IFRS) operating profit.

ii Capital requirements:

The objectives of the limits are to ensure that (a) the Group is economically solvent, (b) the Group achieves its desired target rating to meet its business objectives, (c) supervisory intervention is avoided, (d) any potential capital strains are identified, and (e) accessible capital is available to meet business objectives. 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.

b Group counterparty exposure limits

In addition to business unit operational limits on credit risk, counterparty risk limits are also set at the Group level. Limits on total Group-wide exposures to a single counterparty are specified for different credit rating 'buckets'. Actual exposures are monitored against these limits on a quarterly basis.

i Overview continued
c Risk mitigation
Prudential employs a range of risk mitigation strategies aimed at reducing the impact of a variety of risks. Key mitigation strategies include: adjustment of asset portfolios to reduce investment risks (such as duration mismatches or overweight counterparty exposures); use of derivatives to hedge market risks; reinsurance programmes to limit insurance risk; and corporate insurance programmes to limit impact of operational risks. Revisions to business plans (such as reassessment of bonus rates on participating business and scaling back of target new business volumes) may also be used as a mitigating strategy.

d Asset – liability management
The Group's approach is explained in section (vi) below.

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

iii Market and financial risks
a Equity and interest rate risk
Market risk is the risk that 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. 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.

b Foreign exchange risk
Prudential faces foreign exchange risk, primarily because its presentation currency is pounds sterling, whereas approximately 54 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 2007, 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 70 per cent of the Group's IFRS basis shareholders' equity at 31 December 2007 arose in Prudential's US and Asian operations. 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 (see note G3). Net of the currency position arising from these instruments some 40 per cent of the Group's shareholders' funds are represented by net assets in currencies other than sterling.

c Liquidity risk
Liquidity risk is the risk that Prudential may be unable to meet payment of obligations in a timely manner at a reasonable cost or the risk of unexpected increases in the cost of funding at appropriate maturities or rates. Liquidity management in each business seeks to ensure that, even under adverse conditions, Prudential has access to the funds necessary to cover surrenders, withdrawals and maturing liabilities.

In practice, most of Prudential's invested assets are marketable securities. This, combined with the fact that a large proportion of the liabilities contain discretionary surrender values or surrender charges, reduces the liquidity risk. The Group maintains committed borrowing and securities lending facilities.

d Credit risk
Credit risk is the risk that a counterparty or an issuer of securities, which Prudential holds in its asset portfolio, defaults or another party fails to perform according to the terms of the contract. Some of Prudential's businesses, in particular Jackson, the PAC with-profits fund, Prudential's UK pension annuity business and, prior to the sale in the first half of 2007, Egg, held 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 businesses exposed to credit risks are Jackson and, prior to disposal, Egg. 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.

iii Market and financial risks continued

Further analysis of the credit quality for Jackson is shown in note D3 and for discontinued Egg banking operations in note J7. Additional details on the credit quality of the debt security portfolios of UK and Asian insurance operations are shown in notes D2 and D4.

iv 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.

It is Prudential's policy that cash or corresponding assets cover amounts at risk through derivative transactions. Derivative financial instruments used to facilitate efficient portfolio management and for investment purposes are carried at fair value with changes in fair value included in long-term investment returns.

v Operational, compliance and fiscal risk

Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes people or systems or from external events. Operational risk can result from a variety of factors, including failure to obtain proper internal authorisations or maintain internal controls, failure to document transactions properly, failure of operational and information security procedures or other procedural failures, computer system or software failures, other equipment failures, fraud, inadequate training or errors by employees. Compliance with internal rules and procedures designed to manage these risks is monitored by Prudential's local management boards.

Internal compliance managers who report to the local management boards monitor adherence to local regulatory requirements. The head of Prudential's Group Compliance function reports directly to the Group Chief Executive who submits regular reports to the Board of Directors.

Compliance risk includes the possibility that transactions may not be enforceable under applicable law or regulation as well as the cost of rectification and fines, and also the possibility that changes in law or regulation could adversely affect Prudential's position. Prudential seeks to minimise compliance risk by seeking to ensure that transactions are properly authorised and by submitting new or unusual transactions to legal advisers for review.

Prudential is exposed to certain fiscal risks arising from changes in tax laws and enforcement policies and in reviews by taxation authorities of tax positions taken by Prudential in recent years. Prudential manages this risk and risks associated with changes in other legislation and regulation through ongoing review by relevant departments of proposed changes to legislation and by membership of relevant trade and professional committees involved in commenting on draft proposals in these areas.

vi 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 or longer, 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 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 interest-sensitive and fixed index annuities because of the nature of the liabilities (which include guaranteed surrender values) and options for prepayment contained in the assets.

vi Asset/liability management continued

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.

vii Regulatory capital requirements

Regulatory capital requirements apply at an individual company level for the Group life assurance and asset management business. These are described in sections D5 and E3 respectively. Capital requirements also applied for the Group's discontinued banking operations, as described in note J8.

In addition, the Group as a whole is currently subject to the solvency requirements of the Insurance Groups Directive (IGD) as implemented by the FSA. Previously, whilst Prudential owned Egg, it was required to comply with the broadly equivalent requirements of the Financial Conglomerates Directive (FCD), as implemented by the FSA. Under both the IGD and FCD a continuous parent company solvency test is applied. 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, and 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 2007 the Group held £763 million (31 December 2006: £763 million) of Innovative Tier 1 capital in the form of perpetual securities, £nil million (£250 million) of Upper Tier 2 and £932 million (£1,103 million) of Lower Tier 2 capital. Further details on these amounts and other Group borrowings are shown in note H13.

At 31 December 2006, Prudential met the requirements of the FCD. In addition, during 2007, Prudential met the 'hard test' of the FSA under both the FCD and IGD. The IGD position as at 31 December 2007 will be submitted to the FSA by 30 April 2008 and at the time of preparation of these financial statements the surplus capital under the test was estimated to be around £1.4 billion.

In addition to obligations under subsidiary and Group regulatory requirements, Prudential applies an economic framework to its management of capital.

Economic capital provides a realistic and consistent view of Prudential's capital requirements, allowing for diversification benefits. Two types of 'economic capital' approaches are applied. These are:

- Group economic capital under which the capital requirement is determinable based on a multi-year projection thus taking into account the long-term nature of Prudential's liabilities; and
- One-year Value at Risk Capital (1-yr VaR Capital). This capital is the amount required to withstand a maximum loss over a time period of one year consistent with a confidence level of 99.5 per cent. In additional to its risk management applications, the 1-yr VaR Capital framework is used for Individual Capital Assessments in the UK and anticipated to form the basis of Prudential's capital modelling for future regulatory reporting developments, such as Solvency II.

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.

D1: Group overview continued

i Certain UK unit-linked savings and similar contracts 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 under IFRS 4.

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 has a broadly based exposure to life assurance risk. This is achieved through the geographical spread of the Group's operations and, within those operations, through a broad mix of product types. In addition, looking beyond pure insurance risk, the Group considers itself well developed in its approach to assessment of diversification benefits through its economic capital framework that is used for internal business management. The economic capital methodology seeks to apply a single yardstick to assess and quantify all risks attaching to the Group's insurance business and associated capital requirements.

Prudential's internal Group economic capital requirement is defined as the minimum amount of capital that the Group needs to hold in order to remain economically solvent over a 25-year horizon, given a target probability of insolvency appropriate for AA-rated debt. The target confidence level is based on historic default rates for AA-rated debt, and varies over the time horizon of the projection. The economic capital requirement is calculated in respect of existing contractual and discretionary liabilities only, excluding the impact of future new business and dividend distribution.

For the purposes of calculating Group economic capital, Group economic solvency is defined as the position where both: (a) the capital balance of the parent company is positive, and (b) all business units are solvent on the applicable local regulatory basis. This definition of solvency allows the Group's capital position to be assessed on an economic basis while taking into account the actual regulatory constraints at the business unit level.

The Group economic capital position is calculated using the Group Solvency Model (GSM) – an integrated stochastic asset/liability model of the Group economic solvency position. Projected economic scenarios in the GSM are generated using a stochastic economic scenario generator that captures the correlations between different asset classes and geographies.

The Group regularly determines the level of capital required to cover the risks to its existing contractual and discretionary insurance liabilities on an economic basis and its internal target solvency level. This level of required capital is determined after allowance for diversification across risk and geographies and the capturing of future shareholders' transfers from the business units. This level is then compared with available capital on an equivalent basis (i.e. IFRS shareholders' equity after eliminating goodwill and including subordinated debt capital and valuation differences). The required capital is then analysed into its contributing parts by risk type namely market risk (including interest and equity risk), credit risk, underwriting, persistency and operational risk.

The largest risk exposure continues to be credit risks which reflect the relative size of exposure in Jackson and the UK shareholder annuities business. However, credit risk has reduced due to the sale of Egg and Jackson's maturing fixed annuity 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 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 Asian and US economies.

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 2007, 98 per cent of the reinsurance recoverable insurance assets were ceded by the Group's UK and US operations, of which 88 per cent of the balance were from reinsurers with Standard & Poor's rating AA- and above. A similar position was held at 31 December 2006.

c Guarantees

Notes D2(c), D3(c), D4(b) and D4(h) 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 2007 as described in section D2(e)(ii). The UK business also has products with guaranteed annuity option features, mostly within SAIF, as described in section D2(c). 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(c). Jackson's derivative programme seeks to manage the exposures as described in section D3(d). The most significant exposure for the Group arises on Taiwan whole of life policies as described in section D4(h)(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 (2006: 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 (2006: 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.

D1: Group overview continued

Details of the key assumptions and sensitivity of the EEV value of in-force business are shown in the sections for each geographic segment that follow in this note. The sensitivity of the present value of the discounted future cash flows under the EEV methodology is of particular interest. The sensitivity provides an indication of the movement in the net value ascribable to potential variations in the amounts and timing of future cash flows to shareholders and the uncertainty attached to those cash flows.

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.
— 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.

D1: Group overview continued

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

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 not covered by the equity derivative programmes. However, the main effect is on Jackson IFRS total profit and equity. IFRS profit or loss and equity arise from the accounting rather than economic effect of market value movements on assets and derivatives attaching to fixed annuity, term and institutional business.

Jackson's derivative programme is used to substantially mitigate equity market risk attaching to its equity-based products and interest rate risk associated with its spread-based products. Combined with the spread based nature of Jackson's other products and the US GAAP basis of measuring liabilities to policyholders, Jackson's risk exposure at the operating profit level based on longer-term investment returns is relatively less significant than for other parts of the Group. However, movements in interest rates and credit spreads materially affect the carrying value of derivatives which are used to manage the liabilities to policyholders and backing investment assets of fixed annuity and other general account business. Combined with the use of US GAAP measurement for the 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 of any impairment on the loan book of 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.

D1: Group overview continued

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 for fixed annuity, term, institutional and other variable annuity business not 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 grandfathers 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 give rise to potentially significant volatility in the IFRS income statement and shareholders' equity. As for other shareholder-backed business the profit or loss for Jackson is presented in the Group's supplementary basis of reporting as 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 incidence of guarantee features and variability of asset management fees offset by derivative hedging performance.

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.

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(d) and (h)(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 effect 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 the embedded value of the business in force reflecting an altered value of future expected shareholder transfers.

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

Jackson is sensitive to lapse risk. However, Jackson has swaption derivatives in place to 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(j), D3(j) and D4(i).

In the years 2003 to 2007, claims paid on the Group's life assurance contracts including those classified as investment contracts under IFRS 4 ranged from £11.8 billion to £17.1 billion. Indicatively it is to be expected that of the Group's policyholder liabilities (excluding unallocated surplus) at 31 December 2007 of £176 billion, the amounts likely to be paid in 2008 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, PRIL, unit-linked 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	Prudential Retirement Income Limited £m	Unit-linked business £m	Other business £m	Total £m	2007 Total £m	2006 Total £m
Assets										
Intangible assets attributable to shareholders:										
Deferred acquisition costs and other intangible assets	–	–	–	–	–	55	102	157	**157**	167
	–	–	–	–	–	55	102	157	**157**	167
Intangible assets attributable to PAC with-profits fund:										
In respect of acquired subsidiaries for venture fund and other investment purposes	–	192	–	192	–	–	–	–	**192**	830
Deferred acquisition costs	4	15	–	15	–	–	–	–	**19**	31
	4	207	–	207	–	–	–	–	**211**	861
Total	4	207	–	207	–	55	102	157	**368**	1,028
Other non-investment and non-cash assets	161	2,086	289	2,375	512	660	725	1,897	**4,433**	4,733
Investments of long-term business and other operations:										
Investment properties	1,230	10,197	485	10,682	724	1,030	–	1,754	**13,666**	14,429
Financial investments:										
Loans note v	184	599	163	762	43	–	256	299	**1,245**	1,128
Equity securities and portfolio holdings in unit trusts	6,946	40,756	352	41,108	107	12,659	9	12,775	**60,829**	60,246
Debt securities note vi	4,595	20,383	13,075	33,458	13,173	5,751	203	19,127	**57,180**	53,461
Other investments note vii	244	2,531	127	2,658	90	115	284	489	**3,391**	2,461
Deposits	466	4,021	313	4,334	828	1,418	182	2,428	**7,228**	6,812
Total investments	13,665	78,487	14,515	93,002	14,965	20,973	934	36,872	**143,539**	138,537
Held for sale assets	30	–	–	–	–	–	–	–	**30**	463
Cash and cash equivalents	127	642	56	698	49	836	159	1,044	**1,869**	1,979
Total assets	**13,987**	**81,422**	**14,860**	**96,282**	**15,526**	**22,524**	**1,920**	**39,970**	**150,239**	146,740

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	Prudential Retirement Income Limited £m	Unit-linked business £m	Other business £m	Total £m	2007 Total £m	2006 Total £m
Equity and liabilities										
Equity										
Shareholders' equity	–	–	–	–	1,125	194	45	1,364	**1,364**	1,263
Minority interests	22	20	–	20	–	–	–	–	**42**	79
Total equity	22	20	–	20	1,125	194	45	1,364	**1,406**	1,342
Liabilities										
Policyholder liabilities and unallocated surplus of with-profits funds:										
Insurance contract liabilities	12,927	34,988	12,564	47,552	13,402	8,766	151	22,319	**82,798**	80,323
Investment contract liabilities with discretionary participation features	693	28,773	–	28,773	–	–	–	–	**29,466**	28,665
Investment contract liabilities without discretionary participation features	–	14	–	14	–	12,059	–	12,059	**12,073**	11,453
Unallocated surplus of with-profits funds (reflecting application of 'realistic' provisions for UK regulated with-profits funds)	–	12,486	1,719	14,205	–	–	–	–	**14,205**	13,511
Total	13,620	76,261	14,283	90,544	13,402	20,825	151	34,378	**138,542**	133,952
Operational borrowings attributable to shareholder-financed operations	–	–	–	–	–	12	–	12	**12**	11
Borrowings attributable to with-profits funds	112	875	–	875	–	–	–	–	**987**	1,776
Other non-insurance liabilities	233	4,266	577	4,843	999	1,493	1,724	4,216	**9,292**	9,659
Total liabilities	13,965	81,402	14,860	96,262	14,401	22,330	1,875	38,606	**148,833**	145,398
Total equity and liabilities	**13,987**	**81,422**	**14,860**	**96,282**	**15,526**	**22,524**	**1,920**	**39,970**	**150,239**	146,740

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 £1,245 million comprise mortgage loans of £449 million, policy loans of £35 million and other loans of £761 million. The mortgage loans are collateralised by properties. Other loans are all commercial loans and comprise mainly syndicated loans held by the PAC with-profits fund.

vi Included in debt securities above are £3,511 million (2006: £3,341 million) of securities which are not quoted on active markets and are valued using valuation techniques of which £3,002 million (2006: £2,945 million) related to assets held by with-profits operations and £509 million (2006: £396 million) related to assets held by shareholder-backed operations.

D2: UK insurance operations continued

Notes continued

vii Other investments comprise:

	2007 £m
Derivative assets (note G3)	571
Partnerships in investment pools and other	2,820
	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.

b Information on credit risk of debt securities

The following table summarises by rating the securities held by UK insurance operations as at 31 December 2007 and 2006:

		PAC with-profits sub-fund			Other funds and subsidiaries			UK insurance operations	
	Scottish Amicable Insurance Fund £m	Excluding Prudential Annuities Limited £m	Prudential Annuities Limited £m	Total £m	Prudential Retirement Income Limited £m	Unit-linked business £m	Other business £m	2007 Total £m	2006 Total £m
S&P – AAA	1,453	6,434	4,356	10,790	5,658	3,534	121	**21,556**	18,794
S&P – AA+ to AA-	436	1,978	1,518	3,496	1,541	680	20	**6,173**	4,859
S&P – A+ to A-	1,030	4,356	2,693	7,049	3,354	1,093	31	**12,557**	12,270
S&P – BBB+ to BBB-	652	2,780	920	3,700	781	267	9	**5,409**	5,792
S&P – Other	167	757	11	768	1	6	–	**942**	880
	3,738	16,305	9,498	25,803	11,335	5,580	181	**46,637**	42,595
Moody's – Aaa	138	550	177	727	125	22	9	**1,021**	1,073
Moody's – Aa1 to Aa3	23	198	273	471	82	9	2	**587**	479
Moody's – A1 to A3	74	321	284	605	243	19	3	**944**	1,030
Moody's – Baa1 to Baa3	41	180	150	330	103	14	2	**490**	627
Moody's – Other	10	400	–	400	–	–	–	**410**	127
	286	1,649	884	2,533	553	64	16	**3,452**	3,336
Fitch	43	196	265	461	160	17	1	**682**	1,243
Other	528	2,233	2,428	4,661	1,125	90	5	**6,409**	6,287
Total debt securities	4,595	20,383	13,075	33,458	13,173	5,751	203	**57,180**	53,461

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 2007 which are not externally rated, £2,972 million were internally rated AAA to A-, £2,844 million were internally rated BBB+ to B- and £593 million were unrated. The majority of 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(i) 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.

D2: UK insurance operations continued

c 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, the 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 2007, there are policyholder liabilities of £76.3 billion (2006: £74.1 billion) and unallocated surplus of £14.2 billion (2006: £13.5 billion) that relate to the WPSF. 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 £45 million at 31 December 2007 (2006: £47 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 2007, £29.5 billion (2006: £29.0 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.

D2: UK insurance operations continued

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 £563 million was held in SAIF at 31 December 2007 (2006: £561 million) to honour the guarantees. As SAIF is a separate sub-fund solely for the benefit of policyholders of SAIF this provision has no impact on the financial position of the Group's shareholders' equity.

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

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

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

d 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.

e Process for setting assumptions and determining contract liabilities

i Overview

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

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

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

D2: UK insurance operations continued

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

The contract liabilities for PAL and PRIL are based on the FSA regulatory solvency basis. The valuation is then modified for IFRS reporting purposes to remove some of the margins for prudence within the assumptions, and contingency reserves, which are required under the solvency basis applied for regulatory purposes, but not for financial accounting.

The contract liabilities are the discounted value of future claim payments, adjusted for investment expenses and future administration costs. The interest rates used for discounting claim payments are derived from the yields on the assets held with an allowance for default risk.

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:

	PAL		PRIL	
2007	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

	PAL		PRIL	
2006	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

	PAL		PRIL	
2005	Males	Females	Males	Females
In payment	93% – 100% PMA92 (C = 2004) with medium cohort improvement table with a minimum annual improvement of 1.25%	84% – 105% PFA92 (C = 2004) with 75% of medium cohort improvement table with a minimum annual improvement of 0.75%	88% – 100% PMA92 (C = 2004) with medium cohort improvement table with a minimum annual improvement of 1.25%	84% – 102% PFA92 (C = 2004) 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

D2: UK insurance operations continued

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

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

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

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

f Reinsurance

The Group's UK insurance business cedes only minor amounts of business outside the Group. During 2007, reinsurance premiums for externally ceded business were £59 million (2006: £58 million) and reinsurance recoverable insurance assets were £335 million (2006: £510 million) in aggregate. The gains and losses recognised in profit and loss for these contracts were immaterial.

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

2007

For UK insurance operations, the 2007 results have been 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.

	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
Expenses related[notes c,f]	–	68
Other[notes c,g]	–	90
	272	310
Net charge to unallocated surplus	(392)	
Net credit to shareholder result		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.

D2: UK insurance operations continued

2006

For with-profits business, there was no significant change in assumptions in 2006.

There was no change in mortality assumptions for PAL in 2006 which had a material effect on the measurement of the insurance liabilities. Liabilities for PAL were increased by £47 million for the effect of change of assumptions for renewal expenses. As PAL is owned by the WPSF, this change had no effect on shareholder profit.

In 2006, the FSA made regulatory changes for UK regulated shareholder-backed non-participating business. These changes were confirmed in the December 2006 policy statement PS06/14.

The changes to the FSA rules allow insurance liabilities for this business to incorporate more realism. In particular this is achieved by:

— setting technical provisions for expenses not directly attributable to one particular contract at a homogenous risk group level and not, as previously, at an individual contract level for all non-profit business; and
— recognising the economic effect of making a prudent lapse rate assumption. Previously, no lapses were assumed.

Under IFRS 4, the effect of this change is accounted for as a change in estimate and there was a consequent increase in operating profit based on longer-term investment returns of £46 million.

In addition to the £46 million credit described above, a charge of £4 million was recognised in 2006 for the effect of change of assumption for renewal and termination expenses mainly in respect of PAC.

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

At 31 December 2007, the EEV basis value of in-force business of UK insurance operations, after taking account of the cost of encumbered capital and the cost of the time value of financial options and guarantees, was £5,334 million (2006: £4,835 million). This value has been determined after applying the principles of valuation described in note D1 and the following key assumptions:

	2007 %	2006 %
Risk discount rate for in-force business at the start of the year	7.85	8.0
Pre-tax expected long-term nominal rates of investment return:		
UK equities	8.55	8.6
Overseas equities	8.1 to 10.2	8.6 to 9.3
Property	6.8	7.1
Gilts	4.55	4.6
Corporate bonds – with-profits funds[note i]	6.0	5.3
– other business	6.25	5.3
Expected long-term rate of inflation	3.2	3.1
Post-tax expected long-term nominal rate of return for the with-profits sub-fund pensions business (where no tax applies)	7.85	7.5
Life business	6.9	6.6
Pre-tax expected long-term nominal rate of return for annuity business:[note ii]		
Fixed annuities	5.4 to 5.6	5.0 to 5.1
Linked annuities	5.0 to 5.2	4.8 to 5.0

Notes

i The assumed long-term rate for corporate bonds for 2007 for with-profits business reflects the purchase of credit default swaps.

ii The pre-tax rate of return for annuity business is based on the gross redemption yield on the backing assets net of a best estimate allowance for future defaults.

D2: UK insurance operations continued

The sensitivity of the value of in-force business and net worth to changes in key assumptions is as follows:

	2007 £m	2006 £m
Economic assumptions:		
Discount rates – 1% increase	(534)	(480)
Interest rates (including consequential changes for assumed investment returns for all asset classes, market values of debt securities, and all risk discount rates):*		
– 1% increase	(95)	(66)
– 1% decrease	113	69
Equity/property yields – 1% rise	405	382
Equity/property market values – 10% fall	(519)	(502)
Non-economic assumptions:		
Maintenance expenses – 10% decrease	36	33
Lapse rates – 10% decrease	87	75
Mortality and morbidity – 5% decrease in base rates (i.e. increased longevity)	(103)	(87)

* 2006 comparatives for the sensitivity to interest rate changes have been adjusted from previously published data for the effect of revisions to the calculation of the with-profits fund.

i 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 2007 and 2006 are demonstrated in note D5.

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.

D2: UK insurance operations continued

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

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(c) and (e), 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(e)(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.

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 2007 and 2006 is as follows:

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

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

The market risk sensitivities shown above reflect the impact of temporary market movements and, therefore, the primary effect of such movements would, in the Company's supplementary analysis of profits be included within the short-term fluctuations in investment returns.

j 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(e) 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.

D2: UK insurance operations continued

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 2007 and 2006 for that purpose for insurance contracts, as defined by IFRS, i.e. those containing significant insurance risk, and investment contracts, which do not.

	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	8,917	12,059	20,976
	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

	2006 £m								
	With-profits business			Annuity business (Insurance contracts)			Other		
	Insurance contracts	Investment contracts	Total	PAL	PRIL	Total	Insurance contracts	Investment contracts	Total
Policyholder liabilities	46,223	28,677	74,900	13,379	12,327	25,706	8,394	11,441	19,835
	2006 %								
Expected maturity:									
0 to 5 years	47	23	36	32	30	31	32	37	34
5 to 10 years	28	22	26	24	23	24	24	23	23
10 to 15 years	13	17	15	18	17	18	18	14	16
15 to 20 years	6	15	10	12	12	12	12	13	13
20 to 25 years	3	13	7	7	8	7	7	5	7
Over 25 years	3	10	6	7	10	8	7	8	7

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

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

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

In addition, for Jackson, 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 £244 million. This reduction reflects the effects of widened credit spreads in the US bond market partially offset by the effect of reduced US interest rates and a steepening yield curve. These movements do not reflect defaults or permanent impairments.

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

However, for debt securities classified as 'available-for-sale', unless impaired, fair value movements are recorded as a movement in shareholder reserves direct to equity. Impairments are recorded in the income statement as shown in note B1.

In general, the debt securities of the Group's US insurance operations are purchased with the intention and the ability to hold them for the longer term. In 2007, there was a movement in the balance sheet value for these debt securities classified as available-for-sale from a net unrealised gain of £110 million to a net unrealised loss of £136 million. During 2007, US interest rates fell and the yield curve steepened. Offsetting this movement were market price effects resulting from increasing credit spreads and global credit concerns. As a result of these factors, the gross unrealised gain in the balance sheet decreased from £366 million at 31 December 2006 to £303 million at 31 December 2007 while the gross unrealised loss increased from £256 million at 31 December 2006 to £439 million at 31 December 2007. Details of the securities in an unrealised position are shown in D3(b) below.

D3: US insurance operations continued

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

	2007 £m	Change in unrealised appreciation £m	2006 £m
Assets fair valued at below book value			
Book value	10,730		11,258
Unrealised loss	(439)	(183)	(256)
Fair value (as included in balance sheet)	10,291		11,002
Assets fair valued at or above book value			
Book value	8,041		8,208
Unrealised gain	303	(63)	366
Fair value (as included in balance sheet)	8,344		8,574
Total			
Book value	18,771		19,466
Net unrealised (loss) gain	(136)	(246)	110
Fair value (as included in balance sheet)*	18,635		19,576

	£m
Reflected as part of movement in shareholders' equity	
Movement in unrealised appreciation	(244)
Exchange movements	(2)
	(246)

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

Included within the movement in unrealised losses for the debt securities of Jackson of £244 million as shown above was a value reduction of £55 million relating to the sub-prime and Alt-A securities as referred to in section G2.

D3: US insurance operations continued
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 2007 Total £m	2006 Total £m
Assets				
Intangible assets attributable to shareholders:				
Deferred acquisition costs and other intangible assets	–	1,928	**1,928**	1,712
Total	–	1,928	**1,928**	1,712
Other non-investment and non-cash assets	–	1,651	**1,651**	1,588
Investments of long-term business and other operations:				
Investment properties	–	8	**8**	20
Financial investments:				
Loans[note ii]	–	3,258	**3,258**	3,254
Equity securities and portfolio holdings in unit trusts	15,027	480	**15,507**	11,710
Debt securities[D3b]	–	19,002	**19,002**	20,146
Other investments[note iii]	–	762	**762**	542
Deposits	–	258	**258**	457
Total investments	15,027	23,768	**38,795**	36,129
Cash and cash equivalents	–	169	**169**	99
Total assets	**15,027**	**27,516**	**42,543**	**39,528**
Equity and liabilities				
Equity				
Shareholders' equity	–	2,690	**2,690**	2,656
Minority interests	–	1	**1**	1
Total equity	–	2,691	**2,691**	2,657
Liabilities				
Policyholder liabilities:[note iv]				
Insurance contract liabilities	15,027	17,899	**32,926**	30,184
Investment contract liabilities without discretionary participation features (GIC and annuity certain)	–	1,922	**1,922**	1,562
Total	15,027	19,821	**34,848**	31,746
Core structural borrowings of shareholder-financed operations	–	125	**125**	127
Operational borrowings attributable to shareholder-financed operations	–	591	**591**	743
Other non-insurance liabilities	–	4,288	**4,288**	4,255
Total liabilities	15,027	24,825	**39,852**	36,871
Total equity and liabilities	**15,027**	**27,516**	**42,543**	**39,528**

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 £3,258 million comprise mortgage loans of £2,841 million and policy loans of £417 million. All of the mortgage loans are commercial mortgage loans which are 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.

D3: US insurance operations continued

Notes continued

iii Other investments comprise:

	2007 £m
Derivative assets (note G3)	390
Partnerships in investment pools and other	372
	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 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 2007
The policyholder liabilities, net of reinsurers' share of £436 million (2006: £427 million), reflect balances in respect of the following:

	2007 £m	2006 £m
Policy reserves and liabilities on non-linked business:		
Reserves for future policyholder benefits and claims payable	916	935
Deposits on investment contracts (as defined under US GAAP)	16,784	17,690
Guaranteed investment contracts	1,685	1,327
Unit-linked (variable annuity) business	15,027	11,367
	34,412	31,319

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 £2,607 million (2006: £2,552 million) and are included in 'other non-insurance liabilities' in the balance sheet above.

b Information on credit risks of debt securities

Summary	2007 £m Carrying value	2006 £m Carrying value
Corporate security and commercial loans:		
Publicly traded and SEC Rule 144A traded	10,345	11,569
Non-SEC Rule 144A traded	2,613	2,458
	12,958	14,027
Residential mortgage-backed securities	2,939	2,827
Commercial mortgage-backed securities	1,532	1,155
Other debt securities	1,573	2,137
Total debt securities	19,002	20,146

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.

The following table shows the quality of publicly traded and SEC Rule 144A traded debt securities held by the US operations as at 31 December 2007 and 2006 by NAIC classifications:

D3: US insurance operations continued

	2007		2006	
	Carrying value		Carrying value	
	£m	% of total	£m	% of total
NAIC designation:				
1	4,338	42	4,631	40
2	5,194	50	5,850	51
3	542	5	817	7
4	231	2	249	2
5	40	1	22	0
	10,345	100	11,569	100

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

	2007		2006	
	Carrying value		Carrying value	
	£m	% of total	£m	% of total
NAIC designation:				
1	1,011	39	861	35
2	1,351	52	1,345	54
3	206	8	212	9
4	45	1	40	2
5	–	–	–	–
	2,613	100	2,458	100

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

	2007 Carrying value £m (unless otherwise stated)	2006 Carrying value £m (unless otherwise stated)
Residential mortgage-backed securities (included within debt securities)		
Total residential mortgage-backed securities	2,939	2,827
Residential mortgage-backed securities rated AAA or equivalent by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch):		
Amount	2,542	1,750
Percentage of total	86.5%	61.9%
Residential mortgage-backed securities rated NAIC 1:		
Amount	2,932	2,824
Percentage of total	99.8%	99.9%
Commercial mortgage-backed securities (included within debt securities)		
Total commercial mortgage-backed securities	1,532	1,155
Commercial mortgage-backed securities rated AAA or equivalent by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch):		
Amount	1,351	1,090
Percentage of total	88.2%	94.4%
Commercial mortgage-backed securities rated NAIC 1:		
Amount	1,462	1,076
Percentage of total	95.4%	93.2%

Included within other debt securities of £1,573 million in the summary shown above are £944 million (2006: £1,133 million) of asset backed securities held directly by Jackson, of which £817 million (2006: £791 million) were NAIC designation 1 and £127 million (2006: £342 million) NAIC designation 2. In addition, other debt securities includes £316 million (2006: £405 million) in respect of securities held by the Piedmont trust entity (see note G1) and £313 million (2006: £485 million) from the consolidation of investment funds managed by PPM America.

D3: US insurance operations continued

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 2007 using Standard and Poor's (S&P), Moody's and Fitch ratings:

	2007 £m Carrying value
S&P – AAA	3,896
S&P – AA+ to AA-	1,187
S&P – A+ to A-	3,657
S&P – BBB+ to BBB-	5,415
S&P – Other	1,113
	15,268
Moody's – Aaa	549
Moody's –Aa1 to Aa3	118
Moody's –A1 to A3	47
Moody's – Baa1 to Baa3	79
Moody's – Other	78
	871
Fitch	380
Other	2,483
Total debt securities	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:

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

Included in debt securities are £2,863 million (2006: £2,859 million) of securities which are not quoted on active markets and are valued using valuation techniques.

Debt securities above are shown net of cumulative impairment losses on retained securities of £246 million (2006: £266 million).

Included within the debt securities of Jackson at 31 December 2007 are exposures to sub-prime and Alt-A mortgages and CDO funds as follows:

	2007 £m Carrying value
Sub-prime mortgages (S&P rated AAA)	237
Alt-A mortgages (77% AAA, 17% AA)	660
	897
CDO funds*	260
	1,157

* Including Group's economic interest in Piedmont (as described in note G1) and other consolidated CDO portfolios.

D3: US insurance operations continued

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.

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

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

The following table shows some key attributes of the debt securities that are in an unrealised loss position at 31 December 2007 and 2006.

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

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

Fair value of securities as a percentage of book value	Fair value £m	Unrealised loss £m
Between 90% and 100%	572	(24)
Between 80% and 90%	132	(22)
Below 80%	28	(10)
	732	(56)

	2007 £m				2006 £m			
Aged analysis of unrealised losses for the periods indicated	Not rated	Non-investment grade	Investment grade	Total	Not rated	Non-investment grade	Investment grade	Total
Less than 6 months	(7)	(8)	(52)	(67)	(1)	(1)	(14)	(16)
6 months to 1 year	(10)	(21)	(105)	(136)	(3)	(1)	(10)	(14)
1 year to 2 years	(5)	(2)	(16)	(23)	(24)	(10)	(135)	(169)
2 years to 3 years	(24)	(10)	(140)	(174)	(5)	–	(9)	(14)
3 years to 4 years	(3)	(1)	(5)	(9)	(5)	–	(35)	(40)
4 years to 5 years	(3)	–	(24)	(27)	–	–	–	–
5 years to 6 years	–	–	–	–	(2)	(1)	–	(3)
6 years to 7 years	(1)	(2)	–	(3)	–	–	–	–
	(53)	(44)	(342)	(439)	(40)	(13)	(203)	(256)

At 31 December 2007, the gross unrealised losses in the balance sheet for the sub-prime and Alt-A securities in an unrealised loss position were £56 million. Sub-prime and Alt-A securities with unrealised losses of £37 million in the balance sheet at 31 December 2007 have been in an unrealised loss position for less than one year with the remaining securities with unrealised losses of £19 million being in an unrealised loss position for more than one year.

D3: US insurance operations continued

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

c 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 2007, interest-sensitive fixed annuities accounted for 25 per cent (2006: 31 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 (2006: 1.5 per cent to 5.5 per cent) depending on the jurisdiction of issue and the date of issue, with 80 per cent (2006: 80 per cent) of the fund at three per cent or less. The average guarantee rate is 3.1 per cent (2006: 3.1 per cent).

Approximately 30 per cent (2006: 35 per cent) of the interest-sensitive fixed annuities Jackson wrote in 2007 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 seven per cent (2006: seven per cent) of Jackson's policy and contract liabilities at 31 December 2007. 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 2007, immediate annuities accounted for two per cent (2006: 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 2007, VAs accounted for 45 per cent (2006: 38 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 2007, approximately nine per cent (2006: 13 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(d).

iii Life insurance

Jackson's life insurance products accounted for nine per cent (2006: 10 per cent) of Jackson's policy and contract liabilities at 31 December 2007. 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 2007, institutional products accounted for 12 per cent of policy and contract liabilities (2006: 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 less than one per cent (2006: 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.

d Risk management

Jackson's main exposures are to market risk through its exposure to interest rate risk and equity risk. Approximately 90 per cent (2006: 89 per cent) of its general account investments support interest-sensitive and fixed indexed annuities, life business and surplus and 10 per cent (2006: 11 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.

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.

D3: US insurance operations continued

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 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. The types of derivatives used by Jackson and their purpose are as follows:

— Interest rate swaps generally involve the exchange of fixed and floating payments over the life of the agreement without an exchange of the underlying principal amount. These agreements are used for hedging purposes;
— forwards consist of interest spreadlock agreements, in which Jackson locks in the forward interest rate differential between a swap and the corresponding US Treasury security. The forwards are held as a hedge of corporate spreads;
— 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(i) parts (iii) and (iv) show the sensitivities of Jackson's results through its exposure to equity risk and interest rate risk.

e Process for setting assumptions and determining contract liabilities

Under the MSB of reporting applied under IFRS 4 for insurance contracts, providing the requirements of the Companies Act, UK GAAP standards and the ABI SORP are met, it is permissible to reflect the previously applied UK GAAP basis. Accordingly, and consistent with the basis explained in note 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).

D3: US insurance operations continued

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 2007, the GMDB liability was valued using a series of deterministic investment performance scenarios, a mean investment return of 8.4 per cent (2006: 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 2007 and 2006 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.

The fair values of the GMWB, GMIB and GMAB reinsurance derivatives are calculated based on actuarial assumptions related to the projected cash flows, including benefits and related contract charges, over the expected lives of the contracts, incorporating expectations regarding policyholder behaviour in varying economic conditions. As the nature of these cash flows can be quite varied, stochastic techniques are used to generate a variety of market return scenarios for evaluation. The generation of these scenarios and the assumptions as to policyholder behaviour involve numerous estimates and subjective judgements, including those regarding expected market volatility, correlations of market returns and discount rates, utilisation of the benefit by policyholders under varying conditions, and policyholder lapsation. At each valuation date, Jackson assumes expected returns based on risk-free rates as represented by the LIBOR forward curve rates as of that date and market volatility as determined with reference to implied volatility data and evaluations of historical volatilities for various indices. The risk-free spot rates as represented by the LIBOR spot curve as of the valuation date are used to determine the present value of expected future cash flows produced in the stochastic process.

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.

D3: US insurance operations continued

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.

f 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 2007, the premiums for such ceded business amounted to £60 million (2006: £66 million). Net commissions received on ceded business and claims incurred ceded to external reinsurers totalled £10 million and £47 million, respectively, during 2007 (2006: £12 million and £53 million respectively). There were no deferred gains or losses on reinsurance contracts in either 2007 or 2006. The reinsurance asset for business ceded outside the Group was £436 million (2006: £427 million).

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

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.

2006

The operating profit based on longer-term investment returns of £398 million for US insurance operations for 2006 was determined after taking account of several changes of assumptions during the year. Generally, assumptions were modified in 2006 to conform to more recent experience. These changes included revisions to the assumptions regarding utilisation of free partial withdrawal options, resulting in a decrease in Deferred Acquisition Costs (DAC) of £12 million. In addition, several smaller changes relating to lapse rates, mortality rates and other assumptions resulted in an increase of £6 million in DAC. Combined with other minor modifications, the resulting net impact of all changes during the year was a decrease in pre-tax profits of £7 million.

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

At 31 December 2007, the EEV basis value of in-force business of the US operations, after taking account of the cost of encumbered capital, and the cost of the time value of financial options and guarantees, was £1,386 million (2006: £1,320 million). This value has been determined after applying the principles of valuation described in note D1. The key assumptions in these projections are the risk discount rates, which are 8.1 per cent (2006: 8.4 per cent) for variable annuity business and 4.8 per cent (2006: 5.6 per cent) for other business, and the expected ultimate spread between the earned rate and the rate credited to policyholders for single premium deferred annuity business of 1.75 per cent.

The sensitivity of the value of in-force business and net worth to changes in key assumptions is as follows:

	2007 £m	2006 £m
Economic assumptions:		
Discount rates – 1% increase	(129)	(127)
Interest rates (including consequential changes for assumed investment returns for all asset classes, market values of debt securities and all risk discount rates):		
– 1% increase	(120)	(190)
– 1% decrease	17	116
Equity/property yields – 10% rise	58	46
Equity/property market values – 10% fall	(63)	(58)
Non-economic assumptions:		
Maintenance expenses – 10% decrease	30	32
Lapse rates – 10% decrease	123	110
Mortality and morbidity – 5% decrease in base rates (i.e. increased longevity)	74	75

D3: US insurance operations continued

i 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 2007, the rates were US$2.00 (2006: US$1.84) and US$1.99 (2006: US$1.96) to £1 sterling, respectively. A 10 per cent increase or decrease in these rates would reduce or increase profit before tax attributable to shareholders, profit for the year and shareholders' equity attributable to US insurance operations respectively as follows:

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

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
— spread returns for the difference between investment returns and rates credited to policyholders.

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

— Amortisation of deferred acquisition costs.

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

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

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

D3: US insurance operations continued

iii Exposure to equity risk

As noted in note D3(d), 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(e) for further details on the valuation of the guarantees) and fees are recognised prospectively. It is estimated that an immediate increase in the equity markets of 10 per cent would result in an accounting charge, net of related DAC amortisation, before tax of up to £30 million (2006: £20 million), excluding the impact on future separate account fees. After related deferred tax there would have been an estimated reduction in shareholders' equity at 31 December 2007 of up to £20 million (2006: £13 million). An immediate decrease in the equity markets of 10 per cent would result in an approximately equal and opposite estimated effect on profit and shareholders' equity. The actual impact on financial results would vary contingent upon the volume of new product sales and lapses, changes to the derivative portfolio, correlation of market returns and various other factors including volatility, interest rates and elapsed time.

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

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

iv Exposure to interest rate risk

Notwithstanding the market risk exposure described in note D3(d), except in the circumstances of interest rate scenarios where the guarantee rates included in contract terms are higher than crediting rates that can be supported from assets held to cover liabilities, the accounting measurement of liabilities of Jackson products is not generally sensitive to interest rate risk. This position derives from the nature of the products and the US GAAP basis of measurement described in notes D3(c) and D3(e).

D3: US insurance operations continued

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

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

j 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 2007 and 2006 is as follows:

	2007 £m		2006 £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	19,821	15,027	20,379	11,367
	%	%	%	%
Expected maturity:				
0 to 5 years	51	48	53	48
5 to 10 years	26	30	26	30
10 to 15 years	11	13	11	13
15 to 20 years	5	6	5	6
20 to 25 years	3	2	3	2
Over 25 years	4	1	2	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.

D4: Asian insurance operations

a Summary balance sheet at 31 December 2007

	With-profits business note i £m	Unit-linked assets and liabilities £m	Other £m	Asian insurance operations 2007 Total £m	Asian insurance operations 2006 Total £m
Assets					
Intangible assets attributable to shareholders:					
Goodwill	–	–	111	111	111
Deferred acquisition costs and other intangible assets	–	–	745	745	612
Total	–	–	856	856	723
Other non-investment and non-cash assets	134	58	570	762	602
Investments of long-term business and other operations:					
Investment properties	–	–	14	14	41
Financial investments:					
Loans note ii	560	37	490	1,087	904
Equity securities and portfolio holdings in unit trusts	4,472	4,728	604	9,804	6,894
Debt securities note iii	2,329	1,901	2,690	6,920	5,391
Other investments	13	6	23	42	87
Deposits	44	118	215	377	408
Total investments	7,418	6,790	4,036	18,244	13,725
Cash and cash equivalents	194	123	362	679	618
Total assets	**7,746**	**6,971**	**5,824**	20,541	15,668
Equity and liabilities					
Equity					
Shareholders' equity	–	–	1,369	1,369	1,287
Minority interests	–	–	7	7	–
Total equity	–	–	1,376	1,376	1,287
Liabilities					
Policyholder liabilities and unallocated surplus of with-profits funds:					
Insurance contract liabilities	6,280	6,971	3,661	16,912	12,706
Investment contract liabilities with discretionary participation features	84	–	–	84	68
Investment contract liabilities without discretionary participation features	37	–	–	37	27
Unallocated surplus of with-profits funds	146	–	–	146	88
Total	6,547	6,971	3,661	17,179	12,889
Other non-insurance liabilities	1,199	–	787	1,986	1,492
Total liabilities	7,746	6,971	4,448	19,165	14,381
Total equity and liabilities	**7,746**	**6,971**	**5,824**	20,541	15,668

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 £1,087 million comprise mortgage loans of £132 million, policy loans of £430 million and other loans of £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.

D4: Asian insurance operations continued

Notes continued

iii Credit quality of debt securities

The following table summarises the credit quality of the debt securities of the Asian insurance operations as at 31 December 2007 by rating agency rating:

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

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

Summary policyholder liabilities (net of reinsurance) and unallocated surplus

The policyholder liabilities (net of reinsurance of £12 million (2006: £8 million)) and unallocated surplus shown in the table above reflect the following balances:

	2007 £m	2006 £m
With-profits business	**6,397**	5,410
Unallocated surplus of Asian with-profit operations	**146**	88
Unit-linked business	**6,971**	4,134
Other business	**3,653**	3,249
	17,167	12,881

At 31 December 2007, the policyholder liabilities (net of reinsurance) and unallocated surplus for Asian operations of £17.2 billion (2006: £12.9 billion) comprised the following:

	2007 £m	2006 £m
Singapore	**5,462**	4,355
Hong Kong	**3,901**	3,045
Taiwan	**2,781**	2,249
Malaysia	**1,201**	895
Japan	**695**	572
Other countries	**3,127**	1,765
Total Asian operations	**17,167**	12,881

D4: Asian insurance operations continued

b 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(c) 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 (h) 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 2007 of £261 million and £728 million respectively (2006: £226 million and £316 million respectively). The business is much less sensitive to returns than Taiwan with 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.

D4: Asian insurance operations continued

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.

c 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 (h) 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.

d 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 2.5 per cent (2006: 2 per cent) trend towards 5.5 per cent (2006: 5.5 per cent) at 31 December 2013 (2006: 2013).

e Reinsurance

The Asian businesses cede only minor amounts of business outside the Group with immaterial effects on reported profit. During 2007, reinsurance premiums for externally ceded business were £52 million (2006: £47 million) and the reinsurance assets were £12 million (2006: £8 million) in aggregate.

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

There are no changes of assumptions that had a material impact on the 2007 and 2006 results of Asian operations.

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

At 31 December 2007, the EEV basis value of in-force business of the Asian operations, after taking account of the cost of encumbered capital and the cost of the time value of financial options and guarantees was £2,770 million (2006: £1,628 million). The most significant businesses in Asia are in Hong Kong, Malaysia, Singapore and Taiwan. These businesses account for 74 per cent (2006: 75 per cent) of the total value of business in-force for the Asian operations. These EEV basis in-force values have been determined after applying the principles of valuation described in section D1 and the following key assumptions for the four most significant businesses.

D4: Asian insurance operations continued

	2007 %			2006 %		
	Risk discount rate (in-force business)†	Expected long-term rate of inflation	Government bond yield	Risk discount rate (in-force business)†	Expected long-term rate of inflation	Government bond yield
Hong Kong*	6.0	2.25	4.1	6.8	2.25	4.7
Malaysia	9.1	2.75	6.5	9.2	3.00	7.0
Singapore	6.8	1.75	4.25	6.9	1.75	4.5
Taiwan	9.8	2.25	5.5	9.3	2.25	5.5

* Hong Kong business is predominantly US dollar denominated.
† For 2007, cash rates rather than government bond yields were used in setting the risk discount rates for Malaysia, Singapore, Taiwan and for Hong Kong dollar denominated business. For 2006, cash rates were used for these operations and for all Hong Kong business (i.e. including US dollar denominated business).

The most significant equity holdings in Asian operations are in Hong Kong, Malaysia and Singapore. The arithmetic average equity return assumptions for these three territories at 31 December 2007 were 8.1 per cent, 12.5 per cent and 9.3 per cent respectively (2006: 8.7 per cent, 12.8 per cent and 9.3 per cent respectively).

For Taiwan the same assumptions are applied as under IFRS (see note (d) above).

The sensitivity of the value of in-force business and net worth to changes in key assumptions is as follows:

	2007 £m	2006 £m
Economic assumptions:		
Discount rates – 1% increase	(386)	(271)
Interest rates (including consequential changes for assumed investment returns for all assets classes, market values of debt securities and all risk discount rates):		
– 1% increase	(29)	42
– 1% decrease	2	(115)
Equity/property yields – 10% rise	234	154
Equity/property market values – 10% fall	(136)	(99)
Non-economic assumptions:		
Maintenance expenses – 10% decrease	54	45
Lapse rates – 10% decrease	142	93
Mortality and morbidity – 5% decrease in base rates (i.e. increased longevity)	98	77

In addition to these disclosures, for Asian operations as a whole it should be noted that the cash flows of the Taiwan life business are particularly sensitive to projected rates of investment return (as described in note (h)(iii) below).

h 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 2007, 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	
	2007 £m	2006 £m	2007 £m	2006 £m
Profit before tax attributable to shareholders	(16)	(33)	20	34
Profit for the year	(10)	(21)	13	25
Shareholders' equity, excluding goodwill, attributable to Asian operations	(124)	(116)	151	143

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 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 2.5 per cent. The current low level of bond rates in Taiwan gives rise to a negative spread for the majority of these policies. The current cash cost of funding in-force negative spread in Taiwan is around £45 million a year.

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

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

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

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

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

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

D4: Asian insurance operations continued

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. If the interest rates at 31 December 2006 of circa 2 per cent had been lower by 0.5 per cent and the date for the attainment of the long-term rate deferred by one year to 2014 the effect on the net premium reserve would have been a charge of approximately £60 million.

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

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

Interest rate risk for other business excluding Taiwan

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

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

Excluding with-profit and unit-linked business along with Taiwan, which is detailed above, 72 per cent (2006: 78 per cent) of the bond portfolio for other business of Asian operations at 31 December 2007 was held in Japan, Singapore and Vietnam with corporate bond rates varying from territory to territory and ranging from 1.5 per cent to 9.1 per cent at 31 December 2007 (1.7 per cent to 8.8 per cent at 31 December 2006) for these three countries. An analysis of movements in bond rates during previous periods and its impact on IFRS basis profit or loss and shareholders' equity has been undertaken, with reasonably possible movements for these countries being considered to be 0.25 per cent for Japan, 0.5 per cent for Singapore and 1.0 per cent for Vietnam.

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

D4: Asian insurance operations continued

Equity price risk

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

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

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

i 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:

	2007 £m	2006 £m
Policyholder liabilities	17,033	12,801
	%	%
Expected maturity:		
0 to 5 years	22	22
5 to 10 years	22	20
10 to 15 years	16	16
15 to 20 years	13	13
20 to 25 years	9	10
Over 25 years	18	19

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 2007 and 2006.

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	M&G	Parent company and shareholders' equity of other subsidiaries and funds	Group total
Group shareholders' equity										
Held outside long-term funds:										
Net assets	–	–	–	550	2,690	1,258	4,498	271	(723)	4,046
Goodwill	–	–	–	–	–	111	111	1,153	77	1,341
Total	–	–	–	550	2,690	1,369	4,609	1,424	(646)	5,387
Held in long-term funds[note iii]	–	–	–	814	–	–	814	–	–	814
Total Group shareholders' equity	–	–	–	1,364	2,690	1,369	5,423	1,424	(646)	6,201
Adjustments to regulatory basis										
Unallocated surplus of with-profits funds[note v]	–	14,205	14,205	–	–	146	14,351			
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 surplus attributable to WPSF to pension liability for regulatory purposes[note vii]	–	(530)	(530)	–	–	–	(530)			
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	(96)	1,388			
Total adjustments	0	8,720	8,720	(382)	(439)	(740)	7,159			
Total available capital resources of life assurance businesses on local regulatory bases	0	8,720	8,720	982	2,251	629	12,582			

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	8,198	15,027	6,971	32,225
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	34,378	34,848	13,642	96,660
Total policyholder liabilities shown in the consolidated balance sheet	13,620	76,339	89,959	34,378	34,848	17,033	176,218

D

Financial statements

D5: Capital position statement for life assurance businesses continued

31 December 2006	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	M&G	Egg	Parent company and shareholders' equity of other subsidiaries and funds	Group total
	2006 £m										
Group shareholders' equity											
Held outside long-term funds:											
Net assets	–	–	–	612	2,656	1,176	4,444	230	292	(1,519)	3,447
Goodwill	–	–	–	–	–	111	111	1,153	–	77	1,341
Total	–	–	–	612	2,656	1,287	4,555	1,383	292	(1,442)	4,788
Held in long-term funds[note iii]	–	–	–	700	–	–	700	–	–	–	700
Total Group shareholders' equity	–	–	–	1,312	2,656	1,287	5,255	1,383	292	(1,442)	5,488
Adjustments to regulatory basis											
Unallocated surplus of with-profits funds[note v]	–	13,511	13,511	–	–	88	13,599				
Shareholders' share of realistic liabilities	–	(4,000)	(4,000)	–	–	–	(4,000)				
Deferred acquisition costs of non-participating business and goodwill not recognised for regulatory reporting purposes	(5)	(26)	(31)	(146)	(1,712)	(673)	(2,562)				
Jackson surplus notes[note iv]	–	–	–	–	127	–	127				
Part of IAS 19 basis pension deficit attributable to WPSF not recognised for regulatory purposes[note vii]	–	(244)	(244)	–	–	–	(244)				
Valuation difference on PAL between IFRS basis and regulatory basis	–	(1,076)	(1,076)	–	–	–	(1,076)				
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis)[note v]	5	523	528	(263)	1,012	(136)	1,141				
Total adjustments	0	8,688	8,688	(409)	(573)	(721)	6,985				
Total available capital resources of life assurance businesses on local regulatory bases	0	8,688	8,688	903	2,083	566	12,240				

D5: Capital position statement for life assurance businesses continued

31 December 2006	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
	2006 £m						
Policyholder liabilities							
With-profits liabilities of UK regulated with-profits funds:							
Insurance contracts	13,162	31,925	45,087	–	–	2,659	47,746
Investment contracts (with discretionary participating features)	737	27,928	28,665	–	–	68	28,733
Total	13,899	59,853	73,752	–	–	2,727	76,479
Other liabilities:							
Insurance contracts:							
With-profits liabilities of non-UK regulated funds	–	–	–	–	–	2,658	2,658
Unit-linked, including variable annuity	–	2,039	2,039	7,766	11,367	4,134	25,306
Other life assurance business	231	12,245	12,476	12,955	18,817	3,255	47,503
Investment contracts without discretionary participation features (principally unit-linked and similar contracts in the UK and GIC liabilities of Jackson)note vi	–	12	12	11,441	1,562	27	13,042
Total	231	14,296	14,527	32,162	31,746	10,074	88,509
Total policyholder liabilities shown in the consolidated balance sheet	14,130	74,149	88,279	32,162	31,746	12,801	164,988

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 2006 the other adjustments for UK regulated with-profits funds included inadmissible assets of the WPSF of £ (256) million. For Jackson the principal reconciling item is deferred tax related to deferred acquisition costs of £675 million (2006: £599 million).

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 surplus (deficit) in the Group's main pension scheme used for the calculation includes amounts for investments in Prudential insurance policies (see note I1).

D5: Capital position statement for life assurance businesses continued

b Basis of preparation, capital requirements and management

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

i UK insurance operations

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

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

PAC WPSF and SAIF

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

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

The two separate peaks are:

i the requirement comprised by the mathematical reserves plus the 'Long-Term Insurance Capital Requirement' (LTICR), together known as the 'regulatory peak'; and

ii a calculation of the 'realistic' present value of the insurer's expected future contractual liabilities together with projected 'fair' discretionary bonuses to policyholders, plus a risk capital margin, together known as the 'realistic peak'.

Available capital of the WPSF and SAIF of £8.7 billion (2006: £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 £2.0 billion at 31 December 2007 (2006: £1.9 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(e)(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.

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 £982 million (2006: £903 million) reflects the excess of regulatory basis assets over liabilities of the subsidiaries and funds, before deduction of the capital resources requirement of £841 million (2006: £809 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 £2,251 million (2006: £2,083 million) reflects US regulatory basis assets less liabilities excluding 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.

iii Asian operations

The available capital shown above of £629 million (2006: £566 million) represents the excess of local regulatory basis assets over liabilities before deduction of required capital of £265 million (2006: £211 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.

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.

D5: Capital position statement for life assurance businesses continued

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.

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 sums at risk 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 more than five years.

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. Previously, whilst the Group owned Egg, it was required to comply with the broadly equivalent requirements of the FCD. Discussion of the Group's estimated IGD position at 31 December 2007 is provided in the operating and financial review section of the Group's 2007 Annual Report and in section C.

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 2007 as follows:

	2007 £m				
	WPSF note i	Other UK life assurance subsidiaries and funds note iii	Jackson note ii	Asian life assurance subsidiaries	Group total
Available capital at 31 December 2006	**8,688**	**903**	**2,083**	**566**	**12,240**
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	47	701
Available capital at 31 December 2007	**8,720**	**982**	**2,251**	**629**	**12,582**

Detail on the movement for 2006 is as follows:

	2006 £m				
	WPSF note i	Other UK life assurance subsidiaries and funds note iii	Jackson note ii	Asian life assurance subsidiaries	Group total
Available capital at 31 December 2005	7,979	759	2,257	570	11,565
Changes in assumptions	61	(3)	–	(2)	56
Changes in management policy	–	–	–	–	–
Changes in regulatory requirements	–	80	–	–	80
New business and other factors	648	67	(174)	(2)	539
Available capital at 31 December 2006	8,688	903	2,083	566	12,240

Notes

i WPSF

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(g).

The £648 million increase in available capital in 2006 for new business and other factors incorporates the effects of the strong investment returns in 2006 and the improved outlook for future investment returns at that time.

ii Jackson

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.

The decrease of £174 million in 2006 reflected an underlying increase of £100 million (applying the 2006 year end exchange rate of 1.96) and £274 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.

The increase in available capital in 2006 from changes in regulatory requirements of £80 million was primarily due to regulatory changes for UK regulated shareholder-backed non-participating business from the FSA's policy statement PS06/14 confirmed in December 2006. The changes allowed liabilities for this business to incorporate more economic realism. Additional details are shown in note D2.

D5: Capital position statement for life assurance businesses continued

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 this conditions the approach to asset/liability management.

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

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

D5: Capital position statement for life assurance businesses continued

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.

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. M&G also manage the Group's balance sheet.

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				2006 £m
	M&G	US	Asia	**Total**	Total
Revenue	810	386	201	**1,397**	1,080
Charges	(547)	(377)	(129)	**(1,053)**	(797)
Profit before tax	263	9	72	**344**	283
Profit before tax for asset management operations comprise:					
Operating profit based on longer-term investment returns*	254	8	72	**334**	262
Short-term fluctuations in investment returns	4	1	–	**5**	–
Shareholders' share of actuarial gains and losses on defined benefit schemes	5	–	–	**5**	21
Profit before tax	263	9	72	**344**	283

*Operating profit based on longer-term investment returns includes £nil (2006: £2 million) of UK restructuring costs.

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				2006 £m
	M&G	US	Asia	Total	Total
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	304	132	85	521	415
Investment properties	–	–	–	–	1
Financial investments:					
Loans[note i]	2,334	–	–	2,334	2,181
Equity securities and portfolio holdings in unit trusts	11	–	6	17	13
Debt securities[note ii]	857	–	25	882	678
Other investments	132	19	4	155	80
Deposits	–	15	11	26	10
Total investments	3,334	34	46	3,414	2,963
Cash and cash equivalents[note iii]	1,751	33	56	1,840	951
Total assets	6,548	215	248	7,011	5,565
Equity and liabilities					
Equity					
Shareholders' equity	1,424	81	172	1,677	1,590
Minority interests	52	–	–	52	52
Total equity	1,476	81	172	1,729	1,642
Liabilities					
Intra Group debt represented by operational borrowings at Group level[note iv]	2,477	–	–	2,477	2,032
Net asset value attributable to external holders of consolidated funds[note iii]	1,234	–	–	1,234	513
Other liabilities	1,361	134	76	1,571	1,378
Total liabilities	5,072	134	76	5,282	3,923
Total equity and liabilities	6,548	215	248	7,011	5,565

Notes

i Loans
The M&G loans of £2,334 million comprise £1,383 million of bridging loan finance assets and £951 million in respect of a structured finance arrangement, both 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 £738 million BBB+ to BBB- and £645 million BB+ to BB-. Of the loans receivable under the structured finance arrangement, £826 million of the receivable was with counterparties rated AA by Standard and Poor's and £125 million AA-. In addition a AAA rated credit default swap was held covering £400 million of the AA rated element of the loans.

ii Debt securities
Of the debt securities of £857 million for M&G at 31 December 2007, £278 million were rated AAA by Standard and Poor's, £6 million AA+, £42 million AA, £271 million AA-, £162 million A+, £7 million A and £ 29 million A-. Of the £62 million which was not rated by Standard and Poor's £46 million was rated Aaa by Moody's.

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

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 £2,422 million of commercial paper and £55 million of medium-term notes.

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				2006 £m
	M&G	US	Asia	Total	Total
Capital surplus position					
Beginning of year	114	57	72	**243**	311
Exchange movement	–	(1)	–	**(1)**	(15)
Movement in capital requirement	(6)	–	(3)	**(9)**	(26)
Gains during the year	105	25	59	**189**	172
Distributions made	(114)	–	(36)	**(150)**	(199)
End of year	99	81	92	**272**	243

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.

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 2007, 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 £7 million (2006: £14 million) and £18 million (2006: £19 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 2007 by asset management operations were £882 million (2006: £678 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 including Group Head Office (GHO) and Asia regional head office, with net income and expenditure for the year of £248 million (2006: £248 million) for other operations detailed in note B1. An analysis of assets and liabilities relating to other operations is shown in note B6.

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 2007 and 2006 are as follows:

	2007 £m	2006 £m
Revenue		
Long-term business	31,555	34,197
Asset management	1,397	1,080
Unallocated corporate	182	38
Intra group revenue eliminated on consolidation	(268)	(284)
Total revenue, net of reinsurance per income statement	32,866	35,031
Charges (before income tax attributable to policyholders and unallocated surplus of long-term insurance funds)		
Long-term business, including post-tax transfers to unallocated surplus of with-profits funds	(30,533)	(32,162)
Asset management	(1,053)	(797)
Unallocated corporate	(363)	(135)
Intra group charges eliminated on consolidation	268	284
Total charges per income statement	(31,681)	(32,810)
Segment results – revenue less charges (continuing operations)		
Long-term business	1,022	2,035
Asset management	344	283
Unallocated corporate	(181)	(97)
Profit before tax*	1,185	2,221
Tax attributable to policyholders' returns	(19)	(849)
Profit before tax attributable to shareholders	1,166	1,372
Tax attributable to shareholders' profits	(382)	(392)
Profit from continuing operations after tax	784	980
Segment results – discontinued operations		
Banking	241	(105)
Profit for the year	1,025	875

* 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, unit-linked policies and shareholders' profits.

Within segment results above, the share of post-tax profit of associates that are equity accounted for of £nil (2006: £1 million) is allocated to the discontinued banking segment.

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 £11,295 million (2006: £12,130 million) of non-cash expenses other than depreciation and amortisation mainly relating to changes in technical reserves and pension actuarial and other gains and losses. The majority of this amount is borne by the long-term business segment.

F1: Segmental information continued

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.

	2007 £m	2006 £m
Revenue		
UK	17,886	21,212
US	8,271	8,562
Asia	6,977	5,541
Intra group revenue	(268)	(284)
Total revenue per income statement	32,866	35,031

F2: Revenue

	2007 £m	2006 £m
Long-term business premiums		
Insurance contract premiums	17,308	13,805
Investment contracts with discretionary participation feature premiums	874	1,249
Inwards reinsurance premiums	177	1,103
Less: reinsurance premiums ceded	(171)	(171)
Earned premiums, net of reinsurance	18,188	15,986
Realised and unrealised gains and losses on securities at fair value through profit and loss	2,630	5,964
Realised and unrealised gains and losses on derivatives at fair value through profit and loss	270	932
Realised gains and losses on available-for-sale securities, previously recognised directly in equity	13	(7)
Realised gains and losses on loans	47	(3)
Interest[notes i,ii]	5,857	5,827
Dividends	2,730	3,666
Other investment income	674	749
Investment income	12,221	17,128
Fee income from investment contract business and asset management[note iii]	1,039	886
Income from venture investments of the PAC with-profits funds	1,418	1,031
Other income	2,457	1,917
Total revenue	32,866	35,031

Notes

i Interest income is calculated on the effective interest rate method for all financial assets that are not at fair value through profit and loss.

ii Interest income includes £2 million (2006: £3 million) accrued in respect of impaired securities.

iii Fee income includes £31 million (2006: £34 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.

F3: Acquisition costs and other operating expenditure

	2007 £m	2006 £m
Acquisition costs[notes i,ii]	1,030	1,238
Staff and pension costs[I1]	1,070	647
Administrative and operating costs[note iii]	2,423	2,327
Total acquisition costs and other operating expenditure	4,523	4,212

Notes

i Acquisition costs in 2007 comprise amounts related to insurance contracts of £939 million (2006: £1,165 million), and investment contracts and asset management contracts of £91 million (2006: £73 million). These costs include amortisation of £410 million (2006: £299 million) and £3 million (2006: £6 million) respectively.

ii Acquisition costs also include fee expenses relating to financial liabilities held at amortised costs of £1 million (2006: £2 million). These expenses primarily related to fees incurred on Jackson's investment contract liabilities (GICs and annuity certain contracts).

iii Administrative and operating costs include total depreciation and amortisation expense amounting to £523 million (2006: £516 million). Of this amount, £413 million (2006: £305 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 £110 million (2006: £167 million), £98 million (2006: £156 million) relates to long-term business, £8 million (2006: £8 million) to asset management and £4 million (2006: £3 million) to other operations.

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

Finance costs consist of £158 million (2006: £166 million) interest on core debt of central companies and £10 million (2006: £11 million) on US operations' surplus notes.

F5: Tax

a Total tax expense by nature of expense

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

	2007 £m	2006 £m
Current tax expense:		
Corporation tax	806	688
Adjustments in respect of prior years	(185)	(34)
Total current tax	621	654
Deferred tax arising from:		
Origination and reversal of temporary differences	(170)	556
(Benefit) expense from a previously unrecognised tax loss, tax credit or temporary difference from a prior period	(50)	31
Total deferred tax (credit) expense	(220)	587
Total tax expense	401	1,241

The total tax expense arises as follows:

	2007 £m	2006 £m
Current tax expense:		
UK	377	381
Foreign	244	273
	621	654
Deferred tax (credit) expense:		
UK	(297)	317
Foreign	77	270
	(220)	587
Total	401	1,241

F5: Tax continued

The total deferred tax (credit) expense arises as follows:

	2007 £m	2006 £m
Unrealised gains and losses on investments	(225)	236
Short-term timing differences	62	156
Capital allowances	(4)	2
Balances relating to investment and insurance contracts	(41)	198
Unused tax losses	(12)	(5)
Deferred tax (credit) expense	(220)	587

In April 2008 the standard corporation tax rate for the UK will change from 30% to 28%. Deferred tax at the end of 2007 for UK operations has 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 has taken effect. The effect on the deferred tax assets and liabilities at 31 December 2007 was £20 million.

In 2007, a deferred tax credit of £54 million (2006: £41 million) has been taken directly to reserves. Other movements in deferred tax totalling £46 million credit mainly comprise of foreign exchange losses and as a result of the disposal of operations. When these amounts are taken with the deferred tax credit shown above, the result is a decrease of £320 million in the Group's net deferred tax liability (2006: increase of £546 million).

In 2007, there is a tax credit of £19 million relating to discontinued banking operations (2006: £45 million) (see note J1).

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 profit and tax charge

The income statement includes the following items:

	2007 £m	2006 £m
Profit before tax	1,185	2,221
Tax attributable to policyholders' returns	(19)	(849)
Profit before tax attributable to shareholders	1,166	1,372
Tax attributable to shareholders' profits:		
Tax expense	(401)	(1,241)
Less: tax attributable to policyholders' returns	19	849
Tax attributable to shareholders' profits	(382)	(392)
Profit from continuing operations after tax	784	980

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:

	2007 £m			2006 £m		
	Attributable to shareholders	Attributable to policyholders*	Total	Attributable to shareholders	Attributable to policyholders*	Total
Profit before tax	1,166	19	1,185	1,372	849	2,221
Taxation charge:						
Expected tax rate	31%	100%	32%	30%	100%	57%
Expected tax charge	(356)	(19)	(375)	(418)	(849)	(1,267)
Variance from expected tax charge (note v(ii))	(26)	–	(26)	26	–	26
Actual tax charge	(382)	(19)	(401)	(392)	(849)	(1,241)
Average effective tax rate	33%	100%	34%	29%	100%	56%

* 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.

F5: Tax continued

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 81l 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, then relief for expenses in the I-E calculation has to be restricted 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).

F5: Tax continued

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.

F5: Tax continued

v Reconciliation of tax charge on profits attributable to shareholders

	2007 £m				
	UK insurance operations	Jackson	Asian long-term business operations	Other operations	Total
Profit before tax attributable to shareholders:					
Operating profit based on longer-term investment returns[note iii]	521	444	174	74	1,213
Short-term fluctuations in investment returns	(47)	(18)	(71)	(1)	(137)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	90	90
Total	474	426	103	163	1,166
Expected tax rate:[note i]					
Operating profit based on longer-term investment returns[note iii]	30%	35%	21%	28%	30%
Short-term fluctuations in investment returns	30%	35%	25%	28%	28%
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	30%	35%	20%	28%	28%
Total	30%	35%	18%	28%	31%
Expected tax charge based on expected tax rates:					
Operating profit based on longer-term investment returns[note iii]	(156)	(155)	(37)	(21)	(369)
Short-term fluctuations in investment returns	14	6	18	0	38
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	(25)	(25)
Total	(142)	(149)	(19)	(46)	(356)
Variance from expected tax charge:[note ii]					
Operating profit based on longer-term investment returns[note iii]	(25)	22	(12)	1	(14)
Short-term fluctuations in investment returns	(2)	1	(17)	6	(12)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	–	–
Total	(27)	23	(29)	7	(26)
Actual tax charge:					
Operating profit based on longer-term investment returns[note iii]	(181)	(133)	(49)	(20)	(383)
Short-term fluctuations in investment returns	12	7	1	6	26
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	(25)	(25)
Total	(169)	(126)	(48)	(39)	(382)
Actual tax rate: operating profit	35%	30%	28%	27%	32%
: total	36%	30%	47%	24%	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 tax rates for 2007 for Asia are lower than in 2006 due to an increased proportion of profits in low tax jurisdictions.
The expected tax rate for other operations is lower than 2006. The tax rate of 28% 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 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:
a For UK insurance operations, disallowed expenses and prior year adjustments arising from routine revisions of tax returns;
b For Jackson, the benefit of a deduction from taxable income of a proportion of dividends received attributable to the variable annuity business;
c 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
d 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.

F5: Tax continued
v Reconciliation of tax charge on profits attributable to shareholders continued

	2006 £m				
	UK insurance operations	Jackson	Asian long-term business operations	Other operations	Total
Profit before tax attributable to shareholders:					
Operating profit based on longer-term investment returns[note iii]	469	398	175	8	1,050
Short-term fluctuations in investment returns	(43)	53	134	11	155
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	167	167
Total	426	451	309	186	1,372
Expected tax rate:[note i]					
Operating profit based on longer-term investment returns[note iii]	30%	35%	25%	30%	31%
Short-term fluctuations in investment returns	30%	35%	25%	30%	27%
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	30%	35%	25%	30%	30%
Total	30%	35%	25%	30%	31%
Expected tax charge based on expected tax rates:					
Operating profit based on longer-term investment returns[note iii]	(141)	(139)	(44)	(2)	(326)
Short-term fluctuations in investment returns	13	(19)	(33)	(3)	(42)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	(50)	(50)
Total	(128)	(158)	(77)	(55)	(418)
Variance from expected tax charge:[note ii]					
Operating profit based on longer-term investment returns[note iii]	23	5	(10)	4	22
Short-term fluctuations in investment returns	(4)	3	5	–	4
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	–	–
Total	19	8	(5)	4	26
Actual tax charge:					
Operating profit based on longer-term investment returns[note iii]	(118)	(134)	(54)	2	(304)
Short-term fluctuations in investment returns	9	(16)	(28)	(3)	(38)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	–	–	–	(50)	(50)
Total	(109)	(150)	(82)	(51)	(392)
Actual tax rate: operating profit	25%	34%	31%	25%	29%
: total	26%	33%	27%	27%	29%

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 rate weighted by reference to the source of profits of the operations contributing to the aggregate business result. In 2006, the expected tax rate on total profits of 31 per cent is in part due to the Asian long-term business (which is subject to lower tax rates than the UK and US) being a greater proportion of Group results.

ii Variances from expected tax charge for results attributable to shareholders
For 2006, the principal variances arise from differences between the standard corporation tax rate and actual rates due to a number of factors, including:
a The tax credit arising from relief for excess expenses in respect of the shareholder-backed protection business.
b Prior year adjustments arising from routine revisions of tax returns.

iii For 2006, operating profit based on longer-term investment returns is net of attributable restructuring costs and development expenses.

iv The results from continuing operations shown above exclude those in respect of discontinued banking operations. On 1 May 2007, the Company sold Egg Banking plc. Comparative results for 2006 have been adjusted accordingly from those previously published.

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 for investment contracts with discretionary participating features accounted for under IFRS 4 as described in note A4.

	2007 £m				
	Fair value through profit and loss	Available-for-sale	Loans and receivables	Total carrying value	Fair 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	–	–	1,297	1,297	1,297
	155,902	18,635	24,084	198,621	

	2007 £m				
	Fair value through profit and loss	Amortised cost	IFRS 4 basis value	Total carrying value	Fair 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
Other liabilities (including derivatives)	1,081	790	–	1,871	1,871
	16,951	14,169	29,550	60,670	

G1: Financial instruments – designation and fair values continued

	2006 £m				
	Fair value through profit and loss	Available-for-sale	Loans and receivables	Total carrying value	Fair value
Financial assets					
Cash and cash equivalents	–	–	5,071	5,071	5,071
Deposits	–	–	7,759	7,759	7,759
Equity securities and portfolio holdings in unit trusts	78,892	–	–	78,892	78,892
Debt securities[note i]	60,208	21,511	–	81,719	81,719
Loans[note ii]	–	–	13,754	13,754	14,274
Other investments[note iii]	3,220	–	–	3,220	3,220
Accrued investment income	–	–	1,900	1,900	1,900
Other debtors	–	–	1,052	1,052	1,052
	142,320	21,511	29,536	193,367	

Analysed by:

	2006 £m				
	Fair value through profit and loss	Available-for-sale	Loans and receivables	Total carrying value	Fair value
Continuing operations	142,201	19,576	22,434	184,211	184,731
Discontinued banking operations	119	1,935	7,102	9,156	9,156
	142,320	21,511	29,536	193,367	

	2006 £m				
	Fair value through profit and loss	Amortised cost	IFRS 4 basis value	Total carrying value	Fair value
Financial liabilities					
Banking customer accounts	–	5,554	–	5,554	5,554
Core structural borrowings of shareholder-financed operations[note i,H13]	–	3,063	–	3,063	3,297
Operational borrowings attributable to shareholder-financed operations[H13]	–	5,609	–	5,609	5,609
Borrowings attributable to with-profits funds[H13]	553	1,223	–	1,776	1,798
Obligations under funding, securities lending and sale and repurchase agreements	–	4,232	–	4,232	4,229
Net asset value attributable to unit holders of consolidated unit trust and similar funds	2,476	–	–	2,476	2,476
Investment contracts with discretionary participating features[note iv]	–	–	28,733	28,733	–
Investment contracts without discretionary participating features	11,480	1,562	–	13,042	13,035
Other creditors	–	1,398	–	1,398	1,398
Other liabilities (including derivatives)	663	989	–	1,652	1,652
	15,172	23,630	28,733	67,535	

G1: Financial instruments – designation and fair values continued

Analysed by:

	2006 £m				
	Fair value through profit and loss	Amortised cost	IFRS 4 basis value	Total carrying value	Fair value
Continuing operations	15,018	14,578	28,733	58,329	29,817
Discontinued banking operations	154	9,052	–	9,206	9,231
	15,172	23,630	28,733	67,535	

Notes

i As at 31 December 2007, £722 million (2006: £624 million) of convertible bonds were included in debt securities and £278 million (2006: £279 million) were included in borrowings.

ii Loans and receivables are reported net of allowance for loan losses of £13 million (2006:£14 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 2007 (2006: £nil).

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 Group establishes fair value by using valuation techniques. The valuation techniques include the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option adjusted spread models and if applicable enterprise valuation and may include a number of assumptions relating to variables such as credit risk and interest rates. Changes in assumptions relating to these variables could positively or negatively impact the reported fair value of these instruments.

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

The 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.

Refer to section A4 for 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.

G1: Financial instruments – designation and fair values continued

Use of valuation techniques

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

	2007 £m				
	UK with-profits fund	Shareholder-backed business			
		UK (PRIL)	US	Total	Total
Debt securities	3,002	509	2,863	3,372	6,374
Equity securities	629	–	–	–	629
Other investments	2,108	–	743	743	2,851
	5,739	509	3,606	4,115	9,854

	2006 £m				
	UK with-profits fund	Shareholder-backed business			
		UK (PRIL)	US	Total	Total
Debt securities	2,945	396	2,859	3,255	6,200
Equity securities	59	–	–	–	59
Other investments	1,499	–	453	453	1,952
	4,503	396	3,312	3,708	8,211

The majority of the financial investments valued using valuation techniques were debt securities. Of the debt securities valued using valuation techniques of £6,374 million (2006: £6,200 million) at 31 December 2007, debt securities with a fair value of £3,511 million (2006: £3,341 million) were held by UK operations. £3,002 million (2006: £2,945 million) of this amount related to securities held by with-profits operations and £509 million (2006: £396 million) related to securities held by the shareholder-backed UK annuity subsidiary Prudential Retirement Income Limited (PRIL). Debt securities valued using valuation techniques held by the US operations were £2,863 million (2006: £2,859 million).

These debt securities include private debt securities such as private placements, project finance, asset securitisations and local authority securities. The securities are mainly long-dated and not regularly traded and are valued internally using 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.

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.

In addition to private debt securities, debt securities of US operations valued using valuation techniques also included securities held by the Piedmont trust entity, an 80 per cent Jackson held static trust formed as a result of a securitisation of asset-backed securities in 2003 that are accounted for on an available-for-sale basis. As at 31 December 2007, the fair value of these Piedmont assets valued using valuation techniques was £316 million (2006: £405 million). Significant estimates and judgements are also employed in valuing certain asset-backed and mortgage-backed securities held by the Piedmont trust entity. These valuations may impact reported shareholder profit and loss amounts through the determination of impairment and recovery amounts.

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

Management has obtained broker bids on these Piedmont trust assets that represent the value at which the Group could sell the investments, if forced. These bids are not based on full knowledge and hence analysis of the investments, but represent the best estimate of the worst case decline in market value of these securities. The broker bids for these securities at 31 December 2007 totalled £260 million, a difference of £56 million (2006: £372 million, a difference of £33 million), from the fair value applied.

G1: Financial instruments – designation and fair values continued

The equity securities and other investments which included property and other partnerships in investment pools, venture investments and derivative assets 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. In addition to the investments shown above, there are some minor amounts valued using valuation techniques in the Group's Asian operations.

The total amount of the change in fair value estimation using valuation techniques, including valuation techniques based on assumptions not wholly supported by observable market prices or rates, recognised in the income statement in 2007 was a gain of £101 million (2006: gain of £47 million) for the with-profits fund investments. Changes in values of assets of the with-profits funds are reflected in policyholder liabilities and unallocated surplus. Due to the liability accounting treatment of unallocated surplus, changes in values of securities held by with-profits funds have no direct effect on the profit or loss attributable to shareholders or shareholders' equity.

The total amount of the change in fair value estimation using valuation techniques, including those based on assumptions not wholly supported by observable market prices or rates, recognised in the income statement in 2007 and which was attributable to shareholders, was a gain of £138 million (2006: gain of £68 million) for the PRIL and US investments.

Interest income and expense

The interest income on financial assets not at fair value through profit and loss for the year ended 31 December 2007 from continuing operations was £2,016 million (2006: £2,006 million).

The interest expense on financial liabilities not at fair value through profit and loss for the year ended 31 December 2007 from continuing operations was £842 million (2006: £890 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:

	2007 £m			
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total
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
Other liabilities (including derivatives)	422	243	1,206	1,871
	8,624	4,502	13,418	26,544

G2: Market risk continued

	2006 £m					
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	Total continuing operations	Discontinued banking operations	Total
Financial assets						
Cash and cash equivalents	–	–	5,065	5,065	6	5,071
Deposits	4,872	2,887	–	7,759	–	7,759
Debt securities	53,938	25,805	–	79,743	1,976	81,719
Loans	4,521	2,137	–	6,658	7,096	13,754
Other investments (including derivatives)	292	342	2,508	3,142	78	3,220
Total for continuing operations	63,623	31,171	7,573	102,367		
Discontinued banking operations	1,566	7,584	6	–	9,156	–
	65,189	38,755	7,579			111,523
Financial liabilities						
Banking customer accounts	–	–	–	–	5,554	5,554
Core structural borrowings of shareholder-financed operations	2,612	–	–	2,612	451	3,063
Operational borrowings attributable to shareholder-financed operations	2,282	501	7	2,790	2,819	5,609
Borrowings attributable to with-profits funds	1,486	219	71	1,776	–	1,776
Obligations under funding, securities lending and sale and repurchase agreements	851	3,381	–	4,232	–	4,232
Investment contracts without discretionary participation features	1,562	–	11,480	13,042	–	13,042
Other liabilities (including derivatives)	393	225	652	1,270	382	1,652
Total for continuing operations	9,186	4,326	12,210	25,722		
Discontinued banking operations	451	8,527	228	–	9,206	–
	9,637	12,853	12,438			34,928

Liquidity analysis

	2007 £m							
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	No stated maturity	Total carrying value
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, stocklending and sale and repurchase agreements	4,081	–	–	–	–	–	–	4,081
Other liabilities (including derivatives)	1,314	181	12	33	6	173	152	1,871
	8,116	712	632	399	321	1,114	1,218	12,512

	2006 £m							
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	No stated maturity	Total carrying value
Financial liabilities								
Core structural borrowings of shareholder-financed operations[H13]	150	248	–	335	313	803	763	2,612
Operational borrowings attributable to shareholder-financed operations[H13]	2,048	61	521	–	–	160	–	2,790
Borrowings attributable to with-profits funds[H13]	33	331	541	–	19	57	795	1,776
Obligations under funding, stocklending and sale and repurchase agreements	4,232	–	–	–	–	–	–	4,232
Other liabilities (including derivatives)	749	203	19	39	7	125	128	1,270
Total for continuing operations	7,212	843	1,081	374	339	1,145	1,686	12,680
Discontinued operations	6,869	1,886	250	201	–	–	–	9,206
	14,081	2,729	1,331	575	339	1,145	1,686	21,886

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.

	2007 £bn						
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	Total undis-counted value
Life assurance investment contracts	3	12	16	16	15	25	87

	2006 £bn						
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	Total undis-counted value
Life assurance investment contracts	3	10	14	13	14	27	81

The maturity profile above excludes certain corporate unit-linked business with gross policyholder liabilities of £8 billion which has no stated maturity.

G2: Market risk continued

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 £5 million (2006: £137 million) are past their due date but have not been impaired, with £5 million (2006: £20 million) relating to continuing operations and £nil (2006: £117 million) to discontinued banking operations. Of the total past due but not impaired, £5 million (2006: £122 million) are less than one year past their due date and £nil (2006: £15 million) between two years and three years 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 £nil (2006: £19 million).

The fair value of collateral held against loans that are past due and impaired at 31 December 2007 was £nil (2006: £1 million). The fair value of collateral held against loans that are past due but not impaired at 31 December 2007 was £nil (2006: £3 million). Collateral would predominately consist of policy loans that are secured by the cash values of the underlying policy.

Details with regards to loans and advances to customers by discontinued banking operations are provided in note J5.

In addition, during the year the Group took possession of £7 million (2006: £7 million) of other collateral held as security, which mainly consists of assets that could be readily convertible into cash.

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

Included in the total of debt securities of £83,984 million at 31 December 2007 are the following holdings:

i Sub-prime and Alt-A securities

Shareholder-backed business	2007 £m
US insurance operations – Sub-prime (AAA)	237
– Alt-A (77% AAA, 17% AA)	660
Asian operations	15
	912

With-profits operations	2007 £m
UK insurance operations – Sub-prime (AAA)	129
– Alt-A (96% AAA)	100
Asian operations	7
	236
Total	1,148

Further details on Jackson's sub-prime and Alt-A securities are given in section D3(b)

ii Direct holdings in monoline insurers

	2007 £m
Shareholder-backed operations:	
US insurance operations	23
Asian operations	4
	27
With-profits operations:	
Asian operations	6
Total	33

G2: Market risk continued

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

	2007 £m
Shareholder-backed operations:	
US insurance operations	
Residential mortgage-backed securities:	
Sub-prime	36
Alt-A	18
Asset-backed securities	79
Private corporate issues	22
	155
UK insurance operations (98% held by PRIL)	422
	577
With-profits operations:	
Asian insurance operations	9
UK insurance operations (73% held by PAL)	1,168
	1,177
Total	1,754

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

iv CDO funds (all without sub-prime exposure)

Shareholder-backed business	2007 £m
US insurance operations (65% AAA, 8% AA)*	260
Asian insurance operations (72% AAA, 28% AA-)	62
UK insurance operations – PRIL (AAA)	36
Other operations (AAA)	19
	377

With-profits operations	2007 £m
UK insurance operations (79% AAA, 8% AA)	
Asian operations (AAA)	240
UK insurance operations (98% held by PRIL)	59
	299
Total	676

*Including the Group's economic interest in Piedmont (as described in section G1) and other consolidated CDO funds.

G2: Market risk continued

Currency risk

As at 31 December 2007, the Group held 19 per cent (2006: 16 per cent) and 13 per cent (2006: 15 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 86 per cent (2006: 90 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 19 per cent (2006: 14 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 2007, except for those arising on financial instruments measured at fair value through profit and loss, is £102 million (2006: £73 million). This constitutes £109 million (2006: £107 million) gains on Medium Term Notes (MTN) liabilities and £7 million of net losses (2006: £34 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.

See also note J3 for details of the market risks faced by the discontinued banking operations.

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 2007 were as follows:

	2007 £m			
	UK insurance operations	US operations	Other continuing operations	Total continuing operations
Derivative assets	571	390	136	1,097
Derivative liabilities	(689)	(158)	(233)	(1,080)
	(118)	232	(97)	17

	2006 £m					
	UK insurance operations	US operations	Other continuing operations	Total continuing operations	Discontinued banking operations	Total
Derivative assets	476	254	90	820	78	898
Derivative liabilities	(268)	(92)	(149)	(509)	(154)	(663)
	208	162	(59)	311	(76)	235

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

G3: Derivatives and hedging continued

The notional amount of the derivatives, distinguishing between UK insurance, US, discontinued banking and other operations was as follows:

As at 31 December 2007	2007 £m			
	UK insurance operations Notional amount on which future payments are based		US 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
FTSE swap	–	–	–	–
Total return swaps	956	955	226	–
Interest rate swaps	4,335	4,663	1,708	3,587

As at 31 December 2006	2006 £m					
	UK insurance operations Notional amount on which future payments are based		US Notional amount on which future payments are based		Discontinued banking operations Notional amount on which future payments are based	
	Asset	Liability	Asset	Liability	Asset	Liability
Cross-currency swaps*	579	499	537	26	348	360
Equity index call options	–	–	583	12	–	–
Swaptions	1,125	–	13,540	11,751	–	–
Futures	2,306	2,463	–	274	–	–
Forwards*	12,614	12,465	–	–	383	376
Inflation swaps	1,109	1,109	–	–	–	–
Credit default swaps	–	–	–	–	1,787	–
Single stock options	–	6	–	–	–	–
Credit derivatives	–	–	–	18	–	–
Put options	–	–	2,708	–	–	–
FTSE swap	–	–	–	–	49	49
Total return swaps	895	833	230	65	–	–
Interest rate swaps	2,976	3,388	2,407	1,988	3,117	3,117

* 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 £730 million (2006: £754 million) and £1,401 million (2006: £1,743 million) respectively, forward currency contracts assets and liabilities with notional amounts of £983 million (2006: £443 million) and £773 million (2006: £63 million) respectively, interest rate swaps of £2,799 million (2006: £1,856 million) and inflation swap liabilities with notional amounts of £150 million (2006: £150 million).

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.

G3: Derivatives and hedging continued

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.

During the period of ownership in 2007 and in 2006, Egg used derivative instruments for the purpose of supporting the strategic and operational business activities and reducing and eliminating the risk of loss arising from changes in interest rates and foreign exchange rates. Derivatives were used solely to hedge risk exposures and Egg did not take any trading position in derivatives.

For the purpose of reducing interest rate risk, Egg used a number of derivative instruments, including interest rate swaps and forward agreements. Additionally, swaps were used to provide caps to the funding cost of the credit card product.

Egg also made general use of credit default swaps to manage credit risk without changing the underlying product or investment portfolios.

For the purpose of reducing currency risk, Egg used forward exchange contracts and currency swaps.

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 has had a collar fair value hedge in place since 1 March 2005. This common stock equity collar transaction was entered into to protect Jackson's unrealised gain of US$5.9 million on an equity investment. The hedge expires in March 2008.

The fair value of the derivatives designated as fair value hedges above at 31 December 2007, were an asset of £5 million and liabilities of £25 million (2006: asset of £5 million and liabilities of £29 million). Movements in the fair value of the hedging instruments of a net gain of £6 million (2006: net gain of £4 million) and the hedged items of a net loss of £4 million (2006: 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. In 2006 Egg had cash flow hedged certain balance sheet items which were subject to interest rate risk using interest rate and cross currency interest rate swaps, with the effective part of any gain or loss on the swaps recognised directly in equity. As at 31 December 2006, the notional amount of the cash flow hedge was £1,711 million and the fair value was an asset of £9 million. The cash flows were periodically updated based on the underlying banking portfolios. There was no ineffective portion of the cash flow hedge recognised in the income statement in 2006.

Net investment hedges

The Group has entered into a series of 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 2007 and 2006. The forward currency contracts in place at 31 December 2007 expire in March 2008. The fair value of the forward currency contracts at 31 December 2007 was a liability of £44 million (2006: a liability of £4 million).

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 £763 million (2006: £763 million) as at 31 December 2007. The foreign exchange gain of £13 million (2006: gain of £110 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, securitisation 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 2007, the Group had lent £17,172 million (2006: £11,418 million) (of which £11,461 million (2006: £7,592 million) was lent by the PAC with-profits fund) of securities and held collateral under such agreements of £18,125 million (2006: £11,814 million) (of which £12,105 million (2006: £7,934 million) was held by the PAC with-profits fund).

At 31 December 2007, 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 £1,361 million (2006: £1,435 million), together with accrued interest.

Collateral and pledges under derivative transactions

At 31 December 2007, the Group had pledged £260 million (2006: £263 million) for liabilities and held collateral of £292 million (2006: £212 million) in respect of over-the-counter derivative transactions.

Securitisation

At 31 December 2006 Egg had an outstanding balance of UK credit card receivables in its trust vehicle, Arch (Term) Limited, created in 2002 for the purpose of asset-backed securitisation, of £2.8 billion. The note holders in securitisations from this vehicle had a proportional interest in each account balance in the trust. As at 31 December 2006, the value of this interest was £2.3 billion. This securitisation did not qualify for derecognition under IAS 39 and the total portfolio was, therefore, included in loans and receivables. The funding giving rise to the note-holders' interest was included within operational borrowings attributable to shareholder-financed operations. Following the disposal of Egg the Group no longer holds these balances.

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 policyholder liability provisions.

During the year ended 31 December 2007, impairment losses of £184 million (2006: £416 million) were recognised. These were £149 million (2006: £384 million) for loans and advances to customers in discontinued banking operations and £35 million (2006: £ 32 million) for continuing operations, mainly being in respect of available-for-sale securities held by Jackson.

Impairment losses recognised on available-for-sale securities amounted to £30 million (2006: £24 million). Of this amount, 14 per cent (2006: 76 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. 57 per cent (2006: 24 per cent) of the losses related to the impairment of fixed maturity securities of the top five individual corporate issuers, reflecting a deteriorating business outlook of the companies concerned.

The impairment losses have been recorded in 'acquisition costs and other operating expenditure' in the income statement.

In 2007, the Group realised gross losses on sales of available-for-sale securities of £86 million (2006: £58 million). 46 per cent (2006: 30 per cent) of these losses related to the disposal of fixed maturity securities of six (2006: six) individual issuers, which were disposed of to rebalance the portfolio in the US operations in response to the unstable mortgage lending market in the US.

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 and equity 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 2007, the difference between the carrying value and book cost of equity securities in gross unrealised loss position was £nil (2006: £(1) million). For 2007 the amounts of gross unrealised losses for fixed maturity securities classified as available-for-sale under IFRS in an unrealised loss position was £439 million (2006: £256 million) (see note D3 for further details).

H1: Intangible assets attributable to shareholders

a Goodwill

	2007 £m	2006 £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:

	2007 £m	2006 £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 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) and its current surplus capital.

The discounted cash flow valuation has been based on a three-year plan prepared by M&G, and approved by the directors of Prudential plc, and cash flow projections for later years.

The value in use is particularly sensitive to a number of key assumptions as follows:

i 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.

ii 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. 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.

iii 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.

H1: Intangible assets attributable to shareholders continued

Japanese life company

The aggregate goodwill impairment of £120 million at 31 December 2007 and 2006 relates to the goodwill held in relation to the Japanese life operation which was impaired in 2005.

b Deferred acquisition costs and acquired in-force value of long-term business contracts attributable to shareholders

Other intangible assets in the Group consolidated balance sheet attributable to shareholders consist of:

	2007 £m	2006 £m
Deferred acquisition costs (DAC) related to insurance contracts as classified under IFRS 4	2,644	2,315
Deferred acquisition costs related to investment management contracts, including life assurance contracts classified as financial instruments and investment management contracts under IFRS 4	113	110
	2,757	2,425
Present value of acquired in-force policies for insurance contracts as classified under IFRS 4	59	66
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	4	6
Distribution rights*	16	–
	79	72
Total of deferred acquisition costs and acquired in-force value of long-term business contracts	2,836	2,497

* Distribution rights relate to facilitation fees paid in 2007 of £16 million which are amortised over 8 years. The amortisation charge for the year to 31 December 2007 was £0.3 million.

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:

	2007 £m	2006 £m
Deferred acquisition costs at 1 January	2,315	2,200
Additions	694	623
Amortisation	(410)	(299)
Exchange differences	(44)	(290)
Change in shadow DAC	89	81
Deferred acquisition costs at 31 December	2,644	2,315

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.

	2007 £m	2006 £m
At 1 January		
Gross amount	130	118
Accumulated amortisation	(20)	(14)
Net book amount	110	104
Additions (through internal development)	7	36
Amortisation	(3)	(6)
Other charges	(1)	(24)
At 31 December	113	110
Comprising:		
Gross amount	136	130
Accumulated amortisation	(23)	(20)
Net book amount	113	110

H1: Intangible assets attributable to shareholders continued

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.

	2007 £m		2006 £m	
	Insurance contracts	Investment management	Insurance contracts	Investment management
At 1 January				
Cost	220	12	233	12
Accumulated amortisation	(154)	(6)	(141)	(3)
Net book amount	66	6	92	9
Exchange differences	2	–	(4)	–
Amortisation charge	(9)	(2)	(22)	(3)
At 31 December	59	4	66	6
Comprising				
Cost	161	12	220	12
Accumulated amortisation	(102)	(8)	(154)	(6)
Net book amount	59	4	66	6

H2: Intangible assets attributable to the PAC with-profits fund

a Goodwill and other acquired intangible assets in respect of acquired investment subsidiaries

	2007 £m		
	Goodwill	Other acquired intangible assets	Total
Carrying value at 1 January 2007	587	243	830
Additions	313	–	313
Amortisation charge	–	(35)	(35)
Deconsolidated venture fund investments	(708)	(208)	(916)
At 31 December 2007	192	–	192

All goodwill figures shown above reflect the cost. These have no impairment losses or other write-offs.

All goodwill additions relate to the UK and the long-term business segments. Following the sale by the Group of PPM Capital in November 2007, the Group no longer controls venture fund investments and consequently has ceased to consolidate these operations, with these carried as investments of long-term business at fair value through profit and loss going forwards. Additional details on the changes in consolidated entities are provided in note I6.

The recoverable amount for the venture fund investments previously controlled by the Group through PPM Capital was determined on a portfolio CGU basis by aggregating fair values calculated for each entity less costs to sell these entities.

H2: Intangible assets attributable to the PAC with-profits fund continued

The fair value of each entity prior to deconsolidation following the disposal of PPM Capital was calculated in accordance with the International Private Equity and Venture Capital Valuation Guidelines which set out industry best practice for determining the fair value of private equity investments. The guidelines require that an enterprise value is calculated for each investment, typically using an appropriate multiple applied to the company's maintainable earnings. All amounts relating to financial instruments ranking higher in a liquidation than those controlled by the Group prior to the disposal of PPM Capital were then deducted from the enterprise value and a marketability discount applied to the result to give a fair value attributable to the instruments previously controlled by the Group. The marketability discount ranged from 10 per cent to 30 per cent, depending on the Group's level of control over a realisation process.

Management believes that any reasonable change in the key assumptions would not have given rise to an impairment charge.

b Deferred acquisition costs

	2007 £m	2006 £m
At 1 January	31	35
Additions	1	2
Amortisation	(13)	(6)
At 31 December	19	31

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.

H3: Reinsurers' share of insurance contract liabilities

	2007 £m	2006 £m
Insurance contract liabilities	724	878
Claims outstanding	59	67
	783	945

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

	2007 £m	2006 £m
At 1 January	878	1,203
Movement in the year	(147)	(265)
Foreign exchange translation differences	(7)	(60)
At 31 December	724	878

H4: Tax assets and liabilities

Assets

Of the £285 million (2006: £404 million) current tax recoverable, the majority is expected to be recovered in one year or less.

Deferred tax asset

	2007 £m	2006 £m
Unrealised losses on investments	129	83
Balances relating to investment and insurance contracts	2	439
Short-term timing differences	744	446
Capital allowances	20	12
Unused deferred tax losses	30	–
Continuing operations	925	980
Discontinued banking operations	–	32
Total	925	1,012

H4: Tax assets and liabilities continued

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 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 2007 results and balance sheet position at 31 December 2007, the possible tax benefit of approximately £280 million (2006: £333 million), which may arise from capital losses valued at approximately £1.4 billion (2006: £1.7 billion), is sufficiently uncertain that it has not been recognised. In addition, a potential deferred tax asset of £112 million (2006: £71 million), which may arise from trading losses of approximately £350 million (2006: £245 million), is sufficiently uncertain that it has not been recognised.

Liabilities

Of the £1,237 million (2006: £1,303 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

	2007 £m	2006 £m
Unrealised gains on investments	2,098	2,346
Balances relating to investment and insurance contracts	599	613
Short-term timing differences	766	916
Capital allowances	12	7
	3,475	3,882

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

	2007 £m	2006 £m
Accrued investment income		
Interest receivable	1,434	1,331
Other	589	563
Continuing operations	2,023	1,894
Discontinued banking operations	–	6
Total	2,023	1,900
Other debtors		
Surplus in respect of PSPS defined benefit pension schemes:I1*		
Surplus, 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)	365	–
Attributable to shareholder-financed operations (i.e. to shareholders' equity)	163	–
	528	–
Less investments in Prudential insurance policies	(140)	–
Net surplus after elimination of investments in Prudential insurance policies and matching policyholder liability from Group balance sheet	388	–
Premiums receivable:		
From policyholders	154	200
From intermediaries	13	12
From reinsurers	104	22
Other	638	619
Continuing operations	1,297	853
Discontinued banking operations	–	199
Total	1,297	1,052
Total accrued investment income and other debtors	3,320	2,952

* The 2007 pension surplus amounts relate to the PSPS defined benefit scheme. The 2006 amounts are included in H14 Provisions note.

Of the £3,320 million (2006: £2,952 million) of accrued investment income and other debtors, £452 million (2006: £800 million) is expected to be settled after one year or more.

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 2006						
Cost	262	175	853	1,290	246	1,536
Accumulated depreciation	(36)	–	(433)	(469)	(157)	(626)
Net book amount	226	175	420	821	89	910
Year ended 31 December 2006						
Opening net book amount	226	175	420	821	89	910
Exchange differences	(8)	–	(8)	(16)	–	(16)
Depreciation charge	(6)	–	(96)	(102)	(43)	(145)
Additions	4	36	123	163	11	174
Arising on acquisition of subsidiaries	–	–	40	40	–	40
Disposals	(24)	–	(80)	(104)	6	(98)
Reclassification from held for investment	–	268	–	268	–	268
Closing net book amount	192	479	399	1,070	63	1,133
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 [I6]	(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 31 December 2007						
Cost	172	655	612	1,439	–	1,439
Accumulated depreciation	(21)	–	(406)	(427)	–	(427)
Net book amount	151	655	206	1,012	–	1,012

Of the above net book amounts, £nil (2006: £102 million) of Group occupied property and £nil (2006: £261 million) of tangible assets are attributable to consolidated venture investment subsidiaries of the PAC with-profits fund at 31 December 2007. All additions arising on acquisition of subsidiaries relate to acquisitions of venture investment subsidiaries of the PAC with-profits fund.

H6: Property, plant and equipment continued

Capital expenditure: property, plant and equipment by primary segment

	2007 £m	2006 £m
Long-term business	206	153
Asset management	11	6
Unallocated corporate	11	3
Continuing operations	228	162
Discontinued banking operations	3	12
Total	231	174

Capital expenditure: property, plant and equipment by secondary segment

	2007 £m	2006 £m
UK	145	122
US	33	15
Asia	50	25
Continuing operations	228	162
Discontinued banking operations	3	12
Total	231	174

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:

	2007 £m	2006 £m
At 1 January	14,491	13,180
Additions:		
Resulting from acquisitions	1,707	1,185
Resulting from expenditure capitalised	128	51
Resulting from acquisitions through business combinations	–	2
Disposals	(1,378)	(398)
Net (loss) gains from fair value adjustments	(1,128)	813
Net foreign exchange differences	14	(42)
Transfers to held for sale assets	(25)	(32)
Transfers to development properties	(121)	(268)
At 31 December	13,688	14,491

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

	2007 £m	2006 £m
Rental income from investment properties	670	744
Direct operating expenses (including repairs and maintenance expenses) arising from investment properties:		
That generated rental income during the year	117	118
That did not generate rental income during the year	–	8
Total direct operating expenses	117	126

H7: Investment properties continued

Investment properties of £3,665 million (2006: £4,990 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:

	2007 £m	2006 £m
Future minimum lease payments at 31 December	979	400
Future finance charges on finance leases	(877)	(325)
Present value of minimum lease payments	102	75
Future minimum lease payments are due as follows:		
Less than 1 year	5	4
1 to 5 years	22	15
Over 5 years	952	381
Total	979	400
The present values of these minimum lease payments are:		
Less than 1 year	5	3
1 to 5 years	22	15
Over 5 years	75	57
Total	102	75

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 2007 amounted to £14 million (2006: £11 million). Contingent rents recognised as income in the year amounted to £26 million (2006: £33 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:

	2007 £m	2006 £m
Less than 1 year	679	658
1 to 5 years	2,464	2,382
Over 5 years	8,266	6,135
Total	11,409	9,175

The total minimum future rentals to be received on non-cancellable sub-leases for land and buildings for the year ended 31 December 2007 are £2,746 million (2006: £2,651 million).

H8: Investments in associates and joint ventures

Investments in associates

The Group had four associates at 31 December 2007 (2006: three) that are accounted for using the equity method. The Group acquired one new associate in 2007, a 30 per cent interest in The Nam Khang, a Vietnamese property developer. The Group's other associates, a 30 per cent interest in Apollo Education and Training Organisation Vietnam, a 25 per cent interest in OYO Developments Limited, and a 38.6 per cent interest in IFonline Group Limited (IFonline), were held by the Group in both 2007 and 2006.

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 2007 and 2006 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 2006	4	(6)	(2)	7	5
Share of profit for the year after tax	–	1	1	–	1
Balance at 31 December 2006	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**

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 2007 and 2006 is as follows:

	2007 £m	2006 £m
Financial position		
Total assets (excluding goodwill)	7	4
Total liabilities	(3)	(5)
Net assets	4	(1)
Results of operations		
Revenue	5	3
Profit in the year	–	1

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 managed by PPM Capital, 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 2007 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 £2 billion (2006: £2 billion) at 31 December 2007.

The aggregate assets of these associates are approximately £9 billion (2006: £7 billion). Aggregate liabilities, excluding liabilities to unit holders and shareholders for unit trusts and OEICs, are approximately £2 billion (2006: £3 billion). Fund revenues, with revenue arising in unit trusts and OEICs deemed to constitute the investment return for these vehicles, were approximately £0.5 billion (2006: £0.4 billion) and net profit in the year, excluding unit trusts and OEICs where all investment returns accrue to unit holders or shareholders respectively, was approximately £0.2 billion (2006: £0.2 billion).

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.

Prudential BSN Takaful Berhad was a new joint venture in 2006.

In January 2006, the Group sold its 50 per cent interest in Marlborough Stirling Mortgage Services Limited for £2.9 million. The profit on sale before tax of £1.7 million was included in investment income in the consolidated income statement.

The investments noted in the table above have the same accounting year end as the Group, except for Prudential ICICI Asset Management Company Limited. Although this investment has a reporting period of 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:

	2007 £m	2006 £m
Financial position		
Current assets	1,277	91
Non-current assets	173	638
Total assets	1,450	729
Current liabilities	(115)	(47)
Non-current liabilities	(1,121)	(467)
Total liabilities	(1,236)	(514)
Net equity	214	215
Results of operations		
Revenues	500	265
Expenses	(546)	(273)
Net loss	(46)	(8)

There are several minor service agreements in place between the joint ventures and the Group. During 2007, the aggregate amount of the transactions was £5.4 million and the balance outstanding as at 31 December 2007 was £4.7 million.

During 2006, ICICI Prudential Life Insurance Company Limited invested its own capital of £1.4 million into the joint venture to fund the operational needs of the business.

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 and liabilities held for sale

Assets and liabilities held for sale comprise investment property and consolidated venture subsidiaries 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.

As at 31 December 2006, one venture subsidiary, Pharmacia Diagnostics, was classified as held for sale. The disposal of this subsidiary was completed on 18 January 2007.

Gains on disposal of held for sale assets and liabilities are recorded in 'investment income' within the income statement.

Major classes of assets and liabilities held for sale are as follows:

	2007 £m	2006 £m
Assets		
Goodwill	–	138
Intangible assets	–	112
Property, plant and equipment	–	48
Other assets	–	105
Investment properties	30	60
Non-current assets held for sale	30	463
Liabilities		
Other liabilities	–	64
Borrowings	–	323
Non-current liabilities held for sale	–	387

H10: Cash and cash equivalents

Cash and cash equivalents consist of cash in hand, balances with banks, and certain short-term deposits and debt instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts:

	2007 £m	2006 £m
Cash	4,528	3,902
Cash equivalents	423	260
Continuing operations	4,951	4,162
Discontinued banking operations	–	909
Total cash and cash equivalents	4,951	5,071

Cash and cash equivalents held in the parent company and finance subsidiaries are considered to be available for use by the Group. These funds amount to £339 million and £437 million in 2007 and 2006, respectively. The remaining amounts, generally not available for use by the Group, include cash and cash equivalents held for the benefit of policyholders and, in 2006, loans and advances to banks held by Egg.

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

The authorised share capital of the Company is £220 million (2006: £220 million) (divided into 4,000,000,000 (2006: 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:

	2007 £m	2006 £m
Share capital and share premium		
Ordinary share capital: 2,470 million (2006: 2,444 million)		
Shares issued	123	122
Share premium	1,828	1,822
Reserves		
Retained earnings	4,440	3,640
Translation reserve	(112)	(125)
Available-for-sale and hedging reserves	(78)	29
Total shareholders' equity	6,201	5,488

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

Share capital and share premium

	2006		
	Number of ordinary shares	Share capital £m	Share premium £m
Issued shares of 5p each fully paid:			
At the beginning of the year	2,386,784,266	119	1,564
Shares issued under share option schemes	2,953,552	–	15
Shares issued in lieu of cash dividends	12,940,993	1	75
Shares issued in respect of acquisition of Egg minority interests	41,633,614	2	243
Transfer to retained earnings in respect of shares issued in lieu of cash dividends	–	–	(75)
At end of the year	2,444,312,425	122	1,822

	2007		
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

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 2007, there were options outstanding under Save As You Earn schemes to subscribe for 9,017,442 (2006: 10,722,274) shares at prices ranging from 266 pence to 695 pence (2006: 266 pence to 715 pence) and exercisable by the year 2014 (2013). In addition, there are 2,037,220 (2006: 4,113,481) conditional options outstanding under the RSP and 3,485,617 (2006: 1,623,637) under the GPSP exercisable at nil cost within a 10-year period.

The cost of own shares of £60 million as at 31 December 2007 (2006: £79 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 2007, 6.6 million (2006: 7.5 million) Prudential plc shares with a market value of £47 million (2006: £52 million) were held in such trusts. In 2007, the Company purchased 1.2 million (2006: 2.3 million) shares in respect of employee incentive plans at a cost of £9 million (2006: £15 million). The maximum number of shares held in the year was 8.5 million which was at the beginning of the year. Of this total, 5.1 million (2006: 4.8 million) shares were held in trusts under employee incentive plans.

Of the total shares held in trust, 1.5 million (2006: 2.7 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 at a weighted average exercise price of 274 pence (2006: 303 pence).

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 2007 was 4.1 million (2006: 4.9 million) and the cost of acquiring these shares of £22 million (2006: £26 million) is included in cost of own shares. The market value of these shares as at 31 December 2007 was £29 million (2006: £34 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 hedging reserve consists of the portion of the cash flow hedge that is determined to be an effective hedge, net of related tax. The available-for-sale reserve includes gains or losses arising from changes in fair value of available-for-sale securities, net of 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 2006	120,436	11,330
Income and expense included in the income statement	7,811	2,296
Foreign exchange translation differences	(5,034)	(27)
At 31 December 2006	123,213	13,599
At 1 January 2007	**123,213**	**13,599**
Income and expense included in the income statement	**9,590**	**760**
Foreign exchange translation differences	**(167)**	**(8)**
At 31 December 2007	**132,636**	**14,351**

H13: Borrowings

Core structural borrowings of shareholder-financed operations

				2007 £m	2006 £m
	Innovative Tier 1*	Lower Tier 2*	Senior†	Total	Total
Central companies					
Subordinated debt:					
€500m 5.75% Subordinated Notes 2021 note i		365		**365**	335
€20m Medium-Term Subordinated Notes 2023 note ii		15		**15**	13
£435m 6.125% Subordinated Notes 2031		427		**427**	427
US$1,000m 6.5% Perpetual Subordinated Capital Securities note iii	485			**485**	484
US$250m 6.75% Perpetual Subordinated Capital Securities note iv	124			**124**	125
US$300m 6.5% Perpetual Subordinated Capital Securities notes iv,v	154			**154**	154
	763	807	–	**1,570**	1,538
Senior debt:					
£150m 9.375% Guaranteed Bonds 2007				**–**	150
£249m 5.5% Bonds 2009			248	**248**	248
£300m 6.875% Bonds 2023			300	**300**	300
£250m 5.875% Bonds 2029			249	**249**	249
	–	–	797	**797**	947
Total central companies	**763**	**807**	**797**	**2,367**	**2,485**
US operations					
US$250m 8.15% Surplus Notes 2027 note vi		125		**125**	127
Total continuing operations	**763**	**932**	**797**	**2,492**	**2,612**
Discontinued banking operations					
£250m 7.5% Subordinated Notes 2013				**–**	250
£200m 6.875% Subordinated Notes 2021				**–**	201
	–	–	–	**–**	451
Total note vii	763	932	797	**2,492**	3,063

* These debt classifications are consistent with the treatment of capital for regulatory purposes, as defined in the FSA Handbook.
† The senior debt ranks above subordinated debt in the event of liquidation.

H13: Borrowings continued

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 2008, this was swapped back into fixed rate payments at 6.5 per cent.

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 the US operations.

vii Maturity analysis
The following table sets out the maturity analysis of the Group's core structural borrowings:

	2007 £m	2006 £m
Less than 1 year	–	150
1 to 2 years	248	–
2 to 3 years	–	248
3 to 4 years	–	–
4 to 5 years	–	–
Over 5 years	2,244	2,665
Total	2,492	3,063

Operational borrowings attributable to shareholder-financed operations

	2007 £m	2006 £m
Borrowings in respect of short-term fixed income securities programmes		
Commercial paper	2,422	2,017
Floating Rate Notes 2007	–	5
Medium-Term Notes 2008	48	–
Medium-Term Notes 2010	7	10
	2,477	2,032
Non-recourse borrowings of US operations note i		
Jackson note ii	126	–
Investment subsidiaries note iii	9	76
Piedmont and CDO funds note iv	456	667
	591	743
Other borrowings		
Bank loans and overdrafts	6	9
Obligations under finance leases	7	6
	13	15
Total continuing operations	3,081	2,790
Discontinued banking operations note v	–	2,819
Total note vi	3,081	5,609

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 4.45 per cent at 31 December 2007.

iii In 2006, this constituted senior and subordinated notes and mortgage loans. During 2007, the notes were repaid.

iv 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.

v The borrowings in respect of banking operations comprise deposits by banks of £nil (2006: £2,220 million) and unsubordinated debt securities issued by Egg of £nil (2006: £599 million). The deposits by banks mainly relate to securitisation of credit card receivables. See also note G4.

H13: Borrowings continued

Notes continued

vi Maturity analysis

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

	2007 £m	2006 £m
Less than 1 year	2,618	3,135
1 to 2 years	–	533
2 to 3 years	7	946
3 to 4 years	44	266
4 to 5 years	–	48
Over 5 years	412	681
Total	3,081	5,609

Borrowings attributable to with-profits funds

	2007 £m	2006 £m
Non-recourse borrowings of venture fund investment subsidiaries[note i]	–	926
Non-recourse borrowings of consolidated investment funds[note i]	789	681
£100m 8.5% Undated Subordinated Guaranteed Bonds of Scottish Amicable Finance plc[note ii]	100	100
Other borrowings (predominantly obligations under finance leases)	98	69
Total[note iii]	987	1,776

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 The interests of the holders of the bonds issued by Scottish Amicable Finance plc, a subsidiary of the Scottish Amicable Insurance Fund, are subordinate to the entitlements of the policyholders of that fund.

iii Maturity analysis

The following table sets out the maturity analysis of the Group's borrowings attributable to with-profits funds:

	2007 £m	2006 £m
Less than 1 year	103	33
1 to 2 years	16	12
2 to 3 years	62	–
3 to 4 years	–	319
4 to 5 years	154	–
Over 5 years	652	1,412
Total	987	1,776

H14: Provisions and contingencies

Provisions

	2007 £m	2006 £m
Provision in respect of defined benefit pension schemes:[I1]		
(Surplus) 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)	27	(73)
Attributable to shareholder-financed operations (i.e. to shareholders' equity)	54	8
	81	(65)
Add back: Investments in Prudential insurance policies	172	287
Provision after elimination of investments in Prudential insurance policies and matching policyholder liability from Group balance sheet	253	222
Other provisions (see below)	220	238
Continuing operations	473	460
Discontinued banking operations	–	4
Total provisions	473	464

The pension deficit does not include amounts relating to the PSPS pension scheme for 2007. These amounts are included in the accrued investment income and the other debtors note on H5.

Analysis of other provisions:

	2007 £m	2006 £m
At 1 January	238	175
Charged to income statement:		
Additional provisions	116	161
Unused amounts reversed	(23)	(13)
Used during the year	(112)	(81)
Exchange differences	1	(4)
At 31 December	220	238
Comprising:		
Legal provisions	19	11
Restructuring provisions	35	72
Other provisions	166	155
Total	220	238

Of the other provisions balance, £77 million (2006: £55 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 £19 million (2006: £11 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 2007, an additional provision of £12 million was made and £4 million was paid.

Restructuring provisions

Restructuring provisions of £35 million (2006: £76 million) comprise £35 million (2006: £72 million) relating to restructuring activity of UK insurance operations and £nil (2006: £4 million) relating to discontinued banking operations.

H14: Provisions and contingencies continued

UK restructuring

In 2004 and 2005, Prudential 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 Egg and M&G and in the process facilitate the realisation of substantial annualised pre-tax cost savings and opportunities for revenue synergies.

At 1 January 2006, a provision of £30 million was brought forward, and during 2006 an additional £75 million was provided, £4 million of unused provision was released, and £29 million was paid.

During 2007, an additional provision of £21 million was provided, £14 million of unused provision was released, and £44 million was paid.

On 28 November 2007 Prudential UK 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 to Prudential UK.

Discontinued banking operations restructuring

Following the disposal of Egg in 2007 there was no provision held at 31 December 2007. In 2006, as a result of the UK and Egg initiative described above, a provision of £1 million was brought forward relating to Egg's withdrawal from the French market, and during 2006 an additional £11 million was provided, of which £8 million was used.

Other provisions

Other provisions of £166 million (2006: £155 million) include provisions of £155 million (2006: £134 million) relating to staff benefit schemes. During 2007, another £78 million was provided, £3 million of unused provision was released and £54 million was paid. In 2006, a provision of £94 million was brought forward, an additional £78 million was provided, £7 million of unused provision was released and £31 million was paid. Other provisions also include £11 million (2006: £18 million) relating to various onerous contracts where, in 2007, an additional £2 million was provided, £1 million of unused provision was released and £8 million was used. In 2006, £19 million was brought forward, £1 million was provided and £2 million was used. The remaining provisions of £3 million in 2006 include VAT provisions.

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 arising in the ordinary course of business. 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.

H14: Provisions and contingencies continued

The table below summarises the change in the pension mis-selling provision for the years ended 31 December 2007 and 2006. 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.

	2007 £m	2006 £m
Balance at beginning of year	401	331
Changes to actuarial assumptions and method of calculation	71	108
Discount unwind	22	15
Redress to policyholders	(41)	(48)
Payment of administrative costs	(5)	(5)
Balance at end of year	448	401

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 2007 set out above of £448 million is stochastically determined on a discounted basis. The average discount rate implied in the movement in the year is 4.6 per cent. The undiscounted amounts at 31 December 2007 expected to be paid in each of the years ending 31 December are as follows:

	2007 £m
Year ended 31 December	
2008	51
2009	15
2010	15
2011	15
2012	22
Thereafter	707
Total undiscounted amount	825
Aggregate discount	(377)
Discounted pension mis-selling provision at 31 December 2007	448

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. 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.

H14: Provisions and contingencies continued

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 as claims are paid on the policies covered by it.

The bonus and investment policy for each type of with-profits policy is the same irrespective of whether or not the assurance applies. Hence removal of the assurance for new business has had no impact on policyholder returns and this is expected to continue for the foreseeable future.

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 2007, provisions of £5 million (2006: £5 million) in SAL and £43 million (2006: £45 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 2007 Prudential Assurance's main with-profits fund paid compensation of £5 million (2006: £11 million) in respect of mortgage endowment products mis-selling claims and at 31 December 2007 held a provision of £55 million (2006: £60 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 2007 held a provision of £45 million (2006: £47 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 2007 a provision of £563 million (2006: £561 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 main with-profits fund within the long-term fund of 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 with-profits fund 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 with-profits fund is called the 'inherited estate' and has accumulated over many years from various sources.

The inherited estate represents the major part of the working capital of PAC's long-term insurance fund. This 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.

PAC believes that it would be beneficial if there were greater clarity as to the status of the inherited estate. As a result, PAC has announced that it has begun a process to determine whether it can achieve that clarity through a reattribution of the inherited estate. As part of this process a Policyholder Advocate has been nominated to represent policyholders' interests. This nomination does not mean that a reattribution will occur.

H14: Provisions and contingencies continued

Given the size of the Group's with-profits business any proposal is likely to be time consuming and complex to implement and is likely to involve a payment to policyholders from shareholders' funds. If a reattribution is completed, the inherited estate will continue to provide working capital for the long-term insurance fund.

Support for long-term business funds by shareholders' funds

As a proprietary insurance company, the Group 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 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 £9 million at 31 December 2007 (2006: £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 2007, Jackson has unfunded commitments of £181 million (2006: £174 million) related to its investments in limited partnerships and of £104 million (2006: £38 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.

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

	2007 £m	2006 £m
Creditors arising from direct insurance and reinsurance operations	538	521
Interest payable	76	89
Derivative liabilities	1,080	510
Other items	177	378
Continuing operations	1,871	1,498
Discontinued banking operations	–	154
Total	1,871	1,652

I1: Staff and pension plans

a Staff and employment costs

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

	2007	2006
Business operations:		
UK operations	7,732	8,259
US operations	3,123	2,863
Asian operations	16,807	12,114
Venture fund investment subsidiaries of the PAC with-profits fund (see below)	21,184	8,898
Continuing operations	48,846	32,134
Discontinued banking operations	770	2,655
Total	49,616	34,789

The costs of employment for continuing operations were:

	2007 £m	2006 £m
Business operations:		
Wages and salaries	819	761
Social security costs	62	58
Other pension costs (see below)	62	67
Pension actuarial gains credited to income statement	(296)	(469)
	(234)	(402)
Venture fund investment subsidiaries of the PAC with-profits fund (see below)	423	230
Total for continuing operations	1,070	647
Discontinued banking operations	21	76
Total	1,091	723

Other pension costs comprises £34 million (2006: £45 million) relating to defined benefit schemes and £28 million (2006: £22 million) relating to defined contribution schemes of continuing operations. Of the defined contribution scheme costs, £19 million (2006: £14 million) related to overseas defined contribution schemes. The £34 million (2006: £45 million) comprises a £14 million (2006: £29 million) charge on an economic basis, reflecting the total assets of the schemes, and a further £20 million (2006: £16 million) charge to adjust for amounts invested in Prudential insurance policies to arrive at the IAS 19 basis charge. The £296 million (2006: £469 million) of actuarial gains comprises £295 million (2006: £485 million) of actuarial gains on an economic basis and £1 million actuarial gain (2006: £16 million actuarial losses) for amounts invested in Prudential insurance policies. The derivation of these amounts is shown in note (b)(i)7 below.

Of the £423 million (2006: £230 million) costs of employment for venture fund investment subsidiaries, £349 million (2006: £189 million) relates to wages and salaries, £70 million (2006: £27 million) relates to social security costs and £4 million (2006: £14 million) relates 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 has 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 (2006: £76 million) costs of employment for discontinued banking operations, £18 million (2006: £64 million) relates to wages and salaries, £2 million (2006: £7 million) relates to social security costs and £1 million (2006: £5 million) relates to pension costs.

b Pension plans

i Defined benefit plans

1 Summary

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). Eighty-seven per cent (2006: 88 per cent) of the liabilities of the Group defined benefit schemes are accounted for within PSPS.

I1: 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.

As at 31 December 2007, the shareholders' share of the surplus for PSPS and the deficits of the other schemes amounted to a £76 million surplus net of related tax relief (2006: £8 million deficit). These amounts are determined after including amounts invested by PSPS and the M&G scheme in Prudential policies as explained later in this note.

Defined benefit schemes in the UK are generally required to be subject to full actuarial valuation every three years to assess the appropriate level of funding for schemes having regard 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 and 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.

The finalisation of the valuation as at 5 April 2005 was accompanied by changes to the basis of funding for the scheme with effect from that date. Deficit funding amounts designed to eliminate the actuarial deficit over a 10 year period have been and are being made based on that valuation. 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 over a 10-year period. In 2007, total contributions for the year including expenses and augmentations were £82 million (2006: £137 million). The 2006 amount reflected an increased level of contributions for ongoing service and deficit funding backdated to 6 April 2005 including expenses and augmentations.

Under IAS 19 the basis of valuation differs markedly from the full triennial valuation basis. In particular, IAS 19 requires assets of the scheme to be valued at their market value at the year end, while pension liabilities are required to be discounted at a rate consistent with the current rate of return on a high quality corporate bond. As a result, the difference between IAS 19 basis assets and liabilities can be volatile. For those schemes such as PSPS, which hold a significant proportion of their assets in equity investments, the volatility can be particularly significant. On the economic basis (including investments of PSPS and the M&G scheme in Prudential policies as assets) for 2007, a £23 million (2006: £28 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 credit of £90 million (2006: £167 million) for net actuarial gains.

In addition, also on the economic basis, the PAC with-profits sub-fund was credited £9 million (2006: charge of £1 million) for the aggregate of service cost and net finance income and benefited by £205 million (2006: £318 million) for its share of net actuarial gains 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.

The actuarial gains primarily represent the difference between actual and expected investment returns for the schemes and the reduction in liabilities primarily caused by an increase in the discount rate caused by increases in corporate bond returns, which more than offsets the effects of strengthened mortality assumptions for the UK pension schemes.

Surpluses and deficits on the Group's defined benefit schemes are apportioned to the PAC life fund and shareholders' funds based on estimates of employees' service between them. At 31 December 2005, the deficit of PSPS was apportioned in the ratio 70/30 between the life-fund and shareholder-backed operations following detailed consideration of the sourcing of previous contributions. This ratio was applied to the base deficit position at 1 January 2006 and for the purpose of determining the allocation of the movements in that position up to 31 December 2007. The IAS 19 service charge and ongoing employer contributions are allocated by reference to the cost allocation for current activity. The deficit of the Scottish Amicable Pension Scheme of £54 million has been allocated 50 per cent to the PAC with-profits fund and 50 per cent to the PAC shareholder fund.

Reflecting these two elements, at 31 December 2007, the total share of the surplus on PSPS and the deficit on the smaller Scottish Amicable scheme attributable to the PAC with-profits fund amounted to a net surplus of £304 million (2006: £66 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.

I1: Staff and pension plans continued

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:

	2007 %	2006 %
Discount rate	5.9	5.2
Rate of increase in salaries	5.3	5.0
Rate of increase of pensions in payment for inflation:		
Guaranteed (maximum 5%)	3.3	3.0
Guaranteed (maximum 2.5%)*	2.5	2.5
Discretionary*	2.5	2.5
Expected returns on plan assets	6.2	5.9

* 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 3.3 per cent in 2007 (2006: 3.0 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 2007 were:

Male: 100 per cent PMA92 with CMIR17 improvements to the valuation date and medium cohort improvements subject to a floor of 1.75% up to the age of 90, decreasing linearly to zero by age of 120 (2006: 100 per cent PMA92 with CMIR17 improvements to the valuation date and medium cohort improvements in future); and
Female: 100 per cent PFA92 with CMIR17 improvements to the valuation date and 75% medium cohort improvements subject to a floor of 1% up to the age of 90 and decreasing linearly to zero by age of 120 (2006: 100 per cent PFA92 with CMIR17 improvements to the valuation date and medium cohort improvements in future).

The assumed life expectancies on retirement at age 60, based on the mortality table used was:

	2007 Years		2006 Years	
	Male	Female	Male	Female
Retiring today	26.2	28.3	25.0	28.1
Retiring in 15 years' time	28.7	29.3	26.1	29.1

The mean term of the current PSPS liabilities is around 20 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 internal advice for the Scottish Amicable scheme, the most recent full valuations have been updated to 31 December 2007, applying the principles prescribed by IAS 19.

I1: Staff and pension plans continued

4 Summary financial position

The Group liability in respect of defined benefit pension schemes is as follows:

	2007 £m	2006 £m
Economic position:		
Surplus (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)	338	73
Attributable to shareholder-financed operations (i.e. to shareholders' equity)	109	(8)
Economic surplus – as explained in note 5 below	447	65
Add back: investments in Prudential insurance policies (offset on consolidation in the Group financial statements against insurance liabilities)	(312)	(287)
Surplus (deficit) included in balance sheet under IAS 19 – as explained in note 7 below	135	(222)

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 PSPS and 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.

i The surplus or deficits on the PSPS and Scottish Amicable schemes are partially attributable to the PAC with-profits fund; and

ii The M&G pension scheme has invested £172 million at 31 December 2007 (2006: £161 million) in Prudential insurance policies. Additionally, the PSPS scheme has invested £140 million at 31 December 2007 (2006: £126 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 asset (liability) is £312 million (2006: £287 million) lower than the 'economic basis' surplus of £447 million (2006: 'economic basis' surplus of £65 million).

On the 'economic basis', after including the underlying assets represented by the investments in Prudential insurance policies as scheme assets, the balance sheets of the schemes at 31 December were:

	2007				2006			
	PSPS £m	Other schemes note iii £m	Total £m	%	PSPS £m	Other schemes note iii £m	Total £m	%
Equities	1,278	265	1,543	28	1,346	282	1,628	31
Bonds	1,134	249	1,383	25	2,077	182	2,259	43
Properties	545	54	599	11	580	58	638	12
Cash-like investments note i	1,932	5	1,937	36	745	5	750	14
Total value of assets	4,889	573	5,462	100	4,748	527	5,275	100
Present value of benefit obligations	(4,361)	(654)	(5,015)		(4,607)	(603)	(5,210)	
Pre-tax surplus/(deficit) note ii	528	(81)	447		141	(76)	65	

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 2007, the nominal value of the interest and inflation swaps amounted to £1.2 billion and £0.7 billion respectively.

ii The resulting scheme surplus or deficit arising from the excess of assets over liabilities or vice versa at 31 December 2007 comprised surplus of £338 million (2006: surplus of £73 million) attributable to the PAC with-profits fund and surplus of £109 million (2006: deficit of £8 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 2007 of £71 million (2006: £67 million), gross of tax. There is also a small scheme in Taiwan, which at 31 December 2007 had a deficit of £10 million (2006: £9 million), gross of tax.

I1: Staff and pension plans continued

The movements in the surplus (deficit) on the 'economic basis' between scheme assets and liabilities were:

	2007 £m	2006 £m
Current service cost	(58)	(69)
Contributions	101	152
Other finance income	44	40
Actuarial gains	295	485
Net increase in surplus	382	608

Estimated pension scheme surplus (deficit) attributable to shareholder operations – economic basis

Movements on the pension scheme surplus (deficit) (determined on the 'economic basis'), to the extent attributable to shareholder operations are as follows:

	2007 £m				
	At beginning of year	Charge to operating results (based on longer-term investment returns) note i	Actuarial gains attributable to shareholders note ii	Contributions paid by shareholder operations	At end of year
Gross of tax surplus (deficit)	(8)	(23)	90	50	109
Related deferred tax	–	6	(25)	(14)	(33)
Net of tax surplus (deficit)	(8)	(17)	65	36	76

	2006 £m				
	At beginning of year	Charge to operating results (based on longer-term investment returns) note i	Actuarial gains attributable to shareholders note ii	Contributions paid by shareholder operations	At end of year
Gross of tax deficit	(214)	(28)	167	67	(8)
Related deferred tax	61	9	(50)	(20)	–
Net of tax deficit	(153)	(19)	117	47	(8)

Notes

i Charge to operating results (based on longer-term investment returns)
This comprises:

	2007 £m	2006 £m
Current service cost	(58)	(69)
Finance income (expense):		
Interest on pension scheme liabilities	(265)	(255)
Expected return on pension scheme assets	309	295
	44	40
Total charge net of finance income	(14)	(29)
Less: amount attributable to PAC with-profits fund	(9)	1
Charge to operating results, based on longer-term investment returns, attributable to shareholders	(23)	(28)

I1: Staff and pension plans continued

Notes continued

ii Actuarial gains and losses

This comprises:

	2007 £m	2006 £m
Actual less expected return on pension scheme assets	(8)	156
Experience (losses) gains on scheme liabilities	(14)	18
Changes in assumptions underlying the present value of scheme liabilities[a]	317	311
Total actuarial gains	295	485
Less: amount attributable to PAC with-profits fund	(205)	(318)
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	90	167

a The gains of £317 million relating to changes in assumptions comprises the gains due to changes in economic assumptions of £509 million which are partially offset by a charge of £192 million for the effect of strengthened mortality assumptions for the UK 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 surplus (deficit) attributable to PAC with-profits fund – economic basis

Movements on the pension scheme surplus (deficits) (determined on the 'economic basis' under which PSPS and M&G scheme assets include investments in Prudential insurance policies) are as follows:

	2007 £m				
	At beginning of year	Service cost less net finance income note i above	Actuarial gains (losses) note ii above	Contributions paid by PAC with-profits fund	At end of year
Gross of tax surplus	73	9	205	51	338
Related deferred tax	(7)	(1)	(21)	(5)	(34)
Net of tax surplus	66	8	184	46	304

	2006 £m				
	At beginning of year	Service cost less net finance income note i above	Actuarial gains (losses) note ii above	Contributions paid by PAC with-profits fund	At end of year
Gross of tax surplus (deficit)	(329)	(1)	318	85	73
Related deferred tax	33	0	(32)	(8)	(7)
Net of tax surplus (deficit)	(296)	(1)	286	77	66

The charges and credits for service cost, net finance income, and actuarial 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.

I1: Staff and pension plans continued

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:

	2007 £m				
	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 obligation	Economic basis: net obligation
Fair value of plan assets, beginning of year	4,988	287	5,275		5,275
Present value of benefit obligation, beginning of year				(5,210)	(5,210)
	4,988	287	5,275	(5,210)	65
Service cost – current charge only				(58)	(58)
Interest cost				(265)	(265)
Expected return on plan assets	289	20	309		309
Employee contributions	2	1	3	(3)	–
Employer contributions	92	9	101		101
Actuarial gains	(7)	(1)	(8)	303	295
Benefit payments	(214)	(4)	(218)	218	–
Fair value of plan assets, end of year	5,150	312	5,462		5,462
Present value of benefit obligation, end of year				(5,015)	(5,015)
Economic basis surplus					447

	2006 £m				
	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 obligation	Economic basis: net obligation
Fair value of plan assets, beginning of year	4,622	253	4,875		4,875
Present value of benefit obligation, beginning of year				(5,418)	(5,418)
	4,622	253	4,875	(5,418)	(543)
Service cost – current charge only				(69)	(69)
Interest cost				(255)	(255)
Expected return on plan assets	279	16	295		295
Employee contributions	1	1	2	(2)	–
Employer contributions	148	4	152		152
Actuarial gains	140	16	156	329	485
Benefit payments	(202)	(3)	(205)	205	–
Fair value of plan assets, end of year	4,988	287	5,275		5,275
Present value of benefit obligation, end of year				(5,210)	(5,210)
Economic basis surplus					65

I1: Staff and pension plans continued

7 IAS 19 basis financial position as consolidated

The IAS 19 basis net pensions deficit can be summarised as follows:

	2007 £m	2006 £m	2005 £m	2004 £m
Fair value of plan assets, end of year	**5,150**	4,988	4,622	4,092
Present value of funded benefit obligation	**(4,826)**	(5,023)	(5,228)	(4,777)
Funded status	**324**	(35)	(606)	(685)
Present value of unfunded obligations (M&G scheme)*	**(189)**	(187)	(190)	(140)
Surplus (provision) recognised in the balance sheet	**135**	(222)	(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.

	2007 £m	2006 £m
Components of net periodic pension cost		
Current service cost	**(58)**	(69)
Interest cost	**(265)**	(255)
Expected return on assets – economic basis	**309**	295
Less: expected return on investments of scheme assets in Prudential insurance policies	**(20)**	(16)
Expected return on assets – IAS 19 basis†	**289**	279
Pension cost charge (as referred to in note I1a)	**(34)**	(45)
Actuarial gains – economic basis	**295**	485
Less: actuarial gains on investments of scheme assets in Prudential insurance policies	**1**	(16)
Actuarial gains – IAS 19 basis (as referred to in note I1a)	**296**	469
Net periodic pension credit (included within acquisition and other operating expenditure in the income statement)	**262**	424

† In determining the expected return on plan assets for 2007, 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:

	2007		2006		2005		2004	
	£m	%	£m	%	£m	%	£m	%
Plan assets (IAS 19 basis)								
Equity	**1,332**	**26**	1,432	29	2,376	51	2,516	61
Bonds	**1,299**	**25**	2,185	44	1,593	35	993	24
Properties	**583**	**11**	621	12	575	12	520	13
Cash-like investments	**1,936**	**38**	750	15	78	2	63	2
Total	**5,150**	**100**	4,988	100	4,622	100	4,092	100

	Prospectively for 2008 %	2007 %	2006 %
Long-term expected rate of return			
Equity	**7.5**	7.5	7.1
Bonds	**5.4**	4.8	4.5
Properties	**6.75**	6.8	6.4
Cash	**5.5**	5.0	4.5
Weighted average long-term expected rate of return	**6.1**	5.9	6.1

The expected rates of return have been determined by reference to long-term expectations, the carrying value of the assets and equity and other market conditions at the balance sheet date.

The actual return on plan assets was £282 million (2006: £419 million) on an IAS 19 basis.

I1: Staff and pension plans continued

None of the scheme assets included shares in Prudential plc or property occupied by the Prudential Group.

	2007 £m	2006 £m	2005 £m	2004 £m
Fair value of plan assets, end of year (IAS 19 basis)	**5,150**	4,988	4,622	4,092
Present value of the benefit obligation, end of year	**(5,015)**	(5,210)	(5,418)	(4,917)
Plan assets in surplus (deficit) of benefit obligation	**135**	(222)	(796)	(825)
Experience adjustments on plan liabilities	**(14)**	18	1	(17)
Percentage of plan liabilities at 31 December	**0.28%**	(0.35)%	(0.02)%	0.35%
Experience adjustments on plan assets (IAS 19 basis)	**(7)**	140	527	112
Percentage of plan assets at 31 December	**(0.14)%**	2.81%	11.42%	2.74%

Total employer contributions expected to be paid into the Group defined benefit schemes for the year ending 31 December 2008 amounts to £90 million (2007: £93 million).

8 Sensitivity of PSPS financial position to key variables

The table below shows the sensitivity of the PSPS liabilities at 31 December 2007 of £4,361 million (2006: £4,607 million) to changes in discount rates, inflation rates and mortality assumptions.

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 scheme liabilities by 3.5%
Discount rate	Increase by 0.2% from 5.9% to 6.1%	Decrease scheme liabilities by 3.4%
Rate of inflation	Decrease by 0.2% from 3.3% to 3.1% with consequent reduction in salary increases	Decrease scheme liabilities by 1.3%
Mortality rates	Reduce rates from 100% of table to 95%	Increase liabilities by 1.2%

2006		
Assumption	Change in assumption	Impact on scheme liabilities on IAS 19 basis
Discount rate	Decrease by 0.2% from 5.2% to 5.0%	Increase scheme liabilities by 3.6%
Discount rate	Increase by 0.2% from 5.2% to 5.4%	Decrease scheme liabilities by 3.4%
Rate of inflation	Decrease by 0.2% from 3.0% to 2.8% with consequent reduction in salary increases	Decrease scheme liabilities by 1.3%
Mortality rates	Reduce rates from 100% of table to 95%	Increase liabilities by 1.2%

9 Transfer value of PSPS scheme

At 31 December 2007, 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 2007 was £28 million (2006: £22 million).

I2: Share-based payments

a Relating to Prudential plc shares

The Group maintains 10 main share award and share option plans relating to Prudential plc shares, which are described below.

The 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. 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 2006 and 2007 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 director 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.

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.

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.

I2: Share-based payments continued

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.

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 2007 and 2006 were as follows:

	2007		2006	
Options outstanding (including conditional options)	Number of options (millions)	Weighted average exercise price £	Number of options (millions)	Weighted average exercise price £
Beginning of year:	16.5	2.47	17.2	2.23
Granted	4.0	2.69	7.7	2.96
Exercised	(1.9)	3.42	(5.1)	2.75
Forfeited	(1.4)	1.37	(1.2)	0.85
Expired	(2.7)	2.13	(3.1)	4.09
Adjustment in respect of Egg's employees	–	–	1.0	3.64
End of year	14.5	2.57	16.5	2.47
Options immediately exercisable, end of year	0.2	3.35	0.2	3.56

The weighted average share price of Prudential plc for the year ended 31 December 2007 was £7.15 compared to £6.25 for the year ended 31 December 2006.

Movements in share awards outstanding under the Group's share-based compensation plans relating to Prudential plc shares at 31 December 2007 and 2006 were as follows:

	2007	2006
Awards outstanding	Number of awards (millions)	Number of awards (millions)
Beginning of year:	6.6	4.9
Granted	3.8	3.2
Exercised	(1.3)	(1.0)
Forfeited	(1.1)	(0.5)
Expired	–	–
End of year	8.0	6.6

I2: Share-based payments continued

The following table provides a summary of the range of exercise prices for Prudential plc options (including conditional options) outstanding at 31 December 2007.

	Outstanding			Exercisable	
Range of exercise prices	Number outstanding (millions)	Weighted average remaining contractual life (years)	Weighted average exercise prices £	Number exercisable (millions)	Weighted average exercise prices £
Between £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 following table provides a summary of the range of exercise prices for Prudential plc options (including conditional options) outstanding at 31 December 2006.

	Outstanding			Exercisable	
Range of exercise prices	Number outstanding (millions)	Weighted average remaining contractual life (years)	Weighted average exercise prices £	Number exercisable (millions)	Weighted average exercise prices £
Between £0 and £1	5.7	8.6	–	–	–
Between £1 and £2	–	–	–	–	–
Between £2 and £3	3.2	2.3	2.66	–	2.66
Between £3 and £4	3.1	2.0	3.52	0.2	3.62
Between £4 and £5	3.8	3.6	4.60	–	–
Between £5 and £6	0.7	3.3	5.63	–	5.79
Between £6 and £7	–	0.6	6.41	–	6.34
Between £7 and £8	–	0.9	7.15	–	–
	16.5	4.8	2.47	0.2	3.56

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:

2007 £m			2006 £m		
Weighted average fair value			Weighted average fair value		
GPSP	Other options	Awards	RSP and GPSP	Other options	Awards
4.78	2.55	7.33	4.30	2.05	6.46

I2: Share-based payments continued

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:

	2007		2006	
	GPSP	Other options	RSP and GPSP	Other options
Dividend yield (%)	2.32	2.32	2.64	2.64
Expected volatility (%)	28.90	27.17	25.48	34.32
Risk-free interest rate (%)	5.46	5.25	4.68	4.70
Expected option life (years)	3.0	3.48	3.00	3.42
Weighted average exercise price (£)	–	5.62	–	5.06
Weighted average share price (£)	7.52	7.47	6.80	6.51

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 2007, an average index volatility and correlation of 18 per cent and 72 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.

b Relating to Egg plc shares

In April 2006, Prudential became bound or entitled to acquire shares in Egg following the announcement of its intention in December 2005 to acquire the minority interests in Egg representing approximately 21.7 per cent of the existing issued share capital of Egg. As a consequence of this acquisition, employees of Egg that were participants of its SAYE schemes were requested to either rollover all or part of their options for equivalent options in Prudential shares or to take no action. Employees could adopt different courses of actions for options granted on different dates but may only adopt one course of action in respect of each grant of options. The rollover was based on employees receiving 0.2237 Prudential shares for each Egg share that was under option with total amount payable for the new Prudential shares being exactly the same as the total amount payable for the Egg shares. As a result, all outstanding executive share options became exercisable and awards under the RSP were assessed against the performance conditions. None of the awards met the performance conditions and they have therefore lapsed in February 2006 following consideration of the performance measurement results by the Remuneration Committee.

On 1 May 2007, Egg Banking plc was sold to Citi and, at 31 December 2007, there were no outstanding SAYE options to acquire Egg shares.

I2: Share-based payments continued

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:

	2007 £m	2006 £m
Share-based compensation expense	28	22
Amount accounted for as equity-settled	19	14
Carrying value at 31 December of liabilities arising from share-based payment transactions	18	18
Intrinsic value of above liabilities for which rights had vested at 31 December	4	3

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 £15,670,000 (2006: £13,524,000). This comprises salaries and short-term benefits of £9,496,000 (2006: £8,927,000), post-employment benefits of £967,000 (2006: £1,020,000), termination benefits of £nil (2006: £291,000) and share-based payments of £5,207,000 (2006: £3,286,000).

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 £3,456,000 (2006: £1,880,000), which is determined in accordance with IFRS 2, 'Share-Based Payments' (see note I2) and £1,751,000 (2006: £1,406,000) of deferred share awards.

Total key management remuneration includes total directors' emoluments of £11,959,000 (2006: £11,084,000) as shown in the directors' remuneration report on pages 102 to 123, 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

	2007 £m	2006 £m
Fees payable to the Company's auditor for the audit of the Company's annual accounts	1.8	2.3
Fees payable to the Company's auditor and its associates for other services:		
Audit of subsidiaries and associates pursuant to legislation	4.4	3.8
Other services supplied pursuant to legislation	2.9	4.0
Other services relating to taxation	0.4	0.2
Valuation and actuarial services	0.7	0.0
Services relating to corporate finance transactions	0.2	0.7
All other services	1.0	1.3
Total	11.4	12.3

In addition, there were fees incurred of £0.2 million (2006: £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 on page 95.

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.

Various executive officers and directors of Prudential may from time to time purchase insurance, asset management or annuity products, or be granted mortgages or credit card facilities marketed by Prudential Group companies in the ordinary course of business on substantially the same terms, including interest rates and security requirements, as those prevailing at the time for comparable transactions with other persons.

Apart from the transactions with directors referred to below, no director had an interest in shares, transactions or arrangements that requires disclosure, other than those given in the directors' remuneration report. Key management remuneration is disclosed in note I3.

In 2007, prior to disposal, three (2006: three) directors had credit cards with the discontinued banking operations. In 2007 and 2006, 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 the above noted transactions are on terms 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 2007, 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.

Each subsidiary has one class of ordinary shares and operates mainly in its country of incorporation, except for PRIL which operates mainly in England and Wales.

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 2008, the maximum amount of dividends that can be paid by Jackson without prior regulatory approval is US$490 million (£246 million) (in 2007: US$412 million (£211 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 78 per cent (2006: 76 per cent) of total Group assets. At 31 December 2007, 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 £10.5 billion (2006: £9.7 billion) and the statutory capital and surplus of Jackson was US$4.0 billion (£2.0 billion) (2006: US$3.7 billion (£1.9 billion)). The Group capital position statement for life assurance businesses is set out in note D5.

I6: Subsidiary undertakings continued

iii Acquisition and disposal of subsidiaries
2006
In December 2005, the Company announced its intention to acquire the minority interests in Egg representing approximately 21.7 per cent of the existing issued share capital of Egg. The whole of the minority interests were acquired in the first half of 2006. Under the terms of the offer, Egg shareholders received 0.2237 new ordinary shares in the Company for each Egg share resulting in the issue of 41.6 million new shares in the Company.

The Company accounted for the purchase of minority interests using the economic entity method. Accordingly, £167 million was charged to retained earnings representing the difference between the consideration paid (including expenses) of £251 million and the share of net assets acquired of £84 million.

2007
On 29 January 2007, the Company announced that it had entered into a binding agreement to sell Egg Banking plc to Citi. On 1 May 2007, the Company completed the sale. Additional details regarding the disposal are set out in note J.

On 9 November 2007, the Company announced that it had completed the sale of PPM Capital, its direct private equity business.

iv PAC with-profits fund acquisition
The PAC with-profits fund acquired a number of venture capital holdings through PPM Capital and M&G in which the Group was deemed to have a controlling interest, in aggregate with, if applicable, other holdings held by, for example, the PSPS. Following the disposal of PPM Capital by the Group in November 2007, the Group is no longer deemed to have a controlling interest in investments managed by PPM capital and consequently any subsequent investments have not been consolidated into the Group and the investments previously consolidated ceased to be consolidated from the date of disposal of PPM Capital. There were two venture investment acquisitions in 2007 and three in 2006. These were acquisitions for:

2007
— 71 per cent of the voting equity interest of Orizon AG, an employment hiring agency, in March 2007; and
— 78 per cent of the voting equity interest of Red Funnel, a ferry company, in June 2007.

Orizon AG was managed by PPM Capital while Red Funnel is managed by M&G.

2006
— 53 per cent of the voting equity interests of Histoire D'or, a jewellery retail company, in April 2006;
— 51 per cent of the voting equity interests of Azzuri Communications, a business IT service company, in June 2006; and
— 60 per cent of the voting equity interests of Paramount plc, a restaurant company, in September 2006.

All of these venture investments were managed by PPM Capital.

These acquisitions are considered individually immaterial and therefore all information relating to ventures acquisitions has been presented in aggregate throughout this note. Due to the nature of venture investments, it is not practicable to provide certain information for those acquisitions, including the pro forma Group revenue and consolidated net profit information as if the acquisitions had occurred at the beginning of the year, and the carrying amounts, in accordance with IFRS, of each class of the acquirees' assets, liabilities, and contingent liabilities immediately before acquisition.

The results of the aggregated ventures acquisitions in 2007 and 2006 have been included in the consolidated financial statements of the Group commencing on the respective dates of acquisition and contributed a loss of £8.3 million (2006: loss of £7.7 million) to earnings within the income statement, which is also reflected as part of the change in unallocated surplus of the with-profits fund. The results of Orizon AG included in the loss of £8.3 million above was from the date of its acquisition to November 2007 when it ceased to be consolidated.

I6: Subsidiary undertakings continued

The table below identifies the net assets of these acquisitions and minor business purchases by existing venture holdings. This reconciles the net assets to the consideration paid in 2007 and 2006:

	2007 £m Fair value on acquisition	2006 £m Fair value on acquisition
Cash and cash equivalents	20	18
Other current assets	26	31
Property, plant and equipment	38	45
Intangible assets other than goodwill	1	139
Other non-current assets	3	100
Less liabilities, including current liabilities and borrowings	(304)	(581)
	(216)	(248)
Less minority interests	–	–
Net assets acquired	(216)	(248)
Goodwill	313	336
Cash consideration	97	88

Aggregate goodwill of £313 million (2006: £336 million) has been 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 in 2007.

v PAC with-profits fund disposals and deconsolidation of venture fund investments

2007

In November 2007, the Group disposed of PPM Capital, following which the Group no longer has a controlling interest in venture fund investment subsidiaries managed by PPM Capital and consequently has ceased to consolidate these investments. The cessation of control arises from the Group's interest in venture fund investments being held either through partnership agreements, with the Group a limited partner, or, where there is a direct holding, an asset management agreement being in place, both of which result in the Group only being able to exert control under exceptional circumstances.

As a result 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 from the date of disposal of PPM Capital.

Goodwill and other intangible assets, net of amortisation, relating to these investments of £916 million at the date of disposal of PPM Capital, were derecognised accordingly.

2006

In 2006, Upperpoint Distribution Limited, Taverner Hotel Group Pty Ltd, Orefi, Aperio Group Pty Ltd and BST Safety Textiles Luxembourg S.a.r.l., all venture subsidiaries of the PAC with-profits fund, were disposed of for cash consideration of £133 million. Goodwill of £46 million and cash and cash equivalents of £19 million were disposed of. Note that, in addition, one venture subsidiary was classified as held for sale at 31 December 2006 (see note H9).

I7: 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.

	2007 £m	2006 £m
Future minimum lease payments for non-cancellable operating leases fall due during the following periods:		
Not later than 1 year	38	53
Later than 1 year and not later than 5 years	126	142
Later than 5 years	111	160

The total minimum future sublease rentals to be received on non-cancellable operating leases for land and buildings for the year ended 31 December 2007 was £0.4 million (2006: £1 million).

Minimum lease rental payments for the year ended 31 December 2007 of £50 million (2006: £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 2007, the aggregate amount of contractual obligations to purchase and develop investment properties amounted to £64 million (2006: £146 million). The vast majority of these commitments have been made by the PAC with-profits fund.

I8: Cash flows
Structural borrowings of shareholder-financed operations comprise core debt of the holding company and central finance subsidiaries, Jackson surplus notes and, prior to disposal, Egg debenture loans. 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. 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 and, prior to deconsolidation, venture fund investment subsidiaries, are also included within cash flows from operating activities.

Cash flows relating to discontinued operations, as detailed in note J1, are inflows of £157 million and £184 million for the period of ownership in 2007 and 2006 respectively. All of these relate to cash flows from operating activities except for an outflow of £33 million in 2006 which relates to financing activities.

J: Discontinued banking operations

Discontinued banking operations relate entirely to UK banking operations following the sale on 1 May 2007 of Egg Banking plc to Citi. Consideration payable to the Company was, net of expenses, £527 million cash. The reduction from the £575 million consideration noted in the original announcement primarily reflected Egg's post-tax operating loss of £49 million for the period from 1 January 2007 to the date of sale. Cash and cash equivalents disposed of were £1,065 million. Accordingly, the cash outflow for the Group arising from the disposal of Egg, as shown in the consolidated cash flow statement, was £538 million. Prior to the disposal the Group undertook banking operations almost wholly through its subsidiary, Egg Banking plc. Financial information in respect of Egg Banking plc, together with amounts in respect of its former parent Egg plc and its associate IFonline, have been included in this note. Note I6 shows details of the purchase of the minority interests in Egg plc in 2006.

The Group has presented the income statement and balance sheet for discontinued banking operations in a format that demonstrates the characteristics and principal operations specific to a bank. The format is different from that of the Group consolidated income statement and balance sheet; however, total profit (loss) for the year and net assets remain the same. To understand how the amounts presented from discontinued banking operations are consolidated in the Group financial statements, refer to the primary segmental information for the income statement in note F1 and the primary segmental information for the balance sheet in note B6.

J1: Income statement for discontinued banking operations

The profit (loss) included in the income statement in respect of discontinued banking operations for the period of ownership is as follows:

	Note	2007 £m	2006 £m
Interest income		261	783
Interest expense		(148)	(453)
Net interest income		**113**	**330**
Fee and commission income		41	153
Fee and commission expense		(8)	(23)
Other operating income		–	8
Operating income		**146**	**468**
General administrative expenses		(56)	(192)
Impairment losses on loans and cash advances to customers	J5	(149)	(384)
Other operating expenses		(9)	(49)
Operating loss based on longer-term investment returns		**(68)**	**(157)**
Short-term fluctuations in investment returns		–	7
Profit on sale of Egg Banking plc		290	–
Profit (loss) before tax		**222**	**(150)**
Tax on operating loss based on longer-term investment returns		19	47
Tax on short-term fluctuations in investment returns		–	(2)
Tax on profit on sale of Egg Banking plc		0	–
Tax attributable to shareholders' profits		19	45
Profit (loss) for the year		**241**	**(105)**

The interest income on financial assets not at fair value through profit and loss for the period of ownership in 2007 was £241 million (2006: £769 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 (2006: £428 million).

Fee and commission income includes £27 million (2006: £83 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 includes fee expenses relating to financial liabilities held at amortised cost of £4 million (2006: £13 million) which related to treasury fees.

Of the profit (loss) for the period of ownership in 2007 and 2006, a loss of £nil million and a loss of £2 million, respectively, are attributable to minority interests in Egg.

J2: Balance sheet for discontinued banking operations

Assets, liabilities and shareholders' funds included in the Group consolidated balance sheet as at 31 December 2006 in respect of discontinued banking operations are as follows:

	2006 £m
Assets	
Cash and balances with central banks	6
Loans and advances to banks	903
Loans and advances to customers	6,193
Investment securities	1,976
Derivative financial instruments	78
Other assets	342
Total assets	9,498
Liabilities	
Deposits by banks	2,220
Customer accounts	5,554
Debt securities issued	599
Derivative financial instruments	154
Other liabilities	228
Subordinated liabilities	451
Total liabilities	9,206
Equity	
Shareholders' equity	292
Total equity and liabilities	9,498

J3: Risk management overview

Through Egg the Group offered banking and credit card products and intermediated services. Through its normal operations, Egg was exposed to a number of risks, the most significant of which was credit, operational, liquidity, market and currency risk. The overall responsibility for risk management and the risk appetite of Egg was set by the Egg Board and responsibility for managing these risks resided with the Egg executive committee. The exposure to specific risks was monitored by the Egg executive committee through separate committees: the retail credit committee was responsible for retail credit risk, the wholesale credit committee was responsible for wholesale credit risk, the operational risk committee was responsible for operational risk and the asset and liability committee (ALCO) was responsible for liquidity, market and currency risk.

Egg used financial instruments including derivatives for the purpose of supporting the strategic and operational business activities and to reduce and eliminate the risk of losses arising from changes in interest rates and foreign exchange rates.

Surplus retail and wholesale liabilities were invested in debt securities, including certificates of deposits, government gilts and other high investment grade assets.

J4: Maturities of assets and liabilities and liquidity risk

Liquidity risk was defined for Egg as not having sufficient financial resources available to meet its obligations as they fell due or if such resources could only be secured at excessive cost. Egg used various methods including predictions of daily cash positions to monitor and manage liquidity risk. Maturity mismatches between lending and funding were managed within internal risk policy limits. It ensured that it held sufficient assets, which were immediately realisable into cash without significant exposure to market risk or costs, to cover a realistic estimate of retail funds that could be withdrawn. While a significant proportion of retail savings balances were on instant access terms, in practice the majority of such funds represented a relatively stable and consistent funding base for Egg.

The matching and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the management of a bank. It is unusual for banks ever to be completely matched since business transacted is often of uncertain terms and of different types.

J4: Maturities of assets and liabilities and liquidity risk continued

The following table analyses the assets and liabilities of Egg into relevant maturity groupings based on the remaining period at 31 December 2006 to the contractual maturity date.

	At 31 December 2006 £m					
	Up to 1 month	From 1 month to 3 months	From 3 months to 1 year	From 1 year to 5 years	5 years and over	Total
Assets						
Cash and balances with central banks	6	–	–	–	–	6
Loans and advances to banks	876	–	–	2	25	903
Loans and advances to customers	1	2,725	42	1,338	2,087	6,193
Investment securities	466	696	176	266	372	1,976
Derivative financial instruments	61	–	17	–	–	78
Other assets	68	159	41	74	–	342
Total assets	1,478	3,580	276	1,680	2,484	9,498
Liabilities						
Deposits by banks	18	–	516	1,686	–	2,220
Customer accounts	5,427	3	68	56	–	5,554
Debt securities issued	–	–	553	46	–	599
Derivative financial instruments	56	–	–	98	–	154
Other liabilities	117	68	43	–	–	228
Subordinated liabilities	–	–	–	–	451	451
Total liabilities	5,618	71	1,180	1,886	451	9,206
Net liquidity gap	(4,140)	3,509	(904)	(206)	2,033	292

J5: Losses on loans and advances

The following table details the movements in the allowance for losses on loans and advances to customers held by Egg for the period of ownership in 2007 and 2006. The aggregate loss on loans at the end of the year and the charge during the period of ownership have been included in the consolidated financial statements.

	2007 £m	2006 £m
Balance at the beginning of the year	518	335
Amounts written off	(141)	(201)
New and additional provisions	149	384
Balance at time of disposal of Egg Banking plc	(526)	–
Balance at the end of the year	–	518

Impairment losses on loans and advances to customers

Where financial assets are carried at amortised cost, the Group measures the amount of the impairment loss by comparing the carrying amount of the asset with the present value of its estimated cash flows.

Impairment losses on loans and advances to customers of Egg were based on an actual loss model and all impairments were only being held against debt that had objective evidence of either an individual or a collective impairment. For individually assessed impaired assets this was established by the delinquency state of debt based on the number of payments they are in arrears. For collectively assessed impaired assets this assessment was based on the level of accounts operating out of agreed terms showing other objective evidence of impairment from which behaviour analysis impairment is projected by using Markov probability matrices.

J6: Market risk

Interest rate risk

The primary market risk to which Egg was exposed was interest rate risk. Interest rate risk arose in Egg as a result of fixed rate, variable rate and non-interest bearing assets and liabilities. Exposure to interest rate movements arose when there was a mismatch between interest rate sensitive assets and liabilities.

The composition of interest rate risk was closely monitored and managed on a day-to-day basis by the treasury function where professional expertise and systems existed to control it. This was primarily done via asset and liability models that looked at the sensitivity of earnings to movements in interest rates to measure overall exposure which could then be hedged in accordance with the policy limits set by the ALCO.

For the purpose of reducing interest rate risk, Egg used a number of derivative instruments such as interest rate swaps and forward rate agreements (see note G3).

Financial assets and liabilities not held at fair value through profit and loss and the weighted average effective interest rate for those balances at 31 December 2006 are provided below:

	2006	
	£m	%
Assets		
Debt securities available-for-sale*	1,935	5.3
Loans and receivables	7,096	9.0
	9,031	
Liabilities		
Banking customer accounts	5,554	4.9
Core structural borrowings of shareholder-financed operations	451	6.2
Operational borrowings attributable to shareholder-financed operations	2,819	5.4
	8,824	

* Egg also classified £41 million of debt securities as fair value through profit and loss.

See note G2 for further information on interest rate risk.

Currency risk

The risks arising from assets and liabilities denominated in foreign currencies were managed by a separate treasury function within Egg and within agreed limits set by the ALCO. During the year, cash flows generated by the foreign currency assets and liabilities were hedged by using derivative contracts to manage exposure to exchange rate fluctuations.

At 31 December 2006, Egg held £357 million of assets and £1,751 million of liabilities with foreign currency exposure.

J7: Credit risk

Egg took on exposure to credit risk, which was the risk that a counterparty would be unable to pay amounts in full when due. To limit this risk, Egg placed limits on the amount of risk accepted in relation to a particular borrower, groups of borrowers, and to particular geographical segments. The acceptable risk levels were monitored regularly and reviewed where appropriate.

The following table identifies the geographical concentrations of credit risk, stated in terms of total assets and off-balance sheet items, held by Egg at 31 December 2006:

	2006 £m
UK	18,132
Rest of Europe	244
Other	243
Total*	18,619

* This includes £9,475 million of off-balance sheet items, which mainly relate to unutilised credit limits on credit cards.

J7: Credit risk continued

The following is a breakdown of the credit risk borne by Egg for financial assets and off-balance sheet items at 31 December 2006:

	2006 £m
Loans and advances to banks	903
Investment securities	1,970
Loans and advances to customers	6,711
Allowances for impairment losses on loans and advances to customers	(518)
Fair value of derivative assets	78
Off-balance sheet items (including unutilised credit limits on credit cards)	9,475
Total credit risk net of allowances and provisions	18,619

At 31 December 2006, Egg had certain credit-related commitments in the form of unused credit limits on credit cards of £9,458 million and pre-approved but unused borrowing limits on mortgages and personal loans of £8 million and £9 million respectively which are included in off-balance sheet items above. Egg was potentially exposed to a loss totalling these amounts, but it was unlikely that such a loss would arise as these credit facilities were granted only on the basis of the customers having achieved certain credit standards. Additionally, it was unlikely, should all these customers have utilised their credit or borrowing limits, that all of them would default on their debt entirely.

Egg held significant concentrations of credit risk with other financial institutions. At 31 December 2006, this was estimated at £8.7 billion of which £3.9 billion related to derivative financial instruments and £1.8 billion to credit default swaps. Egg also had significant credit exposure in asset-backed security products which totalled approximately £403 million at 31 December 2006. With regard to loans and advances to customers, Egg had significant concentrations of credit risk in respect of its unsecured lending on credit cards, personal loans and mortgage lending secured on property in the UK.

Assets pledged as collateral and securitisation

Egg entered into securities lending arrangements, including repurchase agreements and over-the-counter derivative transactions, as part of normal operating activities. Assets were pledged as collateral to support these activities. Collateral in respect of repurchase agreements was £nil at 31 December 2006. Collateral in respect of over-the-counter derivative transactions was £29.3 million at 31 December 2006. See note G4 where amounts relating to Egg have been included in the disclosure of these transactions on a Group basis.

Egg issued debt securities in order to finance certain portfolios of loans and investment assets. These obligations were secured on Egg's assets. The securitised assets and the related liabilities were presented gross within the relevant headings in the balance sheet under the 'gross presentation' method.

For further information on Egg's securitisation of credit card receivables, see note G4.

J8: Capital position

At 31 December 2006 Egg had a capital surplus of £210 million over required regulatory capital levels.