Risk management

Philosophy, principles and objectives

Philosophy

As a provider of financial services, including insurance, the Group's business is the managed acceptance of risk. Prudential believes that effective risk management capabilities are a key competitive advantage. A strategic risk, capital and value management framework and risk management culture has been developed to enhance the Group's embedded and franchise value.

Principles

Risk is defined as the uncertainty that Prudential faces in successfully implementing its strategies and objectives. This includes all internal or external events, acts or omissions that have the potential to threaten the success and survival of Prudential.

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 policy is to proactively identify, assess, control, and monitor risk. This forms an essential element of delivering the Group's performance ambition. In so doing, material risks will only be retained where this is consistent with Prudential's risk appetite framework, i.e.:

- The retention of the risk contributes to value creation.
- The Group is able to withstand the impact of an adverse outcome.
- The Group has the necessary capabilities, expertise, processes and controls to manage the risk.

Objectives

The Group has five objectives for risk and capital management:

a *Framework* Design, implement and maintain a consistent risk management framework and policies spanning: economic, regulatory and rating agency capital management; risk appetite; and risk-adjusted profitability (RAP).
b *Monitoring* Establish a 'no surprises' risk management culture by identifying the risk landscape, assessing and monitoring risk exposures and understanding change drivers.
c *Control* Implement risk mitigation strategies and remedial actions where exposures are deemed 'inappropriate' and manage the response to extreme events.
d *Communication* Communicate the Group risk, capital and profitability position to internal and external stakeholders and rating agencies.
e *Culture* Foster a risk management culture, providing quality assurance and facilitating the sharing of best practice risk measurement and management across the Group and industry.

Categorisation model

A common risk language is used across the Group, which allows meaningful comparisons to be made between different business units. Risks are broadly categorised as shown below.

Governance

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.

Risk categorisation

Category	Risk type	Definition
Financial risks	Market risk	The risk that arises from adverse changes in the value of, or income from, assets and changes in interest rates or exchange rates.
	Credit risk	The risk of loss if another party fails to perform its obligations, or fails to perform them in a timely fashion.
	Insurance risk	The inherent uncertainty as to the occurrence, amount and timing of insurance liabilities. This includes adverse mortality, morbidity and persistency experience.
	Liquidity risk	The risk that a business, though solvent on a balance sheet basis, either does not have the financial resources to meet its obligations as they fall due or can secure them only at excessive cost.
Non-financial risks	Operational risk	The risk of direct or indirect loss resulting from inadequate or failed internal processes, people or systems, or from external events. This includes legal and regulatory compliance risk.
	Business environment risk	Exposure to forces in the external environment that could significantly change the fundamentals that drive the business's overall objectives and strategy.
	Strategic risk	Ineffective, inefficient or inadequate senior management processes for the development and implementation of business strategy in relation to the business environment and the Group's capabilities.

For joint ventures where the Group does not control management, the business unit party to the arrangement must satisfy itself that suitable governance and risk management arrangements are in place to protect the Group's interests and comply with the Group's requirements in respect of any operations it performs in support of the joint venture's activities.

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 (see diagram below).

Risk management

Primary responsibility for strategy, performance management and risk control lies with the Prudential plc Board of directors (the Board), the Group Chief Executive and the chief executives of each business unit. Additionally, the Board has delegated responsibility to the Approvals Committee to approve actions which could significantly change the risk profile of any business, capital commitments and divestments within defined materiality thresholds, and certain legal matters involving trademarks, contracts, material guarantees and specific interactions with third parties.

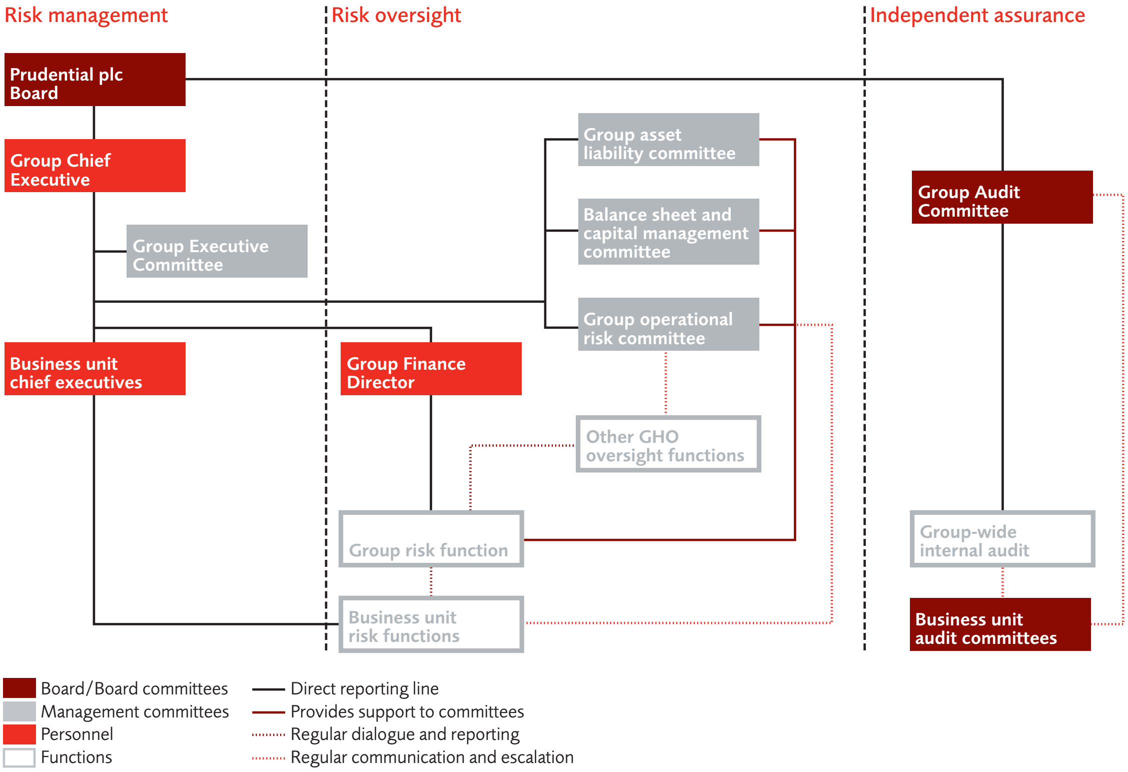
Where appropriate, more detailed policies and procedures have been developed at Group and/or business unit levels. These include Group-wide mandatory policies on certain operational risks, including: health, safety, fraud, money laundering, bribery, business continuity, information security and operational security. Additional guidelines are provided for some aspects of actuarial and finance activity.

Board: The Board has overall responsibility for the system of internal control and risk management. It approves the overall framework for managing the risks faced by the Group and provides strategic direction on the amount and type of risk that the Group is prepared to accept.

Group executive management: The Group Chief Executive has overall responsibility for the risks facing the Group. The Group Chief Executive recommends to the Board the amount and type of risk that the Group is prepared to accept, and recommends risk management strategies as well as an overall framework for managing the risks faced by the Group with support from the Group Executive Committee, Group Finance Director and Group level risk committees. The Group Chief Executive provides regular updates to the Board on the risk position and risk policy.

Business unit management: Business unit chief executives are accountable for the implementation and operation of appropriate business unit risk frameworks and for ensuring compliance with the policy and minimum standards set by the Group. Business units must establish suitable governance structures that are based on the concept of 'three lines of defence', tailored as appropriate to the scale and complexity of the business unit. As the first line of defence, business unit management is responsible for identifying and managing business unit risks and providing regular risk reporting to the Group.

Risk governance framework



Risk management
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Risk oversight
Risk management oversight is provided by Group-level risk committees, the 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.

Group-level risk committees
Group Asset Liability Committee (Group ALCo): The Group ALCo is responsible for oversight of financial risks (market, credit, liquidity and insurance risks) across the Group. It is chaired by the Group Finance Director and its membership includes senior business unit and Group executives (chief actuaries, principal asset liability management officers and chief investment officers) who are involved in the management of the aforementioned risks. Group ALCo meetings are held on a monthly basis.
Balance Sheet and Capital Management Committee (BSCMC): The BSCMC is responsible for managing the balance sheets of Prudential plc and oversight of the Prudential Capital business unit. It is chaired by the Group Finance Director and its membership includes senior representatives from GHO, M&G and Prudential Capital. BSCMC meetings are held on a monthly basis.
Group Operational Risk Committee (GORC): The GORC is responsible for the oversight of non-financial risks (operational, business environment and strategic risks) across the Group. Responsibilities include monitoring operational risk and related policies and processes as they are applied throughout the Group. It is chaired by the Group Finance Director and its membership includes senior representatives of the Group and business unit risk functions. GORC meetings are held on a quarterly basis.

Group Risk
Group Risk's mandate is to establish and embed a strategic risk, capital and value management framework and risk management culture, consistent with Prudential's risk appetite, that protects and enhances the Group's embedded and franchise value.

Group Risk is responsible for the continued enhancement and evolution of the Group Risk Framework; provides functional leadership to the business units for the oversight of risk management across the Group; and acts as secretariat to the Group ALCo and GORC.

Group Risk also has certain finance and actuarial responsibilities related to Group regulatory and rating agency capital requirements, development of actuarial and financial reporting requirements and the RAP value management framework.

Independent assurance
Group Audit Committee: The Group Audit Committee provides independent assurance to the Board on the effectiveness of the Group's system of internal controls and risk management. The Group Audit Committee reviews the Group's risk management framework, and regular risk reports. The Group Audit Committee is supported by Group-wide Internal Audit.
Group-wide Internal Audit (GwIA): The GwIA function independently assures the effective operation of the Group's risk management framework. This involves the validation of methodology application, policy compliance and control adequacy. The GwIA Director reports all audit-related matters to the Group Audit Committee (and business unit audit committees where appropriate) and reports for management purposes (but not audit-related matters) to the Group Chief Executive.

Risk appetite
The Group risk appetite framework sets out the Group's overall tolerance to risk exposures, approach to risk and return optimisation and management of risk. The Board and Group Executive Committee have set up Group-level risk appetite statements concerning the key risk exposures faced by the Group. 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).

Limits
Aggregate risk limits are defined in terms of earnings volatility and capital requirements:

a *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 are European Embedded Value (EEV) operating profit and International Financial Reporting Standards (IFRS) operating profit.

b *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.

Earnings measures (flow)

	EEV	IFRS
Business as usual	**Maintain target EEV operating profit**	**Maintain target IFRS operating profit**
Earnings stress	**No large unexpected falls in EEV operating profit**	**No large unexpected falls in IFRS operating profit**

Capital measures (stock)

	Economic	Regulatory (local/IGD)
Business as usual	**Maintain target level of capitalisation** **Individual tail events should not significantly reduce financial resources**	**Planned IGD coverage**
Capital stress	**Remain above minimum capitalisation**	**Meet Group solvency requirement and hold sufficient resources to pay dividends and fund new business**

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

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.

Usage by business units

Risk appetite is part of the annual business planning cycle. The risk profile of the Group is monitored against the agreed limits throughout the year by Group Risk. Using submissions from business units, Group Risk calculates the Group's position (allowing for diversification effects between business units) relative to the limits implied by the risk appetite statements.

In order to determine its risk position, each business unit calculates the impacts (on earnings and capital measures) of a shock to market, credit, insurance and operational risk exposures.

A two-tier approach is used to apply the limits at business unit level. Firstly, indicative business unit risk limits are calculated; these ensure that, if each business unit keeps within its limits, the Group risk position would be within the Group limits. Secondly, the impact on the risk position is considered as part of Group Risk's scrutiny of large transactions or departures from plan proposed by individual business units.

Any potential breaches of the risk limits implied by a business unit plan will necessitate a dialogue process between GHO and the business units. Group limits may not be breached if, for example, limits in other business units are not fully utilised, or the diversification effect at Group level of a particular risk with other business units means that the Group limit is not breached. Ultimately, authorisation to breach Group limits would require Group Executive Committee approval.

Risk management process

Risk mitigation

The Group expects active management of its actual risk profile against its tolerance of risk. Primary responsibility for identifying and implementing controls and mitigation strategies rests with the business units. Group Risk provides oversight and advice.

Risk registers are maintained that include details of the controls and mitigating actions being employed for identified risks. The effectiveness of controls and progress with actions are routinely assessed. Any mitigation strategies involving large transactions (e.g. a material derivative transaction) would be subject to scrutiny at Group level before implementation.

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.

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

Asset liability management

Prudential manages its assets and liabilities locally, in accordance with local regulatory requirements and reflecting the different types of liabilities of each business unit. Stochastic asset-liability modelling is carried out locally by the business units to perform dynamic solvency testing and assess economic capital requirements. Reserve adequacy testing under a range of scenarios is also carried out, including scenarios prescribed by local regulatory bodies.

The investment strategy for assets held to back liabilities is set locally by business units, taking into account the nature, term and currency of the liabilities, and any local regulatory requirements. The main principles are as follows:

— For liabilities that are sensitive to interest rate movements (in particular, UK non-profit annuities and Jackson fixed annuities), cash flow analysis is used to construct a portfolio of fixed income securities whose value changes in line with the value of liabilities when interest rates change;

— for participating business (in particular, the UK with-profits fund), stochastic asset-liability modelling is used to derive a strategic asset allocation and policyholder bonus strategy that (based on the model assumptions) will optimise policyholder and shareholder returns, while maintaining financial strength.

  The bonus strategy on participating business is an integral part of the asset-liability management approach for participating business; and

— for unit-linked business, the assets held to cover policyholder unit accounts are invested as per the stated investment strategy or benchmark index given in the product marketing literature. Assets in respect of non-unit reserves (e.g. sterling reserves) are invested in fixed income securities (using a cash flow matching analysis).

Derivative hedging strategies are also used on a controlled basis across the Group to manage exposure to market risks. Surplus assets held centrally are predominantly invested in short-term fixed income securities. The Group's central treasury function actively manages the surplus assets to maximise returns, subject to maintaining an acceptable degree of liquidity.

Risk reporting

Group Risk and other GHO oversight functions have individually defined and publicised frameworks, escalation criteria and processes for the timely reporting of risks and incidents by business units. As appropriate, these risks and incidents are escalated to the various Group-level oversight and risk committees and the Board.

Internal business unit routine reporting requirements vary according to the nature of the business. Each business unit is responsible for ensuring that its risk reporting framework meets both the needs of the business unit (for example reporting to the business unit risk and audit committees) and the minimum standards set by the Group (for example, to meet Group-level reporting requirements).

Business units review their risks as part of the annual preparation of their business plans, and review opportunities and risks to business objectives regularly with Group executive management. Group Risk reviews, and reports to Group executive management, on the impact of large transactions or divergences from business plan.

The Group Executive Committee and Board are provided with regular updates on the Group's economic capital position, overall position against risk limits and RAP. They also receive the annual financial condition reports prepared by the Group's insurance operations.

Economic capital

Economic capital provides a realistic and consistent view of Prudential's capital requirements across the Group, allowing for diversification benefits. Economic capital provides valuable insights into the risk profile of the Group and is an integral part of the Group's risk management framework.

The Group distinguishes between two distinct types of 'economic capital' approaches:

— *Group economic capital* Prudential's Group economic capital is calculated using an integrated model of Group-wide risk, capturing dependencies and diversification benefits between different business units and risk categories. The capital requirement is determined based on a multi-year projection, thus taking into account the long-term nature of Prudential's liabilities. 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.

— *One-year Value at Risk Capital (1yr VaR Capital)* 1yr VaR Capital is defined as the capital required to withstand a maximum loss over a time period of one year, consistent with a confidence level of 99.5 per cent. This measure was developed internally as part of Prudential's RAP approach to risk/return optimisation within the Group risk appetite framework. This measure captures the risk arising from individual risk types, and generally allows for diversification by using a correlation matrix approach. The methodology is continually being developed and improved. In addition to its risk management applications, the 1yr 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.

These measures provide a consistent basis for comparing the risk profiles and capital requirements of different business units. The Group economic capital position and risk profile is reported to the Board annually, with more frequent updates on an ad hoc basis. Group Risk is responsible for developing and maintaining the economic capital models, and for calculating the Group economic capital position.

Methodology

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 for in-force 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.

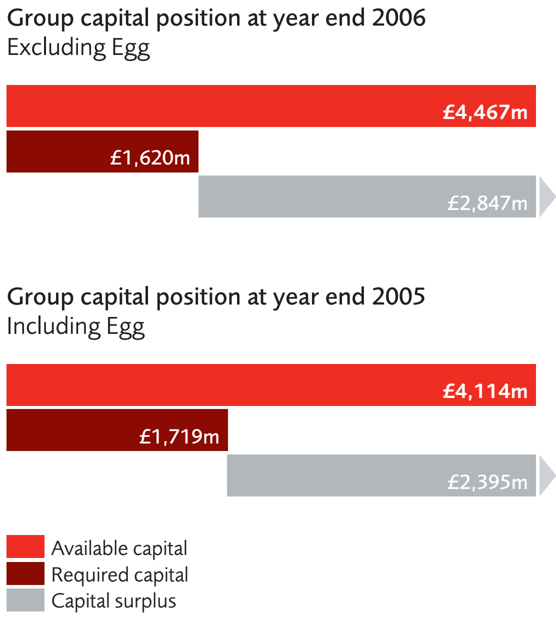
Results

As at 31 December 2006, the Group economic capital requirement was £1.6 billion, compared to available capital resources of £4.5 billion. The Group economic capital requirement quoted is after allowance for diversification benefits between risk types and business units, and inclusive of the local regulatory capital requirements at the business unit level. The economic capital requirement is calculated for in-force liabilities only, excluding the impact of future new business and dividend distributions.

The Group position at the end of 2006 shows a surplus position of £2.8 billion, representing an improvement of £0.5 billion from last year. Most of this improvement comes from the sale of Egg, which has reduced the Group's exposure to credit risk. Note that the economic capital surplus quoted above excludes any surplus in respect of the Group's participating with-profits funds. For Group economic capital, it is assumed that any free assets in participating funds are ring-fenced to support the relevant fund (and excluded from the Group's economic surplus). Any capital injections required by participating funds (on top of the ring-fenced free assets) are captured in the Group economic capital requirement calculation. For year end 2006, none of the Group's participating funds required additional economic capital on top of the ring-fenced free assets.

The allocation of economic capital (diversified) by risk type is shown below. The largest risk exposure continues to be credit risk, which reflects the relative size of the exposure in Jackson and Prudential UK. However, credit risk has reduced due to the sale of Egg and Jackson's maturing fixed annuity business. The market risk exposure mainly reflects equity risk in Jackson and interest rate risk in Taiwan. An increasingly significant component of the underwriting risk is attributable to longevity risk, which has increased due to the growth in annuity business being written in the UK shareholder fund.

Group economic capital position (AA basis) £m



Risk management
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Scenario testing

The impact of a range of deterministic 'shock' scenarios is tested using the Group economic capital model. The purpose is to assess the resilience of the Group's economic solvency position to a range of key threat scenarios.

Scenarios tested include economic capital scenarios relating to stable, falling and rising interest rates, as well as scenarios relating to high oil prices, lower consumption and US dollar depreciation. In addition, scenarios proposed by the FSA's Financial Risk Outlook are tested. These scenarios have included a credit and house price crisis, global risks reappraisal, and a pandemic.

The impact of each scenario was tested by analysing the projected Group cash flow balances over 25 years, assuming in the model that the initial capital held by the Group is zero and the initial capital held in each business unit is equal to the local regulatory capital requirement. The results of the analysis showed that the projected net cash flow balance to the Group remains positive in all future years under each scenario tested.

Business unit local economic capital

Business units must also monitor their own economic capital requirements locally on a 'stand alone' basis (without allowance for diversification effects with the rest of the Group). The business unit economic capital assessments allow management to put the local regulatory capital requirements into an economic context. These assessments must be reported annually, and included in the business unit financial condition reports.

Market risk

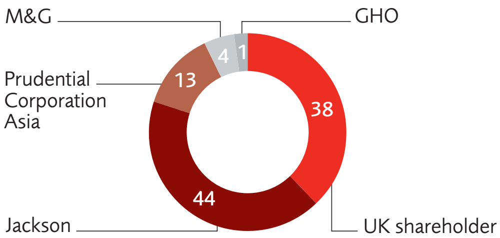
Market risk is the risk that arises from adverse changes in the value of, or income from, assets and changes in interest rates or exchange rates. Prudential's businesses are inherently subject to market fluctuations and general economic conditions.

In the UK, this is because a significant part of Prudential's shareholders' profit is related to bonuses for policyholders declared on its with-profits products, which are broadly based on historic and current rates of return on equity, real estate and fixed income securities, as well as Prudential's expectations of future investment returns.

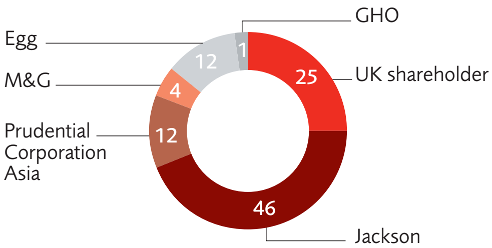
In the US, fluctuations in interest rates can affect results from Jackson, which has a significant spread-based business and where the majority of investments are in fixed-income securities. The spread is the difference between the rate of return Jackson is able to earn on the assets backing the policyholders' liabilities and the amounts that are credited to policyholders in the form of benefit increases, subject to minimum crediting rates. Jackson also writes a significant amount of variable annuities that offer capital or income protection guarantees. Any cost of the guarantees that remain unhedged will affect the Company's results.

Economic capital requirement split by business unit (AA basis) %

Risk exposure at year end 2006
Excluding Egg

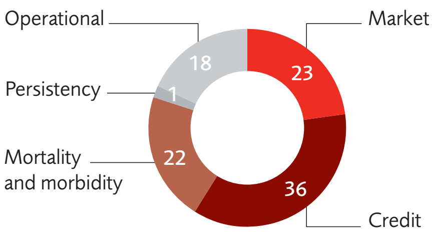


Risk exposure at year end 2005
Including Egg

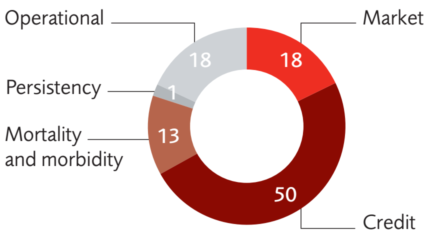


Economic capital requirement split by risk type (AA basis) %

Risk exposure at year end 2006
Excluding Egg



Risk exposure at year end 2005
Including Egg



For some non-linked investment products, in particular those written in some of the Group's Asian operations, it may not be possible to hold assets which will provide cash flows to exactly match those relating to policyholder liabilities. This is particularly true in those countries where bond markets are not developed and in certain markets, such as Taiwan, where regulated surrender values are set with reference to the interest rate environment prevailing at time of policy issue. This results in a mismatch due to the duration and uncertainty of the liability cash flows and the lack of sufficient assets of a suitable duration. This residual asset-liability mismatch risk can be managed but not eliminated. Where interest rates for these markets remain lower than those implied by surrender values over a sustained period this could have an adverse impact on the Group's reported profit.

For each of the major components of market risk, described in more detail below, Prudential has put in place policies and procedures to set out how each risk should be managed and monitored, and the approach to setting an appropriate risk appetite.

Foreign exchange risk

Prudential currently operates in the UK, the US, 13 countries in Asia and Europe. Due to the geographical diversity of Prudential's businesses, it is subject to the risk of exchange rate fluctuations. Prudential's international operations in the US and Asia, which represent a significant proportion of operating profit and shareholders' funds, generally write policies and invest in assets denominated in local currency. Although this practice limits the effect of exchange rate fluctuations on local operating results, it can lead to significant fluctuations in Prudential's consolidated financial statements upon translation of results into pounds sterling. The currency exposure relating to the translation of reported earnings is not separately managed. Consequently, this could impact on the Group's gearing ratios (defined as debt over debt plus shareholders' funds). The impact of gains or losses on currency translations is recorded as a component within the statement of changes in equity.

Prudential does not generally seek to hedge foreign currency revenues, as these are substantially retained locally to support the growth of the Group's business and meet local regulatory and market requirements. However, where foreign surplus is deemed to be supporting UK capital or shareholders' interests this exposure is hedged if it is deemed optimal from an economic perspective. Currency borrowings and derivatives are used to manage exposures within the limits that have been set.

Interest rate risk

Interest rate risk arises primarily from Prudential's investments in long-term debt and fixed income securities. Interest rate risk also exists in policies that carry investment guarantees on early surrender or at maturity, where claim values can become higher than the value of backing assets when interest rates rise or fall.

The Group manages this risk by adopting close asset-liability matching criteria, to minimise the impact of mismatches between the value of assets and liabilities from interest rate movements. Interest rate risk is also controlled through the use of a variety of derivative instruments, including futures, options and swaps, in order to hedge against unfavourable market movements in interest rates inherent in the underlying assets and liabilities. The impact of exposure to sustained low interest rates is regularly monitored.

Equity risk

The Group is subject to equity price risk due to daily changes in the market values of its equity securities portfolio. The Group's shareholders are exposed to both direct equity shareholdings in its shareholder assets, and indirectly to the impact arising from changes in the value of equities held in policyholders' funds from which management charges or a share of performance are taken, as well as from its interest in the free estate of long-term funds.

At a business unit level, equity price risk is actively managed through the use of derivative instruments, including futures and options, in order to mitigate anticipated unfavourable market movements where this lies outside the risk appetite of the fund concerned. Business units actively model the performance of equities through the use of stochastic models, in particular to understand the impact of equity performance on guarantees, options and bonus rates.

In particular, Jackson actively hedges its exposure to the guarantees arising from its variable annuity business. Where possible, Jackson will seek to find offsetting exposures across its asset and liability portfolios and to conduct its hedging activities on a macro basis, and relies on option-based strategies to address extreme risks. Although the macro approach and the hedging of extreme events are not consistent with the way certain accounting methods test for effectiveness, our view is that the efficiency of execution and the need to hedge on an economic basis outweighs the need to avoid any short-term accounting volatility.

The Group does not have material holdings of unquoted equity securities. In addition, local asset admissibility regulations require that business units hold diversified portfolios of assets, thereby reducing exposure to individual equities.

Credit risk

Credit risk is the risk of loss if another party fails to meet its obligations, or fails to perform them in a timely manner. Credit risk is Prudential's most significant financial risk, and it is actively monitored by business units via business unit investment committees and ALCos.

In addition to business unit operational limits on credit risk (requiring business units to implement local credit risk policies), Prudential's management of credit risk includes monitoring exposures at Group level. Large individual counterparty exposures are aggregated and monitored on a quarterly basis against centrally-set red zone, amber zone and green zone limits. This active monitoring of counterparty exposures, on a consolidated Group level, is undertaken by the Group ALCo.

Financial assets are graded according to current credit ratings issued by the rating agencies. Financial assets are classified within the range of AAA to D ratings, with AAA being the highest possible rating. Typically, around 95 per cent of the Group's assets are rated within the investment grade category (BBB- and higher). The level of financial assets which fall outside the range of the ratings is also monitored on an ongoing basis, and this tends to be less than one per cent of shareholder assets at any given point in time.

Insurance risk

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

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

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

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

Liquidity risk

Liquidity risk is the risk that a business, though solvent on a balance sheet basis, either does not have the financial resources to meet its obligations as they fall due or can secure the resources only at excessive cost.

Business units have their own liquidity policies, which also depend on the maturity of the business, and the available assets in the markets. For Prudential UK, liquidity risk is managed through holding assets at the greater of a specified percentage of total funds managed or a specified multiple of the average peak daily cash flow over the last 12 months. For Jackson, modelling is performed on how quickly their different liabilities could be called, and how quickly they could also liquidate their assets, ensuring that at 30 days, 90 days and one year the cash available exceeds potential obligations.

For Prudential Group, there is a committed corporate credit facility for liquidity.

Non-financial risk

Prudential's Group Risk Framework also covers non-financial risks – operational risk, business environment risk and strategic risk. Prudential processes a large number of complex transactions across numerous and diverse products, and is subject to a number of different legal and regulatory regimes. Prudential outsources several operations, including certain UK processing and IT functions and is thus reliant upon the operational processing performance of its outsourcing partners.

Business units are responsible for the management of the non-financial risks associated with their business. They conduct a formal self-assessment of material operational risks and assess their impact and likelihood. Business units also identify controls available to mitigate the impact and/or likelihood of the identified risk. The quality of the control's design is also assessed.

Quantitative analysis is carried out for operational risks with material and potential direct losses (i.e. excluding opportunity costs and lost revenue). For each risk, the analysis describes the possible manifestations of the risk and the controls against it in each business unit and, on this basis, frequency and severity parameters are assigned to each risk. The effect of operational risk on the Group as a whole is analysed by aggregating the individual risks using a Group operational risk capital model, allowing for the correlations and diversification effects between different risk types and business units.