# Generating value while maintaining an appropriate risk profile

**'We seek to retain only those risks consistent with our risk appetite with the aim of ensuring we deliver on our long-term commitments to our customers and shareholders.'**

**Penny James**
Group Chief Risk Officer


**The Group aims to help customers achieve their long-term financial goals by providing and promoting a range of products and services that meet customer needs, are easy to understand and deliver real value. We recognise that we are implicitly committing to customers that we will maintain a healthy company, and are there to meet our long-term commitments to them.**

From the shareholders' perspective, we generate value by selectively taking exposures to risks that are adequately rewarded and that can be appropriately quantified and managed. The Group's approach is to retain risks where doing so contributes to value creation, the Group is able to withstand the impact of an adverse outcome, and has the necessary capabilities, expertise, processes and controls to manage appropriately the risk.

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

## Principles and objective

Prudential defines 'risk' 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. As such, material risks will be retained only where this is consistent with the Group's risk appetite framework and its philosophy towards risk-taking.

## Risk governance

The organisational structures, reporting relationships, delegation of authority, and roles and responsibilities that Group Head Office and the business units establish to make decisions and control their activities on risk-related matters form the foundation of Prudential's risk governance. Effective risk governance encompasses individuals, Group-wide functions and committees involved in the management of risk.

## Risk framework

The Group's risk framework has been developed to monitor and manage the risk of the business at all levels and is owned by the Board. The aggregate Group exposure to market, credit, insurance, liquidity and operational risks is monitored and managed by the Group Risk function whose responsibility it is to seek to ensure the maintenance of an adequate risk exposure and solvency position from the Group economic, regulatory and ratings perspectives.

Our Group Risk Framework requires that all our businesses and functions establish processes for identifying, evaluating and managing the key risks faced by the Group and is based on the concept of the 'three lines of defence'. These comprise risk-taking and management, risk control and oversight, and independent assurance.

The key risks inherent in the insurance and capital management operations of Prudential's business:

### Risks from our investments

Uncertainty around investment returns can arise through **credit risk** via the potential of defaults, and **market risks** resulting from the volatility of asset values as a result of fluctuations in equity prices, interest rates, foreign exchange and property prices. **Liquidity risk** is also a key area of focus. Regular stress testing is undertaken to ensure the Group is able to generate sufficient cash resources to meet financial obligations as they fall due in business as usual and in stress scenarios.

### Risks from our products

**Insurance risk**
The processes of determining the price of our products and reporting the results of our long-term business operations require us to make a number of assumptions.

In common with other life insurers, the profitability of our businesses depends on a mix of factors including **mortality and morbidity** levels and trends, **persistency**, and claim inflation.

### Risks from our business operations

**Operational risk**
As a group, we are dependent on the successful processing of a large number of transactions, utilising various IT systems and platforms across numerous and diverse products.

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

## Risk mitigation and hedging

We manage our risk profile according to our desired acceptance of risk. To do this, Group Head Office and the business units maintain risk registers that include details of the risks identified and of the controls and mitigating actions used in managing them. Our identified keys risks are set out in the table below.

### Key risks

| Risk type | Risk definition | Risk management and mitigation |
|---|---|---|
| Market risk<br>Equity<br>Investment risk<br>Interest rates<br>Foreign exchange | The risk of loss for our business, or of adverse change in the financial situation, resulting, directly or indirectly, from fluctuations in the level or volatility of market prices of assets and liabilities. | — Market risk policy<br>— Risk appetite statements, limits and triggers in place<br>— Monitoring and oversight of market risks through the reporting of regular management information<br>— Asset Liability Management programmes in place<br>— Use of derivative programmes<br>— Currency hedging of expected business unit remittances |
| Credit risk<br>Counterparty<br>Invested credit | The risk of loss for our business, or of adverse change in the financial situation, resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors in the form of default or other significant credit event (eg downgrade or spread widening). | — Credit risk policy<br>— Risk appetite statements and limits defined on an issuer/counterparty/average credit quality of the portfolio basis<br>— Collateral arrangements in place for derivative transactions<br>— Group Credit Risk Committee oversight of credit and counterparty credit risk and sector and/or name-specific reviews<br>— Close monitoring/restricting of investments that may be of concern |
| Insurance risk<br>Mortality/longevity<br>Morbidity/health<br>Persistency<br>Medical expense inflation risk | The risk of loss for our business, or of adverse change in the value of insurance liabilities, resulting from changes in the level, trend, or volatility of a number of insurance risk drivers. This includes adverse mortality, longevity, morbidity, persistency and claim inflation. | — Insurance and Underwriting risk policies<br>— Risk appetite statements, limits and triggers in place<br>— Longevity, morbidity and persistency assumptions reflect recent experience and expectation of future trends; industry data and expert judgement are used, where appropriate<br>— Reinsurance is used to mitigate longevity and morbidity risks<br>— Morbidity mitigated by appropriate underwriting when policies are issued and claims received<br>— Persistency mitigated through improving quality of sales processes and customer retention initiatives<br>— Medical expense inflation risk mitigated through regular product re-pricing |
| Liquidity risk | The risk of the Group being unable to generate sufficient cash resources to meet financial obligations as they fall due in business as usual and stress scenarios. | — Liquidity risk policy<br>— Risk appetite statements, limits and triggers in place<br>— Monitoring of liquidity risk through regular management information<br>— Regular stress testing<br>— Liquidity contingency plans established and sources identified<br>— Ability to access the money and debt capital markets<br>— Access to external sources of finance through committed credit facilities |
| Operational risk<br>Regulatory and legislative compliance<br>Third-party management<br>IT and information (including cyber security)<br>Business continuity | The risk of loss (or unintended gain/profit) arising from inadequate or failed internal processes, or from personnel and systems, or from external events (other than those external events covered under Business Environment Risk). | — Operational risk and Outsourcing and Third-Party supply policies<br>— Corporate insurance programmes to limit the impact of operational risks<br>— Scenario analysis for operational risk capital requirements, which focus on extreme, yet plausible, events<br>— Internal and external review of cyber security capability<br>— Regular testing of elements of the disaster-recovery plan |
| Business environment risk<br><br>Strategic risk | Exposure to forces in the external environment that could significantly change the fundamentals that drive the business's overall strategy.<br><br>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. | — A Risk and Capital Plan that includes considerations of current strategies<br>— Business environment and strategic risks closely monitored and assessed for consideration in the business plans where appropriate<br>— Board strategy sessions consider risk themes<br>— Systemic Risk Management Plan which details the Group's strategy and risk management framework<br>— Recovery Plan which covers the Group's corporate and risk governance for managing a distressed environment, a range of credible recovery options, and scenarios to assess the effectiveness of these recovery options |

The drivers of each of the key risks vary by business unit, and depend primarily on the value of locally-held products.

## Market risk

### *Investment risk*

(Audited)

In Prudential UK, investment risk arising out of the assets in the with-profits fund impacts the shareholders' interest in future transfers and is driven predominantly by equities in the fund as well as by other investments such as property and bonds. The value of the future transfers is partially protected against equity falls by hedging conducted outside the fund. The fund's large inherited estate – estimated at £7.6 billion[1] as at 31 December 2015 on a Solvency II basis – can absorb market fluctuations and protect the fund's solvency. The inherited estate is partially protected against falls in equity markets through an active hedging programme within the fund.

In Asia, our shareholder exposure to equities arises from unit-linked products where revenue is linked to funds under management and on its with-profits businesses where bonuses declared are broadly based on historical and current rates of return on equity.

In Jackson, investment risk arises in relation to the assets backing the policies. In the case of 'spread business', including fixed annuities, these assets are generally bonds and our shareholder exposure comes from the minimum asset return required to be generated to meet the guaranteed rates of return offered to policyholders. For the variable annuity business, these assets include equities as well as other assets such as bonds. In this case, the impact on the shareholder comes from the guarantees on return on investments embedded in variable annuity products. Shareholders' exposure to these guarantees is mitigated through a hedging programme, as well as reinsurance. Further measures have been undertaken including re-pricing initiatives and the introduction of variable annuities without guarantees. Furthermore, it is our philosophy not to compete on price; rather, we seek to sell at a price sufficient to fund the cost incurred to hedge or reinsure the risks and to achieve an acceptable return.

Jackson hedges the guarantees on its variable annuity book on an economic basis and, thus, accepts variability in its accounting results in the short term in order to achieve the appropriate economic result. In particular, under Prudential's Group IFRS reporting, the measurement of the Jackson variable annuity guarantees is typically less sensitive to market movements than the corresponding hedging derivatives, which are held at market value. However, depending on the level of hedging conducted regarding a particular risk type, certain market movements can drive volatility in the economic result which may be either more or less significant under IFRS reporting. The Jackson IFRS shareholders' equity and US statutory capital are also sensitive to the effects of policyholder behaviour on the valuation of guarantees.

### *Interest rate risk*

(Audited)

Long-term rates remain close to historic lows. Products that we offer are sensitive to movements in interest rates. We have already taken a number of actions to de-risk the in-force business as well as re-price and restructure new business offerings in response to historically low interest rates. However, this remains an area of sensitivity and persistently low rates may impact policyholders' savings patterns and behaviour.

Interest rate risk arises in our UK business from the need to match cash flows for annuity payments with those from investments; movements in interest rates may have an impact on profits where durations are not perfectly matched. As a result, we aim to match the duration of assets and liabilities as closely as possible and the position is monitored regularly. Under the European Union's Solvency II Directive, additional interest rate exposure is created due to the nature of the construction of this balance sheet, such as the inclusion of the risk margin. The UK business continually assesses the need for any derivative overlays in managing this sensitivity. The with-profits business is exposed to interest rate risk as a result of underlying guarantees. Such risk is largely borne by the with-profits fund, but shareholder support may be required in extremis.

In Asia, exposure to interest rate risk arises from the guarantees of some non-unit-linked investment products. This exposure arises because it may not be possible to hold assets which will provide cash flows to match exactly those relating to policyholder liabilities. While this residual asset/liability mismatch risk can be managed, it cannot be eliminated.

Jackson is exposed to interest rate risk in its fixed, fixed index and variable annuity books. Movements in interest rates can influence the cost of guarantees in such products, in particular the cost of guarantees may increase when interest rates fall.

Interest rate risk across the entire business is managed through the use of interest rate swaps, interest rate options and hybrid options (options protecting against simultaneous decreases in equity values and interest rates).

### *Foreign exchange risk*

(Audited)

We principally operate in Asia, the US and the UK. The geographical diversity of our businesses means that we are inevitably subject to the risk of exchange rate fluctuations. Our operations in the US and Asia, which represent a significant proportion of our operating profit and shareholders' funds, generally write policies and invest in assets denominated in local currencies. Although this practice limits the effect of exchange rate fluctuations on local operating results, it can lead to significant fluctuations in our consolidated financial statements when results are expressed in UK sterling.

We retain revenues locally to support the growth of our business and capital is held in the local currency of the business to meet local regulatory and market requirements, accepting the accounting balance sheet translation risks this can produce. However, in cases where a surplus arising in an overseas operation supports Group capital or where a significant cash remittance is due from an overseas subsidiary to the Group, this exposure is hedged where we believe it is economically optimal to do so. We do not have appetite for significant shareholder exposure to foreign exchange risks in currencies outside the local territory. Where this arises, currency borrowings, swaps and other derivatives are used to manage exposures.

## Credit risk

(Audited)

We invest in fixed income assets in order to match policyholder liabilities and enter into reinsurance and derivative contracts to mitigate various types of risk. As a result, we are exposed to credit and counterparty credit risk across our business. We employ a number of risk management tools to manage credit risk, including limits defined on an issuer/counterparty basis as well as on average credit quality to seek to ensure the diversification of the portfolio and have in place collateral arrangements in derivative transactions. The Group Credit Risk Committee oversees credit and counterparty credit risk across the Group and conducts sector and/or name-specific reviews as required. In particular, in 2015, it has conducted sector reviews in the banking, commodities and energy sectors.

### *Debt and loan portfolio*

(Audited)

Our UK business is primarily exposed to credit risk in the shareholder-backed portfolio, with fixed income assets of £32.1 billion. Credit risk arising from a further £44.5 billion of fixed income assets is largely borne by the with-profits fund, although, in extremis, shareholder support may be required should the with-profits fund become unable to meet its liabilities.

The debt portfolio of our Asia business totalled £28.3 billion at 31 December 2015. Of this, approximately 68 per cent was in unit-linked and with-profits funds with minimal shareholder risk. The remaining 32 per cent is shareholder exposure.

Credit risk arises in the general account of our US business, where £34.1 billion of fixed income assets back shareholder liabilities including those arising from fixed annuities, fixed index annuities and life insurance.

The shareholder-owned debt and loan portfolio of the Group's asset management operations of £2.2 billion as at 31 December 2015 is principally related to Prudential Capital operations. Prudential Capital generates revenue by providing bridging finance, managing investments and operating a securities-lending and cash-management business for the Prudential Group and our clients.

Certain sectors have seen specific pressure during 2015 and into early 2016. The Group's credit exposure to the oil and gas sector represents approximately 4 per cent or £3.1 billion of the shareholder credit portfolio. Prolonged, depressed oil prices are expected to exert downward rating pressure within the sector, which is being monitored closely through Group risk processes and the Group Credit Risk Committee. The Group's credit exposure to the metal and mining sector represents 1 per cent of the total shareholder debt portfolio (£78 billion). Similarly, this sector is subject to ongoing monitoring and regular management information reporting to the Group's risk committees.

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

### *Group sovereign debt*

(Audited)

Sovereign debt represented 17 per cent or £12.8 billion of the debt portfolio backing shareholder business at 31 December 2015 (31 December 2014: 15 per cent or £11.0 billion). 44 per cent of this was rated AAA and 94 per cent investment grade (31 December 2014: 43 per cent AAA, 95 per cent investment grade). At 31 December 2015, the Group's shareholder-backed business's holding in Eurozone sovereign debt[2] was £546 million. 75 per cent of this was AAA rated (31 December 2014: 82 per cent AAA rated). We do not have any sovereign debt exposure to Greece.

### *Bank debt exposure and counterparty credit risk*

(Audited)

Our bank exposure is a function of our core investment business, as well as of the hedging and other activities undertaken to manage our various financial risks. Given the importance of our relationship with our banks, exposure to the banking sector is a key focus of management information provided to the Group's risk committees and the Board.

The exposures held by the shareholder-backed business and with-profits funds in sovereign debt and bank debt securities at 31 December 2015 are given in note C3.3(f) of the Group's IFRS financial statements.

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

Where appropriate, we reduce our exposure, purchase credit protection or make use of additional collateral arrangements to control our levels of counterparty credit risk. At 31 December 2015, shareholder exposure to corporate debt by rating and sector is shown below:

- 95 per cent of the shareholder portfolio is investment grade rated. In particular, 67 per cent of the portfolio is rated A- and above[3].
- The Group's shareholder portfolio is well diversified: no individual sector makes up more than 10 per cent of the total portfolio (excluding the financial and utilities sectors).

## Insurance risk

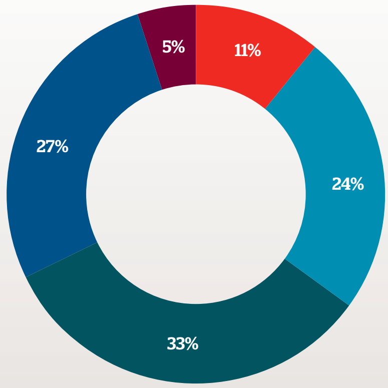
(Audited)

Insurance risk constitutes a sizeable proportion of the Group's exposure; the profitability of our businesses depends on a mix of factors including mortality and morbidity levels and trends, persistency, investment performance and claim inflation.

Longevity risk (people's propensity to live longer) is a significant contributor to our insurance risk exposure and is also capital intensive under the Solvency II regime. One tool used to manage this risk is reinsurance. During 2015, we completed deals on a number of tranches of bulk and retail annuity liabilities when terms were sufficiently attractive and aligned with our risk management framework. The recently enhanced pensions freedoms in the UK have greatly reduced the demand for retail annuities and further liberalisation is anticipated. However, given our significant UK annuity portfolio, the assumptions that we make about future rates of mortality improvement will remain key to the measurement of insurance liabilities and to the assessment of any subsequent reinsurance transactions.

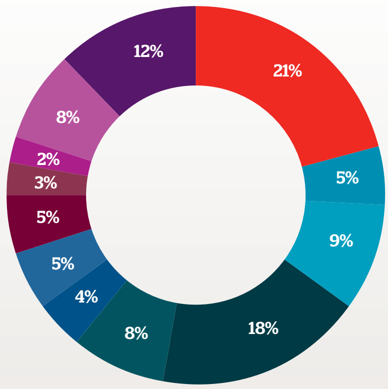
We continue to conduct research into longevity risk using both experience from our annuity portfolio and industry data. Although the general consensus in recent years is that people are living longer, there remains considerable volatility in year-on-year longevity experience, which is why we need expert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

### Shareholder exposure to corporate debt by rating




- AAA
- AA
- A
- BBB
- BB or below, or non-rated assets

### Shareholder exposure by sector




- Financial
- Mortgage securities
- Utilities
- Government
- Consumer, non-cyclical
- Communications
- Industrial
- Energy
- Consumer, cyclical
- Asset-backed securities
- Real estate
- Others

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

In Asia, a key assumption is the rate of medical inflation, typically in excess of general price inflation. This is the risk that the expenses of medical treatment increase more than expected, so that the medical claim cost passed on to Prudential is much higher. Medical expense inflation risk is best mitigated through retaining the right to re-price our products each year and by having suitable overall claim limits within our policies, either limits per type of claim or in aggregate across policies.

Our persistency assumptions similarly reflect recent experience for each relevant line of business, and future expectations. Persistency risk is mitigated by appropriate training and sales processes and managed locally post-sale through regular experience monitoring and the identification of common characteristics of poor persistency business. Where appropriate, allowance is also made for the relationship – either assumed or historically observed – between persistency and investment returns, and for the resulting additional risk. Modelling this 'dynamic' policyholder behaviour is particularly important when assessing the likely take-up rate of options embedded within product features.

### Liquidity risk

(Audited)

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

Liquidity uses and sources have been assessed at the Group and at a business unit level under base case and stressed assumptions. The liquidity resources available and the subsequent Liquidity Coverage Ratio are regularly monitored and are assessed to be sufficient.

### Operational risk

(Unaudited)

The Group does not actively seek to take operational risk to generate returns. Instead, it accepts a level of risk whereby the controls in place should prevent material losses, but should also not excessively restrict business activities. Direct and/or indirect financial losses are likely to arise if there is a failure to develop, implement and monitor appropriate controls.

For each business unit, accountabilities for operational risk management and oversight are based on the principles of the 'three lines of defence' model of risk-taking and management, risk control and oversight, and independent assurance. The approach adopted is proportional to the size, nature and complexity of the business unit and the risks it manages.

We have an operational risk management framework in place that facilitates both the qualitative and quantitative analysis of operational risk exposures. The output of this framework, in particular management information on key operational risk and control assessments, scenario analysis, internal incidents and external incidents, is reported by the business units and presented to the Group Operational Risk Committee.

This information also supports business decision-making and lessons-learned activities, the ongoing improvement of the control environment, and determination of the adequacy of our corporate insurance programme.

#### *Top operational risks*

Key areas of focus within the operational risk framework are:

- The risk of non-compliance due to the momentum of regulatory change in both our developed and developing markets, as well as recognising that Prudential's designation as a Global Systemically Important Insurer which requires the Group to comply with additional policy measures including enhanced Group-wide supervision;
- The risk of improper, or mis-selling of Prudential products and the resulting risk of censure from local regulators;
- The risk of regulatory censure due to poor conduct or weaknesses in systems and controls;
- The risk of censure for money laundering, sanctions or anti-bribery and corruption failures;
- The risk that reliance on IT infrastructures which support core activities/processes of the business, could fail or otherwise negatively impact business continuity and scalability needed to support the growth and changing needs of the business;
- The risk of a significant failure of a third-party provider impacting critical services;
- The risk of trading, transacting or modelling errors having a material cost across Group;
- The risk of the Group failing to attract and retain quality senior managers and other key employees;
- The risk that key people, processes and systems are unable to operate (thus impacting the on-going operation of the business) due to a significant unexpected external event occurring (eg a pandemic, terrorist attack, natural disaster, political unrest); and
- The risk of losses resulting from damage to the firm's reputation. This can be either real or perceived reputational damage but which could nevertheless diminish the standing of the organisation in the eyes of key stakeholders (eg customers, shareholders), destroy shareholder value, adversely impact revenues or result in significant costs to rectify.

#### *Cyber security*

Cyber security is an increasingly important risk facing the Group. The risk is that a member of the Group could be the target of a cyber-related attack which could result in disruption to the key operations, make it difficult to recover critical services, damage assets, and compromise data (both corporate and customer). This is a global issue which is rising in prominence across the financial services industry. As a result of Prudential's increasing market profile, the growing interest by customers to interact with their insurance provider and asset manager through the internet and social media, improved brand awareness and the classification of Prudential as a Global Systemically Important Insurer, there is an increased likelihood of Prudential being considered a target by cyber criminals. A number of industry, company-wide and local business unit-specific initiatives are underway in response to this risk.

### Business environment and strategic risks

(Unaudited)

#### *Global regulatory and political risk*

There are a number of ongoing policy initiatives and regulatory developments that are having, and will continue to have, an impact on the way Prudential is supervised. These include addressing Financial Conduct Authority reviews, on-going engagement with the Prudential Regulation Authority and includes the work of the Financial Stability Board and standard-setting institutions such as the International Association of Insurance Supervisors.

The International Association of Insurance Supervisors has various initiatives. On 18 July 2013, it published a methodology for identifying Global Systemically Important Insurers, and a set of policy measures that will apply to them, which the Financial Stability Board endorsed. Groups designated as a Global Systemically Important Insurer are subject to additional regulatory requirements, including enhanced group-wide supervision, effective resolution planning, development of a Systemic Risk Management Plan, a Recovery Plan and a Liquidity Risk Management Plan. Prudential's designation as a Global Systemically Important Insurer was reaffirmed on 3 November 2015. Prudential is monitoring the development and potential impact of the policy measures and is continuing to engage with the Prudential Regulation Authority on the implications of the policy measures and Prudential's designation as a Global Systemically Important Insurer.

The Global Systemically Important Insurer regime also introduces two types of capital requirements. The first, a Basic Capital Requirement, is designed to act as a minimum group capital requirement; and the second, a Higher Loss Absorption requirement reflects the drivers of the assessment of Global Systemically Important Insurer designation. The International Association of Insurance Supervisors intends for these requirements to take effect from January 2019, but Global Systemically Important Insurers will be expected to report privately to their group-wide supervisors in the interim.

The International Association of Insurance Supervisors is also developing a Common Framework (ComFrame) which is focused on the supervision of large and complex Internationally Active Insurance Groups. ComFrame will establish a set of common principles and standards designed to assist regulators in addressing risks that arise from insurance groups with operations in multiple jurisdictions. As part of this, work is underway to develop a global Insurance Capital Standard that would apply to Internationally Active Insurance Groups. Once the development of the Insurance Capital Standard has been concluded, it is intended to replace the Basic Capital Requirement as the minimum group capital requirement for Global Systemically Important Insurers. Further consultations on the Insurance Capital Standard are expected over the coming years and a version of the Insurance Capital Standard is expected to be adopted as part of ComFrame in late 2019.

The International Association of Insurance Supervisors' Insurance Core Principles, which provide a globally accepted framework for the supervision of the insurance sector and ComFrame evolution, are expected to create continued development in both prudential and conduct regulations over the next two to three years, particularly in the emerging markets of Asia.

The European Union's Solvency II Directive came into effect on 1 January 2016. The European Commission will review elements of the Solvency II legislation from 2016 onwards including a review of the Long Term Guarantee measures by 1 January 2021.

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

The UK government has committed to holding a 'remain/leave' referendum on EU membership which will be held on 23 June 2016. The possible withdrawal of the UK from the EU would have political, legal and economic ramifications for both the UK and the EU, although these are expected to be more pronounced on the UK.

In the US, the implementation of the Department of Labor proposal to introduce new fiduciary obligations for distributors of investment products to holders of regulated accounts would dramatically reshape the distribution of retirement products. If approved, the final rule could be in place in 2016. Jackson's strong relationships with distributors, history of product innovation and efficient operations should help mitigate any impacts.

### Emerging risks
(Unaudited)

Generally, emerging risks are qualitative in nature and are not amenable to modelling using statistical techniques. The emerging risk identification process at Prudential seeks to leverage the expertise of the organisation through a combination of top-down and bottom-up assessments of risks. Following two years of development, the emerging risk identification process is now well-embedded across the Group.

The use of 'brainstorming' sessions at various levels of the organisation is used as a central pillar of the emerging risk identification process to identify, develop and challenge potential emerging risks. Input is also taken from external speakers, forums and databases.

The Group has also sought to maintain contacts with industry experts and peers to benchmark and refine the emerging risk-management process. For example, Prudential has been a member of the Emerging Risk Initiative at the CRO Forum for two years, and chaired this initiative for 2015.

### Risk factors
(Unaudited)

Our disclosures covering risk factors can be found at the end of this document.

## Risk management cycle and governance

Our Group risk framework requires that all our businesses and functions establish processes for identifying, evaluating and managing the key risks faced by the Group. The framework is based on the concept of 'three lines of defence' comprising risk-taking and management, risk control and oversight and independent assurance.

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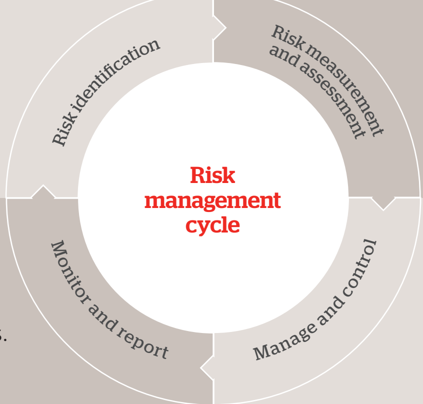
## Risk management cycle and governance

Risk identification covers Group-wide:
— Top-down risk identification
— Bottom-up risk identification
— Emerging risk identification

Risks are assessed in terms of materiality.

Material risks which are modelled are included in capital models, including E-Cap.

Risks which cannot be quantified are assessed qualitatively.




Risk reports are provided to the Group Executive Risk Committee, Group Risk Committee and Board which include updates on exposure against Board-approved risk appetite statements and limits.

Risk reports also provide updates on the Group top risks.

Risk processes that support the management and controlling of risk exposures include:
— Risk appetite and limits
— Financial Incidents Procedures
— Large Risk Approval Process
— Global Counterparty Limit Framework
— Own Risk and Solvency Assessment
— Reverse Stress Testing

### Risk identification

(Unaudited)

The Group's risk profile is a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity. The risk profile is a key output from the risk identification and risk measurement processes, and is used as a basis for setting Group-wide limits, management information, assessment of solvency needs, and determining appropriate stress and scenario testing.

An annual 'top-down' identification of our key risks assesses the risks that have the greatest potential to impact the Group's operating results and financial condition. The bottom-up approach of risk identification is more granular and refers to the processes by which the business units identify, assess and document risks, with the appropriate coordination and challenge from the risk functions.

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

In accordance with provision C.2.1 of the UK Corporate Governance Code, the directors have performed robust assessment of the principal risks facing the Company, through the Group Own Risk and Solvency Assessment Report and the risk assessments completed as part of the business planning review including how they are managed and mitigated given in this Chief Risk Officer's report.

Insurers are also required to undertake Reverse Stress Testing, which requires firms to work backwards from an assumed point of business model failure, to identify the stress scenarios that could result in such adverse outcomes. Each firm must then consider whether the likelihood of these scenarios, taking into account likely management actions, is consistent with its risk appetite and, if not, must initiate actions to address any inconsistencies. The actions considered form a part of our Recovery Plan.

### Risk measurement and assessment

(Unaudited)

All identified risks are assessed based on an appropriate methodology for that risk. All quantifiable risks which are material and mitigated by holding capital are modelled in the Group's Internal Model, which is used to determine capital requirements under the Solvency II Pillar 1 and economic capital bases. Governance arrangements are in place to support the internal model. This includes independent validation and process and controls around model changes and limitations.

### Manage and control

(Unaudited)

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

The management and control of risks are set out in the Group risk policies. These risk policies define:

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

### Monitoring and reporting

(Unaudited)

The management information received by the Group Risk Committees and the Board is tailored around the risks identified in the annual 'top-down' process, and also covers ongoing developments in other key and emerging risks.

## Risk appetite and limits

(Unaudited)

The extent to which the Group is willing to take risk in the pursuit of its objective to create shareholder value is defined by a number of risk appetite statements, operationalised through measures such as limits, triggers and indicators.

Risk appetite has been set at a Group aggregate level and by risk type, and covers all risks to shareholders, including those from participating and third-party business. The qualitative statements are operationalised down to the local business units through measures such as limits, triggers and indicators, and cover the most significant exposures to the Group, particularly those that could impact the Group's aggregate risk appetite metrics.

The Group Risk function is responsible for reviewing the scope and operation of these measures at least annually, to determine that they remain relevant. On the recommendation of the Group Risk Committee, the Board approves all changes made to the Group's risk appetite framework.

We define and monitor aggregate risk limits based on financial and non-financial stresses for our earnings volatility, liquidity and capital requirements as follows:

**Earnings volatility:**

The objectives of the aggregate risk limits seek to manage that:

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

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

**Liquidity:**

The objective is to monitor that the Group is able to generate sufficient cash resources to meet financial obligations as they fall due in business as usual and stressed scenarios.

**Capital requirements:**

The limits aim to manage that:

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

The two measures used to define the limits are Solvency II capital requirements and internal economic capital requirements. In addition, outside the UK, capital requirements are monitored on local statutory bases.

We use an internal economic capital assessment calibrated on a multi-term basis to monitor our capital requirements across the Group. This approach considers, by risk drivers, the timeframe over which each risk can threaten the ability of the Group to meet claims as they fall due, allowing for realistic diversification benefits. This assessment provides valuable insights into our risk profile and for continuing to maintain a strong capital position.

With the introduction of Solvency II, the existing European Union Insurance Group Directive's risk appetite statement has been replaced with a Solvency II Pillar 1 risk appetite. As part of our annual business planning cycle the risk appetite framework plays an integral role. The Group Risk Committee is responsible for reviewing the risks inherent in the Group's business plan and for providing the Board with input on the risk/reward trade-offs implicit therein. This review is supported by the Group Risk function, which uses submissions from our local business units to calculate the Group's aggregated position (allowing for diversification effects between local business units) relative to the aggregate risk limits.

### Risk policies

(Unaudited)

Risk policies set out specific requirements for the management of, and articulate the risk appetite for, key risk types. There are core risk policies for credit, market, insurance, liquidity and operational risks and a number of internal control policies covering, internal model risk, underwriting, dealing controls and tax risk management. They form part of the Group Governance Manual, which was developed to make a key contribution to the sound system of internal control that we maintain in line with the UK Corporate Governance Code and the Hong Kong Code on Corporate Governance Practices.

## Risk culture

(Unaudited)

The increasing regulatory focus on market participants instilling corporate cultures that support prudent management and outcomes for consumers is indelibly linked to what we do and how we do it. The 'risk culture' (as a subset of the broader business culture) is reflected in the values and behaviours the Group displays when managing risk. It therefore permeates throughout the Group's Risk Framework and governance processes.

The Group promotes a responsible risk culture in three main ways:

— By the leadership and behaviours demonstrated by management;

— By building skills and capabilities to support risk management; and

— By including risk management (through the balance of risk with profitability and growth) in the performance evaluation of individuals.

### Senior management leadership

Senior management promote a responsible culture of risk management by emphasising the importance of balancing risk with profitability and growth in decision making, while seeking to ensure compliance with regulatory requirements and internal policies. As part of this, they encourage all employees to be risk-aware and to take personal responsibility for identifying and helping to address risk issues.

### Building skills and capabilities

The Group works to build skills and capabilities in risk management, which are needed by both senior management and risk management specialists, while attempting to allocate scarce resources appropriately.

### Performance management

The Group includes risk management measures that balance risk taken with profitability and growth achieved in the performance evaluation of key individuals, including both senior management and those directly responsible for risk management (objectives may be quantitative or qualitative as appropriate).

The remuneration strategy at Prudential is designed to be consistent with its risk appetite, and the Group Chief Risk Officer advises the Group Remuneration Committee on adherence to our risk framework and appetite.

## Viability statement

In accordance with provision C.2.2 of the UK code, the directors have assessed the prospects of the Company and the Group by reference to the three-year planning period to December 2018. The Group prepares a business plan annually covering a three-year period on a rolling basis. This plan covers projected performance with regards to profitability, cash generation, the capital position of the Group and the parent company's liquidity over this three-year period. The Group's risk appetite framework forms an integral part of the annual business plan. The financial performance, capital, and liquidity positions over the plan period are tested against the Group's risk appetite statements which are set by the Board to ensure the ongoing viability of the Group. They are also subjected to other stress scenarios, such as substantial declines to interest rates and equity markets based on a macroeconomic assessment for each period, so as to evaluate the Group's resilience to significant deteriorations in market conditions and other shock events. The impact on the business of known areas of regulatory change whose financial implications can be reasonably quantified is also considered as part of the plan.

In making the assessment, the directors have taken into account the Group's current position and the potential impact of the principal risks faced by the Group. The Group's business activities and the factors likely to affect its future development, successful performance and position in the current economic climate are set out on pages 4 to 35. The risks facing the Group's capital and liquidity positions and their sensitivities are referred to on pages 45 to 54.

Based on this assessment, the directors have a reasonable expectation that the Company and the Group will be able to continue in operation and meet their liabilities as they fall due over the three-year plan period to December 2018.

In addition to these considerations, the directors regularly consider strategic matters that may affect the longer-term prospects of the Group. Further, the Group as a whole, and each of its life assurance operations, are subject to extensive regulation and supervision, which are designed primarily to reinforce the Company's management of its long-term solvency, liquidity and viability to ensure that it can continue to meet obligations to policyholders.

In particular, the Group and UK insurance subsidiaries are subject to the capital adequacy requirements of the European Union Solvency II regulatory basis as implemented by the Prudential Regulation Authority in the UK. Capital requirements for the Group's other subsidiaries are also monitored on their local regulatory bases. In addition to these external capital metrics, the Group uses an internal economic capital assessment to monitor its capital requirements across the Group. Further details on the capital strength of the Group are provided on pages 45 and 46.

**Notes**

1 Representing Solvency II own funds of the UK with-profits funds.
2 Excludes Group's proportionate share in joint ventures and unit-linked assets and holdings of consolidated unit trust and similar funds.
3 In the 'Shareholder exposure by rating', 75 per cent of non-rated assets are internally rated, privately held loans.