

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.

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Sterling reserves

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

ii Jackson - GICs and funding arrangements

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

b Concentration of risk

i Business accepted

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

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

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

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

ii Ceded business

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

c Guarantees

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

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

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

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

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

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

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

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

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

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

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

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

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

i Overview of risks by business unit

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

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

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

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

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

Three key points are to be noted, namely:

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

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

Type of business	Market and credit risk			Insurance and lapse risk
	Investments/derivatives	Liabilities/unallocated	Other exposure	
UK insurance operations (see also section D2(j))				
With-profits business (including Prudential Annuities Limited)	Net neutral direct exposure (Indirect exposure only)		Investment performance subject to smoothing through declared bonuses	Persistency risk to future shareholder transfers
SAIF sub-fund	Net neutral direct exposure (Indirect exposure only)		Asset management fees earned by M&G	
Unit-linked business	Net neutral direct exposure (Indirect exposure only)		Investment performance through asset management fees	Persistency risk
Shareholder-backed annuity business	Asset/liability mismatch risk			Mortality experience and assumptions for longevity
	Credit risk Interest rate risk for assets in excess of liabilities i.e. representing shareholder capital			
US insurance operations (see also section D3(j))				
All business	Currency risk			Persistency risk
Variable annuity business	Net effect of market risk arising from incidence of guarantee features and variability of asset management fees offset by derivative hedging programme			
Fixed indexed annuity business	Derivative hedge programme to the extent not fully hedged against liability and fund performance	Incidence of equity participation features		
Fixed indexed annuity, Fixed annuity and GIC business	Credit risk Interest rate risk 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	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
Asian insurance operations (see also section D4(j))				
All business	Currency risk			Mortality and morbidity risk Persistency risk
With-profits business	Net neutral direct exposure (Indirect exposure only)		Investment performance subject to smoothing through declared bonuses	
Unit-linked business	Net neutral direct exposure (Indirect exposure only)		Investment performance through asset management fees	
Non-participating business (in particular Taiwan)	Interest rate and price risk	Long-term interest rates		

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ii IFRS shareholder results - Exposures for market and other risk

Key Group exposures

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

For Jackson at the level of operating profit based on longer-term investment returns, the results are sensitive to market conditions to the extent of income earned on spread-based products and equity-based exposure (excluding movement in market implied volatility and based on average Corporate AA interest rates) not mitigated by the equity and interest derivative programmes. Jackson's total profit and equity are exposed to similar market movements (including the effects of movements in market implied volatility and actual Corporate AA interest rates). In each case, IFRS profit or loss and equity movements arise from the accounting rather than economic effect of market value movements on assets and derivatives attaching to fixed annuity, term and institutional business.

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

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

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

M&G profits are affected primarily by movements in the growth in funds under management and of the effect any impairment on the loan book and fair value movements on debt securities held by Prudential Capital.

Market and credit risk

UK insurance operations

With-profits business

• With-profits business

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

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

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

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

• Prudential Annuities Limited (PAL)

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

• Scottish Amicable Insurance Fund (SAIF)

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

Shareholder-backed business

The factors that may significantly affect the IFRS results of UK shareholder-backed business are the mortality experience and assumptions and credit risk attaching to the annuity business of Prudential Retirement Income Limited and the PAC non-profit sub-fund.

- Prudential Retirement Income Limited (PRIL)

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

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

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

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

- PAC non-profit sub-fund

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

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

- Other shareholder-backed unit-linked business

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

Jackson

The IFRS basis results of Jackson are highly sensitive to market risk on the assets covering liabilities other than variable annuity business segregated in the separate accounts.

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

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

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

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

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

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

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Asian operations

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

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

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

In addition to these features the overriding factor that affects IFRS basis results for Asian non-participating business is the return on the assets covering the Taiwan whole of life policies. This factor directly affects the actual return in any given reporting period. In addition though, the measurement of the liabilities to policyholders and the carrying value of deferred acquisition costs for this business is dependant upon an assessment of longer-term interest rates. This key feature is described in more detail in notes D4(g) and (j)(iii).

Insurance and lapse risk

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

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

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

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

iii Impact of diversification on risk exposure

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

Correlation across geographic regions

- Financial risk factors
- Non-financial risk factors.

Correlation across risk factors

- Longevity risk
- Expenses
- Persistency
- Other risks.

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

f Duration of liabilities

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

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

D2: UK insurance operations

a Summary balance sheet

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

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

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

Notes

- i For the purposes of this table and subsequent explanation, references to the WPSF also include, for convenience, the amounts attaching to the Defined Charges Participating Sub-fund.
- ii SAIF is a separate sub-fund within the PAC long-term business fund.
- iii Wholly-owned subsidiary of the PAC WPSF that writes annuity business.
- iv Excluding policyholder liabilities of the Hong Kong branch of PAC.
- v The loans of the Group's UK insurance operations of £1,902 million (2007: £1,245 million) comprise mortgage loans of £701 million (2007: £449 million), policy loans of £29 million (2007: £35 million) and other loans of £1,172 million (2007: £761 million). The mortgage loans are collateralised by properties. Other loans are all commercial loans and comprise mainly syndicated loans held by the PAC with-profits fund.
- vi Included in debt securities above are £13,026 million (2007: £11,149 million) of securities which are not quoted on active markets and for which fair value is determined using internal valuation techniques, or is provided by brokers or pricing services, where the specific securities have been valued using valuation techniques by these third-party providers. Of this amount, £12,341 million (2007: £10,640 million) related to securities held by with-profit operations and £685 million (2007: £509 million) related to securities held by the UK shareholder-backed business. See note G1 for additional details.
- vii Other investments comprise:

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

b Reconciliation of movement in investments

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

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

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

d Information on credit risk of debt securities

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

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

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

Where no external ratings are available internal ratings produced by the Group's asset management operations, which are prepared on the Company's assessment of a comparable basis to external ratings, are used where possible. Of the total debt securities held at 31 December 2008 which are not externally rated, £2,325 million (2007: £2,972 million) were internally rated AAA to A-, £3,149 million (2007: £2,844 million) were internally rated BBB+ to B- and £661 million (2007: £593 million) were unrated. The majority of unrated debt security investments were held in SAIF and the PAC with-profits fund and relate to convertible debt and other investments which are not covered by ratings analysts nor have an internal rating attributed to them.

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

e Products and guarantees

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

These products are written primarily in:

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

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

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

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

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

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

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

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

ii Annuity business

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

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

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

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

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

iii SAIF

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

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

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

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

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

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

f Exposure to market risk

i Non-linked life and pension business

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

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

ii Pension annuity business

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

iii Unit-linked business

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

g Process for setting assumptions and determining contract liabilities

i Overview

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

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

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

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

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

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

Tax assumptions are set equal to current rates of taxation.

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

ii WPSF and SAIF

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

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

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

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

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

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

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

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

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

iii Annuity business

Credit risk provisions

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

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

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

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

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

Notes

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

Mortality

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

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

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

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

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

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

h Reinsurance

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

i Effect of changes in assumptions used to measure insurance assets and liabilities 2008

Mortality

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

Credit risk

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

Aggregate effect of assumptions changes

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

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

Notes

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

2007

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

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

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

Notes

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

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

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

i With-profits business

SAIF

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

With-profits sub-fund business

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

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

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

The level of unallocated surplus is particularly sensitive to the level of investment returns on the portion of the life fund assets that represents the surplus. The effects for 2008 and 2007 are demonstrated in note D5.

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

ii Shareholder-backed annuity business

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

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

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

iii Unit-linked and other business

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

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

iv Shareholder exposure to interest rate risk and other market risk

By virtue of the fund structure, product features and basis of accounting described in note D2(e) and (g), the policyholder liabilities of the UK insurance operations are, except for pension annuity business, not generally exposed to interest rate risk. For pension annuity business, liabilities are exposed to fair value interest rate risk. However, the net exposure to the PAC WPSF (for PAL) and shareholders (for liabilities of PRIL and the non-profit sub-fund) is very substantially ameliorated by virtue of the close matching of assets with appropriate duration.

The close matching by the Group of assets of appropriate duration to annuity liabilities is based on maintaining economic and regulatory capital. The measurement of liabilities under capital reporting requirements and IFRS is not the same as detailed in note D2(g)(iii), with contingency reserves and some other margins for prudence within the assumptions required under the FSA regulatory solvency basis not included for IFRS reporting purposes. As a result IFRS equity is higher than regulatory capital and therefore more sensitive to interest rate risk.

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

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

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D2: UK insurance operations continued

k Duration of liabilities

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

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

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

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

Notes

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

D3: US insurance operations

a Summary results and balance sheet

i Results and movements on shareholders' equity

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

Included within the movements in shareholders' equity is a net reduction in value of Jackson's debt securities classified as 'available-for-sale' under IAS 39 of £2,710 million (2007: £244 million). This reduction reflects the effects of widening of global credit spreads partially offset by the effect of reduced risk-free interest rates and a steepening yield curve. These temporary market movements do not reflect defaults or impairments.

With the exception of debt securities for US insurance operations classified as 'available-for-sale' under IAS 39, unrealised value movements on the Group's investments are booked within the income statement. For debt securities classified as 'available-for-sale', unless impaired, fair value movements are recorded as a movement in shareholder reserves direct to equity. Realised gains and losses, including impairments, are recorded in the income statement. In 2008, Jackson recorded £497 million (2007: £35 million) of impairment losses arising from:

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

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

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

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

In general, the debt securities of the Group's US insurance operations are purchased with the intention and the ability to hold them for the longer term. In 2008, there was a movement in the balance sheet value for debt securities classified as available-for-sale from a net unrealised loss of £136 million to a net unrealised loss of £2,897 million (2007: net unrealised gain of £110 million to a net unrealised loss of £136 million). During 2008, as a result of these factors, the gross unrealised gain in the balance sheet decreased from £303 million at 31 December 2007 to £281 million at 31 December 2008 while the gross unrealised loss increased from £439 million at 31 December 2007 to £3,178 million at 31 December 2008. Details of the securities in an unrealised loss position are shown in D3(d) below.

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

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

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

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

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

ii Balance sheet

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

Notes

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

ii Loans

The loans of Jackson of £5,121 million (2007: £3,258 million) comprise mortgage loans of £4,534 million (2007: £2,841 million) and policy loans of £587 million (2007: £417 million). All of the mortgage loans are commercial mortgage loans which are collateralised by properties. The property types are mainly industrial, multi-family residential, suburban office, retail and hotel.

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

The policy loans are fully secured by individual life insurance policies or annuity policies. These loans are accounted for at amortised cost, less any impairment.

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

Notes continued

iii Other investments comprise:

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

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

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

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

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

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

b Reconciliation of movement in investments

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

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

c Reconciliation of movement in policyholder liabilities

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

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

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

d Information on credit risks of debt securities

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

i Credit quality

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

The following table shows the quality of publicly traded and SEC Rule 144A traded debt securities held by the US operations as at 31 December 2008 and 2007 by NAIC classifications:

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

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

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

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

	2008	2007
	Carrying value £m (unless otherwise stated)	Carrying value £m (unless otherwise stated)
Residential mortgage-backed securities (included within debt securities)		
Total residential mortgage-backed securities	4,509	3,177
Residential mortgage-backed securities rated AAA or equivalent by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch):		
Amount	3,754	2,724
Percentage of total	83.3%	85.7%
Residential mortgage-backed securities rated NAIC 1:		
Amount	4,241	3,170
Percentage of total	94.1%	99.8%
Commercial mortgage-backed securities (included within debt securities)		
Total commercial mortgage-backed securities	1,869	1,532
Commercial mortgage-backed securities rated AAA or equivalent by a nationally recognised statistical ratings organisation (including Standard & Poor's, Moody's and Fitch):		
Amount	1,586	1,264
Percentage of total	84.9%	82.5%
Commercial mortgage-backed securities rated NAIC 1:		
Amount	1,815	1,462
Percentage of total	97.1%	95.4%

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

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

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

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

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

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

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

e Products and guarantees

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

i Fixed annuities

Interest-sensitive annuities

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

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

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

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

Fixed indexed annuities

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

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

Immediate annuities

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

ii Variable annuities

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

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

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

iii Life insurance

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

iv Institutional products

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

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

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

f Exposure to market risk and risk management

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

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

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

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

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

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

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

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

g Process for setting assumptions and determining contract liabilities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

h Reinsurance

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

i Assumptions used to measure insurance assets and liabilities

2008

a Measurement basis for embedded derivatives of variable annuity business

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

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

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

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

b Deferred acquisition costs

Income statement – amortisation for variable annuity business

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

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

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

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

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

Statement of changes in equity – 'shadow DAC adjustments'

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

2007

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

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

i Currency fluctuations

Consistent with the Group's accounting policies, the profits of the Group's US operations are translated at average exchange rates and shareholders' equity at the closing rate for the reporting period. For 2008, the rates were US\$1.85 (2007: US\$2.00) and US\$1.44 (2007: US\$1.99) to £1 sterling, respectively. A 10 per cent increase or decrease in these rates would reduce or increase profit before tax attributable to shareholders, profit for the year and shareholders' equity attributable to US insurance operations respectively as follows:

	A 10% increase in exchange rates		A 10% decrease in exchange rates	
	2008	2007	2008	2007
(Loss) profit before tax attributable to shareholders*	59	(39)	(72)	48
(Loss) profit for the year	51	(29)	(62)	35
Shareholders' equity attributable to US insurance operations	(158)	(242)	193	296

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

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

ii Other sensitivities

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

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

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

- Amortisation of deferred acquisition costs.

For term business, acquisition costs are deferred and amortised in line with expected premiums. For annuity business, acquisition costs are deferred and amortised in line with expected gross profits on the relevant contracts. For interest-sensitive business, the key assumption is the expected long-term spread between the earned rate and the rate credited to policyholders, which is based on an annual spread analysis. In addition, expected gross profits depend on mortality assumptions, assumed unit costs and terminations other than deaths (including the related charges) all of which are based on a combination of actual experience of Jackson, industry experience and future expectations.

A detailed analysis of actual experience is measured by internally developed mortality and persistency studies. For variable annuity business, the key assumption is the expected long-term level of equity market returns, which for 2008 and 2007 was 8.4 per cent per annum implemented using a mean reversion methodology. These returns affect the level of future expected profits through their effects on the fee income and the required level of provision for guaranteed minimum death benefit claims. The mean reversion methodology dampens the impact of equity market movements during a particular year, but does not fully eliminate the effects of movements in the equity markets.

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D3: US insurance operations continued

iii Exposure to equity risk

As noted in note D3(f), Jackson is exposed to equity risk through the options embedded in the fixed indexed liabilities and GMDB and GMWB guarantees included in certain VA benefits. This risk is managed using a comprehensive equity hedging programme to minimise the risk of a significant economic impact as a result of increases or decreases in equity market levels while taking advantage of naturally offsetting exposures in Jackson's operations. Jackson purchases external futures and options that hedge the risks inherent in these products, while also considering the impact of rising and falling separate account fees.

As a result of this hedging programme, if the equity markets were to increase, Jackson's free-standing derivatives would decrease in value. However, over time, this movement would be broadly offset by increased separate account fees and reserve decreases, net of the related changes to amortisation of deferred acquisition costs. Due to the nature of the free-standing and embedded derivatives, this hedge, while highly effective on an economic basis, may not completely mute the immediate impact of the market movements as the free-standing derivatives reset immediately while the hedged liabilities reset more slowly (see note D3(g) for further details on the valuation of the guarantees) and fees are recognised prospectively.

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

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

The actual impact on financial results would vary contingent upon the volume of new product sales and lapses, changes to the derivative portfolio, correlation of market returns and various other factors including volatility, interest rates and elapsed time.

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

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

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

iv Exposure to interest rate risk

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

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

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

k Duration of liabilities

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations

a Summary balance sheet

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

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

Notes

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations continued

Summary policyholder liabilities (net of reinsurance) and unallocated surplus

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

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

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

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

b Reconciliation of movement in investments

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

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

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

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

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

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

d Information on credit risks of debt securities

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations continued

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

e Products and guarantees

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

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

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

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

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

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

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

Cash value and interest rate guarantees are of three types:

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

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

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

Whole of life contracts with floor levels of policyholder benefits that accrue at rates set at inception are also written in the Korean life operations, though to a much less significant extent than in Taiwan. The Korean business has non-linked liabilities and linked liabilities at 31 December 2008 of £312 million and £742 million respectively (2007: £261 million and £728 million respectively). The business is much less sensitive to returns than Taiwan with a higher proportion of linked and health business.

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

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

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

f Exposure to market risk

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

g Process for setting assumptions and determining liabilities

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

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

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

h Reinsurance

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

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

a Changes in key assumptions

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

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

The adequacy of the insurance contract liabilities is tested by reference to best estimates of expected investment returns on policy cash flows and reinvestment income. The assumed earned rates are used to discount the future cash flows. For 2008 the projection assumes that the current bond yields at 31 December 2008 of 1.4 per cent trend towards 5.5 per cent at 31 December 2018. This compares to the 2007 results for which the projections assume the current bond yields of around 2.5 per cent trend towards 5.5 per cent at 31 December 2013. Under the liability adequacy testing applied for IFRS the change of progression period had no effect on the carrying value of the deferred acquisition costs or liability to policyholders.

The liability adequacy test is more sensitive to changes in the expected long-term rate, further delays in the assumed progression period, or a combination thereof. However, as explained in note I10, on 20 February 2009 the Company announced the intended sale of the legacy agency book and agency force in Taiwan to China Life Insurance of Taiwan.

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations continued

b Deferral and amortisation of acquisition costs

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

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

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

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

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

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

Currency translation

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

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

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

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

Other risks

i With-profits business

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

ii Unit-linked business

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

iii Other business

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

The principal other business of Asian operations which is most sensitive to interest rates is the traditional whole of life business written in Taiwan.

The in-force business of the Taiwan life operation includes traditional whole of life policies where the premium rates have been set by the regulator at different points for the industry as a whole. Premium rates were set to give a guaranteed minimum sum assured on death and a guaranteed surrender value on early surrender based on prevailing interest rates at the time of policy issue. Premium rates also included allowance for mortality and expenses. The required rates of guarantee have fallen over time as interest rates have reduced from a high of eight per cent to current levels of around 1.4 per cent. The current low level of bond rates in Taiwan gives rise to a negative spread for the majority of these policies. The current cash cost of funding in-force negative spread in Taiwan is around £50 million a year.

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

The adequacy of the insurance contract liabilities is tested by reference to best estimates of expected investment returns on policy cash flows and reinvested income. The assumed earned rates are used to discount the future cash flows. The assumed earned rates consist of a long-term best estimate determined by consideration of long-term market conditions and rates assumed to be earned in the trending period. For 2008 and 2007, it has been projected that rates of return for Taiwanese bond yields will trend from the current levels of some 1.4 per cent (2.5 per cent) to 5.5 per cent by 31 December 2018 (2007: 5.5 per cent by 2013).

The liability adequacy test results are sensitive to the attainment of the trended rates during the trending period. Based on the current asset mix, margins in other contracts that are used in the assessment of the liability adequacy tests and currently assumed future rates of return, if interest rates were to remain at current levels in 2009 and 2010 and the target date for attainment of the long-term bond yield deferred to 31 December 2020, the premium reserve, net of deferred acquisition costs, would be sufficient. If interest rates were to remain at current levels beyond the end of 2009 with the date of the attainment of the long-term rate further delayed, the margin within the net GAAP reserve will reduce further.

However, the need to write off deferred acquisition costs or increase the liabilities, and by how much, would be affected by the impact of new business written between 31 December 2008 and the future reporting dates to the extent that the business is taken into account as part of the liability adequacy testing calculations for the portfolio of contracts.

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

At 31 December 2008, if the assumed long-term bond yield applied had been reduced by both 0.5 and 1.0 per cent from 5.5 per cent to 4.5 per cent and continued to apply the same progression period to 31 December 2018, by assuming bond yields increase from current levels in equal annual instalments to the long-term rate, the premium reserve, net of deferred acquisition costs, would have been sufficient. An additional 0.5 per cent reduction in the assumed long-term rate from 4.5 per cent to 4.0 per cent would lead to a charge of some £150 million.

The adequacy of the Taiwan insurance contract liabilities is also sensitive to movements in short-term movements in market interest rates. This is because a reduction in the current interest rates would alter the progression rate to the long-term rate and the assumed timing of attainment of the rate may be insufficient and they would have been deferred. Based on the in-force business at 31 December 2008, a delay of one to two years in the attainment of the long-term rate of 5.5 per cent would not give rise to an additional charge. Based on the in-force business at 31 December 2008, a delay of three to four years in the attainment of the long-term rate of 5.5 per cent would not give rise to a significant charge. A delay of five years would give rise to a charge of some £60 million.

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

Interest rate risk for other business excluding Taiwan

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

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

Excluding with-profit and unit-linked business along with Taiwan, which is detailed above, 71 per cent (2007: 72 per cent) of the bond portfolio for other business of Asian operations at 31 December 2008 was held in Japan, Singapore and Vietnam with corporate bond rates varying from territory to territory and ranging from 1.17 per cent to 10.18 per cent at 31 December 2008 (1.5 per cent to 9.1 per cent at 31 December 2007) for these three countries. An analysis of movements in bond rates during previous periods and its impact on IFRS basis profit or loss and shareholders' equity has been undertaken, with reasonably possible movements for these countries being considered to be 0.5 per cent for Japan, 1.0 per cent for Singapore and 1.5 per cent for Vietnam.

Notes on the Group financial statements

D: Life assurance businesses

continued

D4: Asian insurance operations continued

Based on these movements, plus indicative changes for bonds held in other Asian operations within the region, the impact on IFRS basis profit or loss and shareholders' equity from a reasonably possible change in interest rates for Asian operations excluding Taiwan at 31 December 2008 has been assessed, with rate movements ranging from 0.5 per cent to 1.5 per cent (2007: 0.25 per cent to 1.0 per cent) dependent on country. Looking at the region in aggregate and noting that interest rates are unlikely to move consistently by the same degree from period to period, the range of movements considered to be reasonably possible would result in a change in IFRS profit or loss of plus or minus £56 million (2007: £30 million). These amounts, if they arose, would be recorded within the category short-term fluctuations in investment returns in the Group's supplementary analysis of profit before tax. After adjusting for deferred tax the reasonably possible effect on shareholders' equity is plus or minus £45 million (2007: £22 million).

Equity price risk

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

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

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

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

k Duration of liabilities

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

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

D5: Capital position statement for life assurance businesses

a Summary statement

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D5: Capital position statement for life assurance businesses continued

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

2007 £m

31 December 2007	SAIF	WPSF note 1	Total PAC with- profits fund	Other UK life assurance subsidi- aries and funds note 11	Jackson	Asian life assurance subsidi- aries	Total life assurance opera- tions	M&G (including Prudential Capital)	Parent company and share- holders' equity of other subsidi- aries and funds	Group total
Group shareholders' equity										
Held outside long-term funds:										
Net assets	-	-	-	550	2,690	1,258	4,498	271	(862)	3,907
Goodwill	-	-	-	-	-	111	111	1,153	77	1,341
Total	-	-	-	550	2,690	1,369	4,609	1,424	(785)	5,248
Held in long-term funds ^{note iii}	-	-	-	814	-	-	814	-	-	814
Total Group shareholders' equity	-	-	-	1,364	2,690	1,369	5,423	1,424	(785)	6,062
Adjustments to regulatory basis										
Unallocated surplus of with-profits funds ^{note v}	-	13,813	13,813	-	-	146	13,959			
Shareholders' share of realistic liabilities	-	(4,178)	(4,178)	-	-	-	(4,178)			
Deferred acquisition costs of non- participating business and goodwill not recognised for regulatory reporting purposes	(4)	(15)	(19)	(143)	(1,928)	(790)	(2,880)			
Jackson surplus notes ^{note iv}	-	-	-	-	125	-	125			
Adjustment from IAS 19 basis pension deficit attributable to WPSF to pension liability for regulatory purposes ^{note vii}	-	(138)	(138)	-	-	-	(138)			
Valuation difference on PAL between IFRS basis and regulatory basis	-	(1,117)	(1,117)	-	-	-	(1,117)			
Other adjustments to restate these amounts to a regulatory basis (with SAIF and the WPSF on a Peak 2 realistic basis) ^{note v}	4	355	359	(239)	1,364	149	1,633			
Total adjustments	-	8,720	8,720	(382)	(439)	(495)	7,404			
Total available capital resources of life assurance businesses on local regulatory bases	-	8,720	8,720	982	2,251	874	12,827			

Notes on the Group financial statements

D: Life assurance businesses

continued

D5: Capital position statement for life assurance businesses continued

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

Notes

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

b Basis of preparation, capital requirements and management

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

i UK insurance operations

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

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

PAC WPSF and SAIF

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

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

The two separate peaks are:

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

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

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

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

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

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D5: Capital position statement for life assurance businesses continued

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

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

Other UK life assurance subsidiaries and funds

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

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

ii Jackson

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

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

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

iii Asian operations

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

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

Singapore

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

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

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

Taiwan

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

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

Japan

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

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

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

Malaysia

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

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

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

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

Vietnam

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

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

Korea

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

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

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

iv Group capital requirements

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

Notes on the Group financial statements

D: Life assurance businesses

continued

D5: Capital position statement for life assurance businesses continued

c Movements in total available capital

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

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

Detail on the movement for 2007 is as follows:

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

Notes

i WPSF

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

ii Jackson

The increase of £507 million reflects an underlying decrease of £358 million (applying the 2008 year end exchange rate of 1.44) and £865 million of exchange translation gain.

The increase of £168 million in 2007 reflects an underlying increase of £203 million (applying the 2007 year end exchange rate of 1.99) and £35 million of exchange translation loss.

iii Other UK life assurance subsidiaries and funds

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

iv Asian life assurance subsidiaries

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

d Transferability of available capital

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

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

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

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

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

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

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

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

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

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

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

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

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

f Intra-group arrangements in respect of SAIF

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

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