

Notes on the Group financial statements

G: Financial assets and liabilities

G1: Financial instruments - designation and fair values

The Group designates all financial assets as either fair value through profit and loss, available-for-sale, or as loans and receivables. Financial liabilities are designated as either fair value through profit and loss or amortised cost, or as investment contracts with discretionary participating features accounted for under IFRS 4 as described in note A4.

	2008 £m				Fair value
	Fair value through profit and loss	Available-for-sale	Loans and receivables	Total carrying value	
Financial assets					
Cash and cash equivalents	–	–	5,955	5,955	5,955
Deposits	–	–	7,294	7,294	7,294
Equity securities and portfolio holdings in unit trusts	62,122	–	–	62,122	62,122
Debt securities ^{note i}	71,225	23,999	–	95,224	95,224
Loans ^{note ii}	–	–	10,491	10,491	10,043
Other investments ^{note iii}	6,301	–	–	6,301	6,301
Accrued investment income	–	–	2,513	2,513	2,513
Other debtors	–	–	1,232	1,232	1,232
	139,648	23,999	27,485	191,132	

	2008 £m				Fair value
	Fair value through profit and loss	Amortised cost	IFRS 4 basis value	Total carrying value	
Financial liabilities					
Core structural borrowings of shareholder-financed operations ^{notes i, H13}	–	2,958	–	2,958	2,137
Operational borrowings attributable to shareholder-financed operations ^{H13}	–	1,977	–	1,977	1,977
Borrowings attributable to with-profits funds ^{H13}	158	1,150	–	1,308	1,320
Obligations under funding, securities lending and sale and repurchase agreements	–	5,572	–	5,572	5,676
Net asset value attributable to unit holders of consolidated unit trust and similar funds	3,843	–	–	3,843	3,843
Investment contracts with discretionary participating features ^{note iv}	–	–	23,446	23,446	–
Investment contracts without discretionary participating features	11,616	2,885	–	14,501	14,568
Other creditors	–	1,496	–	1,496	1,496
Derivative liabilities	4,832	–	–	4,832	4,832
Other liabilities	–	890	–	890	890
	20,449	16,928	23,446	60,823	

	2007 £m				Fair value
	Fair value through profit and loss	Available-for-sale	Loans and receivables	Total carrying value	
Financial assets					
Cash and cash equivalents	–	–	4,951	4,951	4,951
Deposits	–	–	7,889	7,889	7,889
Equity securities and portfolio holdings in unit trusts	86,157	–	–	86,157	86,157
Debt securities ^{note i}	65,349	18,635	–	83,984	83,984
Loans ^{note ii}	–	–	7,924	7,924	8,105
Other investments ^{note iii}	4,396	–	–	4,396	4,396
Accrued investment income	–	–	2,023	2,023	2,023
Other debtors	–	–	909	909	909
	155,902	18,635	23,696	198,233	

	2007 £m				Fair value
	Fair value through profit and loss	Amortised cost	IFRS 4 basis value	Total carrying value	
Financial liabilities					
Core structural borrowings of shareholder-financed operations ^{notes i, H13}	–	2,492	–	2,492	2,476
Operational borrowings attributable to shareholder-financed operations ^{H13}	–	3,081	–	3,081	3,081
Borrowings attributable to with-profits funds ^{H13}	204	783	–	987	1,006
Obligations under funding, securities lending and sale and repurchase agreements	–	4,081	–	4,081	4,100
Net asset value attributable to unit holders of consolidated unit trust and similar funds	3,556	–	–	3,556	3,556
Investment contracts with discretionary participating features ^{note iv}	–	–	29,550	29,550	–
Investment contracts without discretionary participating features	12,110	1,922	–	14,032	14,034
Other creditors	–	1,020	–	1,020	1,020
Derivative liabilities	1,080	–	–	1,080	1,080
Other liabilities	1	790	–	791	791
	16,951	14,169	29,550	60,670	

Notes

i As at 31 December 2008, £620 million (2007: £722 million) of convertible bonds were included in debt securities and £363 million (2007: £278 million) were included in borrowings.

ii Loans and receivables are reported net of allowance for loan losses of £27 million (2007: £13 million).

iii See note G3 for details of the derivative assets included. The balance also contains the PAC with-profits fund's participation in various investment funds and limited liability property partnerships.

iv It is impractical to determine the fair value of investment contracts with discretionary participation features due to the lack of a reliable basis to measure such features.

v For financial liabilities designated as fair value through profit and loss there was no impact on profit from movements in credit risk during 2008 and 2007.

Determination of fair value

The fair values of the financial assets and liabilities as shown on the table above have been determined on the following bases.

The fair values of the financial instruments for which fair valuation is required under IFRS and which are in an active market are determined by the use of current market bid prices for quoted investments, or by using quotations from independent third-parties, such as brokers and pricing services. If the market for a financial investment of the Group is not active, the fair values of the financial instruments are established by using valuation techniques. These include financial investments which are not quoted on active markets and financial investments for which markets are no longer active as a result of market conditions e.g. market illiquidity. The valuation techniques used include comparison to recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option adjusted spread models and, if applicable, enterprise valuation. These techniques may include a number of assumptions relating to variables such as credit risk and interest rates. Changes in assumptions relating to these variables could positively or negatively impact the reported fair value of these

Notes on the Group financial statements

G: Financial assets and liabilities

continued

G1: Financial instruments - designation and fair values continued

instruments. The source of pricing for the financial investments valued using valuation techniques could be from using quotations from independent third-parties, such as brokers and pricing services or by using valuation techniques modelled internally by the Group. Priority is given to publicly available prices from independent sources, when available but overall, the source of pricing is chosen with the objective of arriving at a fair value measurement which reflects the price at which an orderly transaction would take place between market participants on the measurement date.

The fair value estimates are made at a specific point in time, based upon available market information and judgements about the financial instruments, including estimates of the timing and amount of expected future cash flows and the credit standing of counterparties. Such estimates do not reflect any premium or discount that could result from offering for sale at one time the Group's entire holdings of a particular financial instrument, nor do they consider the tax impact of the realisation of unrealised gains or losses. In some cases the fair value estimates cannot be substantiated by comparison to independent markets, nor can the disclosed value be realised in immediate settlement of the financial instrument. Illiquid market conditions have resulted in inactive markets for certain of the Group's financial instruments. As a result, there is generally no or limited observable market information for these instruments. Fair value estimates for financial instruments deemed to be in an illiquid market are based on judgements regarding current economic conditions, liquidity discounts, currency, credit and interest rate risks, loss experience and other factors. These fair values are estimates and involve considerable uncertainty and variability as a result of the inputs selected and may differ significantly from the values that would have been used had the ready market existed, and the differences could be material.

The loans and receivables have been shown net of provisions for impairment. The fair value of loans has been estimated from discounted cash flows expected to be received. The rate of discount used was the market rate of interest.

The estimated fair value of derivative financial instruments reflects the estimated amount the Group would receive or pay in an arm's length transaction. This amount is determined using quotations from independent third-parties or valued internally using standard market practices. In accordance with the Group's risk management framework, all internally generated valuations are subject to independent assessment against external counterparties' valuations.

The fair value of borrowings is based on quoted market prices, where available.

Section A4 provides details of the determination of fair value for investment contracts without fixed and guaranteed terms (notably UK unit-linked policies). For investment contracts in the US with fixed and guaranteed terms the fair value is determined based on the present value of future cash flows discounted at current interest rates.

The fair value of other financial liabilities is determined using discounted cash flows of the amounts expected to be paid.

Use of valuation techniques

The carrying value of financial investments (including derivative liabilities) on the balance sheet of the Group which are not quoted on active markets and for which fair value is determined using internal valuation techniques, or is provided by brokers or pricing services, where the specific securities have been valued using valuation techniques by these third-party providers are as follows:

	2008 £m				
	Shareholder-backed business				Total
	UK with-profits fund	UK insurance operations	US insurance operations	Other operations	
Debt securities	12,341	685	24,246	47	37,319
Equity securities	661	–	235	–	896
Other investments (including derivative assets)	2,189	257	1,215	324	3,985
	15,191	942	25,696	371	42,200
Derivative liabilities	(496)	(238)	(863)	(351)	(1,948)
Net of derivative liabilities	14,695	704	24,833	20	40,252

	2007 £m				
	Shareholder-backed business				Total
	UK with-profits fund	UK insurance operations	US insurance operations	Other operations	
Debt securities	10,640	509	18,996	–	30,145
Equity securities	683	–	166	–	849
Other investments (including derivative assets)	2,425	103	744	73	3,345
	13,748	612	19,906	73	34,339
Derivative liabilities	(168)	(53)	(158)	(138)	(517)
Net of derivative liabilities	13,580	559	19,748	(65)	33,822

* Including SAIF

The majority of the financial investments valued using valuation techniques were debt securities.

The debt securities shown above include private debt securities such as private placements, project finance, asset securitisations and local authority securities. The securities are mainly long-dated and not regularly traded and are valued internally using market standard practices. The majority of the debt securities above are valued using matrix pricing, which is based on assessing credit quality of the underlying borrower to derive a suitable discount rate relative to government securities. Under matrix pricing, the debt securities are priced by taking the credit spreads on comparable quoted public debt securities and applied to the equivalent debt instruments factoring a specified liquidity premium. The majority of the parameters used in this valuation technique are readily observable in the market and, therefore, are not subject to interpretation.

Debt securities valued using valuation techniques held for UK insurance operations were £13,026 million (2007: £11,149 million) and of this amount £12,341 million (2007: £10,640 million) related to securities held by with-profits operations and £685 million (2007: £509 million) related to securities held by the UK shareholder-backed business.

Of the debt securities valued using valuation techniques held by the UK with-profits fund of £12,341 million at 31 December 2008 (2007: £10,640 million), £8,647 million (2007: £7,638 million) have been priced by independent third-parties and £3,694 million (2007: £3,002 million) determined using internal valuation techniques.

The debt securities held by the UK with-profits fund at 31 December 2008 of £12,341 million include US securities managed by PPM America with a value of £8,773 million. This amount comprises £8,738 million in respect of securities for which the fair value has been measured using valuation techniques for which all inputs significant to the measurement are based on observable market data. This categorisation corresponds to 'Level 2' assets under amendments to IFRS 7. £35 million is in respect of securities for which the fair value has been measured using valuation techniques that include any input significant to the measurement that is not based on observable market data i.e. 'Level 3' securities.

For the UK operations, in accordance with the Group's Risk Management Framework, all internally generated calculations are subject to independent assessment by the Group's Fair Value Committees which comprise members who are independent of the fund managers involved in the day-to-day trading in these assets.

Of the debt securities valued using valuation techniques of £37,319 million (2007: £30,145 million) at 31 December 2008, debt securities with a fair value of £24,246 million (2007: £18,996 million) were held by the US insurance operations. The £24,246 million value at 31 December 2008 comprises 'Level 2' and 'Level 3' securities with values of £20,564 million and £3,681 million, respectively. Typical inputs used in pricing these debt securities include, but are not limited to, reported trades, benchmark yields, credit spreads, liquidity premiums, and/or estimated cash flows based on default and prepayment assumptions.

The majority of the debt securities of the US insurance operations are priced by independent pricing services and included as 'Level 2' securities. As a result of typical trading volumes and the lack of quoted market prices for most debt securities, independent pricing services will normally derive the security prices through recently reported trades for identical or similar securities, making adjustments through the reporting date based upon available market observable information. If there are no reported trades, the independent pricing services and brokers may use matrix or pricing model processes to develop a security price where future cash flow expectations are developed based upon collateral performance and discounted at relevant market rates.

Debt securities of US insurance operations valued using internally derived valuation techniques in 2008 include certain asset-backed securities which had previously been valued using prices provided by a pricing service or brokers in the context of active markets. The current market dislocations have caused a reassessment of the valuation process for these asset-backed securities. In particular, beginning at the end of the third-quarter of 2008, the external prices obtained for certain asset-backed securities were deemed to be inappropriate in the current market conditions. For the valuations at 31 December 2008, the US operations have therefore utilised internal valuation models, provided by PPM America, to derive fair values for all non-agency residential mortgage-backed securities and asset-backed securities and certain commercial mortgage-backed securities. Details of these asset-backed securities are provided in notes B6 and D3. The techniques used by PPM America include cash flow models based on spreads and, when available, market indices. The models used begin with current spread levels of similarly-rated securities to determine the market discount rate for the security. Additional risk premiums for illiquidity and non-performance are incorporated, if warranted, and included in the discount rate. Cash flows, as estimated by PPM America using issuer-specific default statistics and prepayment assumptions, are discounted to determine an estimated fair value. The use of internal valuation models has resulted in a fair value of these securities that was higher than those provided from pricing services and brokers of £760 million on a total amortised cost of £3.5 billion.

The equity securities and other investments which included property and other partnerships in investment pools, venture investments and derivative assets and derivative liabilities as shown on the table above are valued using valuation techniques which apply less readily observable market factors and more non-observable factors than the matrix pricing technique as used for the majority of the debt securities.

The total amount of the change in fair value estimation using valuation techniques, including valuation techniques based on assumptions not wholly supported by observable market prices or rates, recognised in the income statement in 2008 was a gain of £355 million (2007: gain of £288 million) for the with-profits fund investments. The gain in 2008 reflects an underlying loss which is more than offset by the exchange gains of the foreign currency denominated investments of the with-profits fund. Changes in values of assets of the with-profits funds are reflected in policyholder liabilities and unallocated surplus. Due to the liability accounting treatment of unallocated surplus, changes in values of securities held by with-profits funds have no direct effect on the profit or loss attributable to shareholders or shareholders' equity.

Notes on the Group financial statements

G: Financial assets and liabilities

continued

G1: Financial instruments - designation and fair values continued

The total amount of the change in fair value estimation using valuation techniques, including those based on assumptions not wholly supported by observable market prices or rates, recognised in the income statement in 2008 and which was attributable to shareholders, was a loss of £685 million (2007: gain of £116 million).

The 2007 comparatives shown above differ from the previously published information for the inclusion of the financial investments for which prices have been provided by independent third-parties, such as pricing services and brokers, and for which the prices have been derived using valuation techniques by these providers. The previously published 2007 information included only the financial investments valued internally using valuation techniques.

Interest income and expense

The interest income on financial assets not at fair value through profit and loss for the year ended 31 December 2008 from continuing operations was £2,532 million (2007: £2,016 million).

The interest expense on financial liabilities not at fair value through profit and loss for the year ended 31 December 2008 from continuing operations was £645 million (2007: £699 million).

G2: Market risk

Interest rate risk

The following table shows an analysis of the classes of financial assets and liabilities and their direct exposure to interest rate risk. Each applicable class of the Group's financial assets or liabilities is analysed between those exposed to fair value interest rate risk, cash flow interest rate risk and those with no direct interest rate risk exposure:

	2008 £m			Total
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	
Financial assets				
Cash and cash equivalents	–	–	5,955	5,955
Deposits	1,126	6,084	84	7,294
Debt securities	89,353	5,532	339	95,224
Loans	6,979	3,485	27	10,491
Other investments (including derivatives)	1,539	686	4,076	6,301
	98,997	15,787	10,481	125,265
Financial liabilities				
Core structural borrowings of shareholder-financed operations	2,958	–	–	2,958
Operational borrowings attributable to shareholder-financed operations	1,520	454	3	1,977
Borrowings attributable to with-profits funds	729	482	97	1,308
Obligations under funding, securities lending and sale and repurchase agreements	889	4,683	–	5,572
Investment contracts without discretionary participation features	2,885	–	11,616	14,501
Derivative liabilities	1,185	785	2,862	4,832
Other liabilities	218	105	567	890
	10,384	6,509	15,145	32,038

	2007 £m			Total
	Fair value interest rate risk	Cash flow interest rate risk	Not directly exposed to interest rate risk	
Financial assets				
Cash and cash equivalents	–	–	4,951	4,951
Deposits	678	7,211	–	7,889
Debt securities	76,481	7,503	–	83,984
Loans	4,319	3,605	–	7,924
Other investments (including derivatives)	664	285	3,447	4,396
	82,142	18,604	8,398	109,144
Financial liabilities				
Core structural borrowings of shareholder-financed operations	2,492	–	–	2,492
Operational borrowings attributable to shareholder-financed operations	2,743	331	7	3,081
Borrowings attributable to with-profits funds	451	441	95	987
Obligations under funding, securities lending and sale and repurchase agreements	594	3,487	–	4,081
Investment contracts without discretionary participation features	1,922	–	12,110	14,032
Derivative liabilities	244	145	691	1,080
Other liabilities	178	98	515	791
	8,624	4,502	13,418	26,544

Liquidity analysis

	2008 £m							Total carrying value
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	No stated maturity	
Financial liabilities								
Core structural borrowings of shareholder-financed operations ^{H13}	249	–	–	801	–	849	1,059	2,958
Operational borrowings attributable to shareholder-financed operations ^{H13}	1,584	339	–	–	–	54	–	1,977
Borrowings attributable to with-profits funds ^{H13}	272	580	278	–	–	78	100	1,308
Obligations under funding, securities lending and sale and repurchase agreements	5,572	–	–	–	–	–	–	5,572
Derivative liabilities	3,066	448	266	408	156	488	–	4,832
Other liabilities	646	11	5	–	–	–	228	890
	11,389	1,378	549	1,209	156	1,469	1,387	17,537

	2007 £m							Total carrying value
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	No stated maturity	
Financial liabilities								
Core structural borrowings of shareholder-financed operations ^{H13}	–	248	–	366	315	801	762	2,492
Operational borrowings attributable to shareholder-financed operations ^{H13}	2,618	51	355	–	–	57	–	3,081
Borrowings attributable to with-profits funds ^{H13}	103	232	265	–	–	83	304	987
Obligations under funding, securities lending and sale and repurchase agreements	4,081	–	–	–	–	–	–	4,081
Derivative liabilities	684	174	10	33	6	173	–	1,080
Other liabilities (including derivatives)	630	7	2	–	–	–	152	791
	8,116	712	632	399	321	1,114	1,218	12,512

Notes on the Group financial statements

G: Financial assets and liabilities

continued

G2: Market risk continued

The table below shows the maturity profile for investment contracts on an undiscounted basis to the nearest billion. This maturity profile has been based on the cash flow projections of expected benefit payments as part of the determination of the value of in-force business when preparing EEV basis results.

	2008 £bn						Total undiscounted value
	1 year or less	After 1 year to 5 years	After 5 years to 10 years	After 10 years to 15 years	After 15 years to 20 years	Over 20 years	
Life assurance investment contracts	3	18	12	12	9	13	67

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

The maturity profile above excludes certain corporate unit-linked business with gross policyholder liabilities of £8 billion (2007: £8 billion) which has no stated maturity.

This table has been prepared on an undiscounted basis and accordingly the amounts shown for life assurance investment contracts differ from those disclosed on the balance sheet. Durations of long-term business contracts, covering insurance and investment contracts, on a discounted basis are included in section D.

Credit risk

Of the total loans and receivables held £21 million (2007: £5 million) are past their due date but have not been impaired. Of the total past due but not impaired, £21 million (2007: £5 million) are less than one year past their due date. The Group expects full recovery of these loans and receivables. Financial assets that would have been past due or impaired had the terms not been renegotiated amounted to £1 million (2007: £nil).

There was no collateral held against loans that are past due and impaired or that are past due but not impaired at 31 December 2008 (2007: £nil).

In addition, during the year the Group took possession of £66 million (2007: £7 million) of other collateral held as security, which mainly consists of assets that could be readily convertible into cash.

Currency risk

As at 31 December 2008, the Group held 20 per cent (2007: 19 per cent) and 13 per cent (2007: 13 per cent) of its financial assets and financial liabilities respectively, in currencies, mainly US dollar and Euro, other than the functional currency of the relevant business unit.

The financial assets, of which 77 per cent (2007: 86 per cent) are held by the PAC with-profits fund, allow the PAC with-profits fund to obtain exposure to foreign equity markets.

The financial liabilities, of which 38 per cent (2007: 19 per cent) are held by the PAC with-profits fund, mainly relate to foreign currency borrowings.

The exchange risks inherent in these exposures are mitigated through the use of derivatives, mainly forward currency contracts (note G3 below).

The amount of exchange gains recognised in the income statement in 2008, except for those arising on financial instruments measured at fair value through profit and loss, is £638 million (2007: £102 million). This constitutes £32 million (2007: £109 million) gains on Medium Term Notes (MTN) liabilities and £606 million of net gains (2007: £7 million net losses), mainly arising on investments of the PAC with-profits fund. The gains on MTN liabilities are fully offset by value movements on cross-currency swaps, which are measured at fair value through profit and loss.

G3: Derivatives and hedging

Derivatives

The Group enters into a variety of exchange traded and over-the-counter derivative financial instruments, including futures, options, forward currency contracts and swaps such as interest rate swaps, cross-currency swaps, swaptions and credit default swaps.

All over-the-counter derivative transactions are conducted under standardised ISDA (International Swaps and Derivatives Association Inc) master agreements and the Group has collateral agreements between the individual Group entities and relevant counterparties in place under each of these market master agreements.

The total fair value balances of derivative assets and liabilities as at 31 December 2008 were as follows:

	2008 £m					
	UK insurance operations	US insurance operations	Asian insurance operations	Asset management	Unallocated to a segment	Group total
Derivative assets	1,326	675	15	74	280	2,370
Derivative liabilities	(3,401)	(863)	(32)	(292)	(244)	(4,832)
	(2,075)	(188)	(17)	(218)	36	(2,462)

	2007 £m					
	UK insurance operations	US insurance operations	Asian insurance operations	Asset management	Unallocated to a segment	Group total
Derivative assets	571	390	15	118	3	1,097
Derivative liabilities	(689)	(158)	(2)	(186)	(45)	(1,080)
	(118)	232	13	(68)	(42)	17

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

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

As at 31 December 2008	2008 £m			
	UK insurance operations Notional amount on which future payments are based		US insurance operations Notional amount on which future payments are based	
	Asset	Liability	Asset	Liability
Cross-currency swaps*	838	1,014	448	218
Equity index call options	17	32	–	–
Swaptions	980	980	28,863	–
Futures	3,286	4,055	–	460
Forwards*	14,315	16,489	–	–
Inflation swaps	2,559	2,482	–	–
Credit default swaps	123	14	–	–
Single stock options	1	1	–	–
Credit derivatives	–	–	31	177
Put options	–	–	6,573	–
Equity options	2	4	3,785	5
Total return swaps	479	514	–	313
Interest rate swaps*	5,074	5,245	1,704	4,514

* In addition, the other operations, including the Group Treasury function and the Asian operations, have cross-currency swap assets and liabilities with notional amounts of £1,503 million (2007: £730 million) and £605 million (2007: £1,401 million) respectively, forward currency contracts assets and liabilities with notional amounts of £1,419 million (2007: £983 million) and £2,310 million (2007: £773 million) respectively, interest rate swaps assets and liabilities of £1,407 million (2007: £2,799 million) and of £2,316 million (2007: £1,563 million), respectively, and cliquet options assets of £1,525 million (2007: £nil).

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G: Financial assets and liabilities

continued

G3: Derivatives and hedging continued

As at 31 December 2007	2007 £m			
	UK insurance operations Notional amount on which future payments are based		US insurance operations Notional amount on which future payments are based	
	Asset	Liability	Asset	Liability
Cross-currency swaps*	658	648	602	–
Equity index call options	–	23	–	–
Swaptions	1,125	–	25,620	1,005
Futures	1,905	2,176	–	371
Forwards*	17,243	17,635	–	–
Inflation swaps	1,758	1,319	–	–
Credit default swaps	4,181	59	–	–
Single stock options	–	–	–	–
Credit derivatives	–	–	3	20
Put options	–	–	3,642	–
Equity options	–	–	5,545	11
Total return swaps	956	955	226	–
Interest rate swaps*	4,335	4,663	1,708	3,587

* In addition, the other operations, including the Group Treasury function and the Asian operations, have cross-currency swap assets and liabilities with notional amounts of £1,503 million (2007: £730 million) and £605 million (2007: £1,401 million) respectively, forward currency contracts assets and liabilities with notional amounts of £1,419 million (2007: £983 million) and £2,310 million (2007: £773 million) respectively, interest rate swaps assets and liabilities of £1,407 million (2007: £2,799 million) and of £2,316 million (2007: £1,563 million), respectively, and cliquet options assets of £1,525 million (2007: £nil).

These derivatives are used for efficient portfolio management to obtain cost effective and efficient exposure to various markets in accordance with the Group's investment strategies and to manage exposure to interest rate, currency, credit and other business risks. See also note D3 for use of derivatives by the Group's US operations.

The Group uses various interest rate derivative instruments such as interest rate swaps to reduce exposure to interest rate volatility.

The UK insurance operations use various currency derivatives in order to limit volatility due to foreign currency exchange rate fluctuations arising on securities denominated in currencies other than sterling. See also note G2 above. In addition, total return swaps and interest rate swaps are held for efficient portfolio management.

As part of the efficient portfolio management of the PAC with-profits fund, the fund may, from time to time, invest in cash-settled forward contracts over Prudential plc shares, which are accounted for consistently with other derivatives. This is in order to avoid a mismatch of the with-profits investment portfolio with the investment benchmarks set for its equity-based investment funds. The contracts will form part of the long-term investments of the with-profits fund. These contracts are subject to a number of limitations for legal and regulatory reasons.

Some of the Group's products, especially those sold in the US, have certain guarantee features linked to equity indexes. A mismatch between product liabilities and the performance of the underlying assets backing them, exposes the Group to equity index risk. In order to mitigate this risk, the relevant business units purchase swaptions, equity options and futures to match asset performance with liabilities under equity-indexed products.

The US operations and some of the UK operations hold large amounts of interest-rate sensitive investments that contain credit risks on which a certain level of defaults is expected. These entities have purchased some swaptions in order to manage the default risk on certain underlying assets and hence reduce the amount of regulatory capital held to support the assets.

Hedging

The Group has formally assessed and documented the effectiveness of the following hedges under IAS 39.

Fair value hedges

The Group uses interest rate derivatives to hedge the interest exposures on its US\$1 billion, 6.5 per cent perpetual subordinated capital securities and US\$300 million, 6.5 per cent perpetual subordinated capital securities. Where the hedge relationship is de-designated and re-designated, the fair value adjustment to the hedged item up to the point of de-designation continues to be reported as part of the basis of the hedged item and is amortised to the income statement based on a recalculated effective interest rate over the residual period to the first break clause date of the perpetual subordinated capital securities.

In addition, Jackson had a common stock equity collar hedge entered into in March 2005. This was to protect Jackson's unrealised gain of US\$5.9 million on an equity investment. The hedge expired in March 2008.

The fair value of the derivatives designated as fair value hedges above at 31 December 2008, were an asset of £17 million and liabilities of £nil (2007: asset of £5 million and liabilities of £25 million). Movements in the fair value of the hedging instruments of a net loss of £4 million (2007: net gain of £6 million) and the hedged items of a net gain of £7 million (2007: net loss of £4 million) are recorded in the income statement in respect of the fair value hedges above.

Cash flow hedges

Following the sale of Egg in 2007, the Group has no cash flow hedges in place.

Net investment hedges

The Group has entered into a series of one to three-month period forward currency transactions which together form a US\$2 billion net investment hedge of the currency exposure of the net investments in the US operations. The forward currency contracts were renewed throughout 2008 and 2007. The forward currency contracts in place at 31 December 2008 expire in January 2009. In December 2008, the Group de-designated the US\$2 billion forward currency contract and re-designated only US\$600 million of the forward currency contract as a partial net investment hedge of the currency exposure of the net investments in the US operations. The change reflected consideration of the direct US dollar exposure for accounting purposes, and the indirect offsetting exposure within the Group's IGD solvency reporting. The fair value of the forward currency contracts at 31 December 2008 was a liability of £56 million (2007: a liability of £44 million), of which £17 million (2007: a liability of £44 million) was designated as a net investment hedge of the currency exposure of the net investments in the US operations.

In addition, the Group has designated perpetual subordinated capital securities totalling US\$1.55 billion as a net investment hedge to hedge the currency risks related to the net investment in Jackson. The carrying value of the subordinated capital securities was £1,059 million (2007: £763 million) as at 31 December 2008. The foreign exchange loss of £299 million (2007: gain of £13 million) on translation of the borrowings to pounds sterling at the balance sheet date is recognised in the translation reserve in shareholders' equity.

The net investment hedges were 100 per cent effective.

G4: Derecognition and collateral

Securities lending and reverse repurchase agreements

The Group has entered into securities lending (including repurchase agreements) whereby blocks of securities are loaned to third-parties, primarily major brokerage firms. The amounts above the fair value of the loaned securities required to be held as collateral by the agreements depend on the quality of the collateral, calculated on a daily basis. The loaned securities are not removed from the Group's consolidated balance sheet, rather they are retained within the appropriate investment classification. Collateral typically consists of cash, debt securities, equity securities and letters of credit. At 31 December 2008, the Group had lent £12,617 million (2007: £17,172 million) (of which £9,701 million (2007: £11,461 million) was lent by the PAC with-profits fund) of securities and held collateral under such agreements of £13,497 million (2007: £18,125 million) (of which £9,924 million (2007: £12,105 million) was held by the PAC with-profits fund).

At 31 December 2008, the Group had entered into reverse repurchase transactions under which it purchased securities and had taken on the obligation to resell the securities for the purchase price of £588 million (2007: £1,361 million), together with accrued interest.

Collateral and pledges under derivative transactions

At 31 December 2008, the Group had pledged £1,154 million (2007: £260 million) for liabilities and held collateral of £829 million (2007: £292 million) in respect of over-the-counter derivative transactions.

Notes on the Group financial statements

G: Financial assets and liabilities

continued

G5: Impairment of financial assets

In accordance with the Group's accounting policy set out in note A4, impairment reviews were performed for available-for-sale securities and loans and receivables. In addition, impairment reviews were undertaken for the reinsurers' share of insurance contract liabilities.

During the year ended 31 December 2008, impairment losses of £525 million (2007: £184 million) were recognised for available-for-sale securities and loans and receivables. These were £497 million (2007: £35 million) in respect of available-for-sale securities held by Jackson and £28 million (2007: £149 million) in respect of loans and receivables. The 2008 impairment charge for loans and receivables of £28 million relates primarily to loans held by the UK with-profits fund. The 2007 impairment charge of £149 million related to loans and advances to customers in the discontinued banking operations during the period of ownership.

Impairment losses recognised on available-for-sale securities amounted to £497 million (2007: £35 million). Of this amount, 8 per cent (2007: 14 per cent) has been recorded on structured asset-backed securities, primarily due to reduced cash flow expectations on such securities that are collateralised by diversified pools of primarily below investment grade securities. Of the losses related to the impairment of fixed maturity securities the top five individual corporate issuers made up 27 per cent (2007: 57 per cent), reflecting a deteriorating business outlook of the companies concerned.

The impairment losses have been recorded in 'investment income' in the income statement.

In 2008, the Group realised gross losses on sales of available-for-sale securities of £184 million (2007: £86 million) with 55 per cent (2007: 46 per cent) of these losses related to the disposal of fixed maturity securities of six (2007: six) individual issuers, which were disposed of to rebalance the portfolio in the US operations in response to the unstable mortgage lending

The effect of those reasonably likely changes in the key assumptions underlying the estimates that underpin the assessment of whether impairment has taken place depends on the factors described in note A3. A key indicator of whether such impairment may arise in future, and the potential amounts at risk, is the profile of gross unrealised losses for fixed maturity securities accounted for on an available-for-sale basis by reference to the time periods by which the securities have been held continuously in an unrealised loss position and by reference to the maturity date of the securities concerned.

For 2008 the amounts of gross unrealised losses for fixed maturity securities classified as available-for-sale under IFRS in an unrealised loss position was £3,178 million (2007: £439 million). Notes B1 and D3 provide further details on the impairment charges and unrealised losses of Jackson's available-for-sale securities.