BASIS OF EEV DISCUSSION

Overview

In addition to IFRS basis results, the Prudential Group prepares results in accordance with the EEV Principles issued by the Chief Financial Officers' Forum of European Insurance Companies in May 2004 and expanded by the Additional Guidance of EEV Disclosures published in October 2005. Over the life of any given product, the total profit recognised will be the same under either the IFRS or the EEV basis. However, the two methods recognise the emergence of that profit in different ways, with profits emerging earlier under the EEV basis than under IFRS.

In broad terms, IFRS profits for long-term business reflect the aggregate of statutory transfers from UK-style with-profits funds and profit on a traditional accounting basis for other long-term business. By their nature, the products sold by the life insurance industry are long-term, as insurance companies commit to service these products for many years into the future. The profit on these insurance sales is generated over this long-term period. In Prudential's view, the result under IFRS does not properly reflect the inherent value of these future profits, as it focuses instead on the amounts accruing to shareholders in the current year. See "Description of EEV Basis Reporting" below for further information regarding how EEV differs from IFRS and why it is used by the Prudential Group. The following discussion and analysis of the Prudential Group's EEV basis supplementary results should be read in conjunction with the Prudential Group's EEV basis supplementary information and the related notes to the Prudential Group's EEV basis supplementary information as of and for the years ended 31 December 2008 and 2009 set out in Appendix IV to this listing document. Where appropriate the EEV basis results include the effects of adoption of IFRS.

The EEV basis results are not determined in accordance with IFRS or any other generally accepted accounting principles, and should not be considered as alternatives to performance measures derived in accordance with IFRS. Other insurance companies may calculate EEV basis results differently, and consequently, the Prudential Group's presentation of these results may not be readily comparable to other companies' figures.

The results discussed below are not necessarily indicative of the results to be expected in any future periods. This discussion contains forward-looking statements based on current expectations, which involve risks and uncertainties. Actual results and the timing of certain events may differ significantly from those projected in these forward-looking statements due to a number of factors, including those set out in "Risk Factors".

Description of EEV Basis Reporting

Embedded Value

Embedded value ("EV") is the present value of the shareholders' interest in the earnings distributable from assets allocated to the life businesses after allowing for aggregate risks. This includes the present value (PV) of future cash flows from in-force business and capital tied-up in the life funds, the cost of holding additional capital, and shareholders' free surplus. EV is a broadly defined concept and different applications of the principle can lead to very different financial results. This has led to attempts to standardise the application of EV in order to improve the rigour of, and comparability between companies' EV results. EEV results are prepared in accordance with Principles issued by the CFO Forum of European Insurance Companies in May 2004 (and expanded by the Additional Guidance of EEV Disclosures published in October 2005), and are a standardised calculation of embedded value that has been adopted by many European life insurance companies to improve credibility and comparability of EV results.

A common set of principles are used under EEV that provide consistent definitions, a framework for setting actuarial assumptions, and a more explicit approach to the underlying methodology and disclosures. So for example:

- The allowance for risk is explicit for EEV through: (i) an allowance for the cost of capital (at the higher of economic capital and the local statutory minimum), (ii) stochastic or other appropriate modelling of financial options and guarantees to ensure that an allowance for their cost is allowed irrespective of their value at the balance sheet date, and (iii) an explicit allowance in the risk discount rate for financial and non-financial risks. EV has no prescribed way for allowing for the risk and uncertainty that is inherent in forecasting future cash flows (typically this has been achieved by including an implicit allowance for risk in the risk discount rate);
- EEV specifically allows for the look-through into profits arising in shareholder service companies, most notably the profit arising in investment management companies from managing the insurance companies funds for covered business;
- There are extensive disclosures required for EEV on all aspects of the calculations, including the methodology adopted and the analysis of return.

The EEV basis not only provides a good indication of the value being added by management in a given accounting period, but also helps demonstrate whether shareholder capital is being deployed to best effect. Indeed insurance companies in many countries use comparable bases of accounting for management purposes.

The EEV basis is a value-based method of reporting in that it reflects the change in value of the business over the accounting period. This value is called the shareholders' funds on the EEV basis which, at a given point in time, is the value of future profits expected to arise from the current book of long-term insurance business plus the net worth of the company. In determining these expected profits, full allowance is made for the risks attached to their emergence and the associated cost of capital, and takes into account recent experience in assessing likely future persistency, mortality and expenses.

The change in value is typically analysed into the following components:

- the value added from new business sold during the year;
- the change in value from existing business already in place at the start of the year;
- short-term fluctuations in investment returns;
- changes in economic assumptions;
- change in the time value of cost of options and guarantees and economic assumption changes;
- other items (for example, profit from other group operations, tax, foreign exchange, exceptional items); and
- dividends.

The value added from new business — defined as the present value of the future profits arising from new business written in the year — is a key metric that the Prudential Group uses in the management of its business. The change in value of business in-force at the start of the year demonstrates how the existing book is being managed. Together, these metrics provide management and shareholders with valuable information about the underlying development of the Prudential Group's business and the success or otherwise of management actions.

EEV basis results are prepared first of all by setting 'best estimate' assumptions, by product, for all relevant factors including expenses, surrender levels and mortality. Economic assumptions as to future investment returns and inflation are generally based on a combination of market data and long-term assumptions. These assumptions are used to project future cash flows. The present value of the future cash flows is then calculated using a discount rate which reflects both the time value of money and the risks associated with the cash flows. The risk discount rate is determined by adding a risk margin to the appropriate risk-free rate of return. The actual outcome may differ from that projected, in which case the effect will be reflected in the experience variances for that year.

The assumptions used for the EEV basis of accounting are set out in the notes that accompany the supplementary EEV basis information. An indication of the sensitivity of the results to changes in key assumptions is also provided within that information.

The publication of the EEV Principles represented a significant step towards the harmonisation of embedded value reporting in Europe. However, even with these principles and the accompanying guidance, a divergence of approaches between companies has emerged in practice. In June 2008, in an effort to improve the consistency and transparency of embedded value reporting, the CFO Forum published the Market Consistent Embedded Value ("MCEV") Principles. However, the MCEV Principles were designed during a period of relatively stable market conditions and their application could, in the current turbulent markets, lead to misleading results. In December 2008, the CFO Forum announced that it intended to conduct a review of the impact of turbulent market conditions on the MCEV Principles, the result of which may lead to changes in the published principles or the issue of additional guidance. In May 2009, the CFO Forum announced that it had decided to perform further work to seek to improve the consistency in the adjustments made for liquidity premium and volatilities. In light of these developments, mandatory MCEV reporting was deferred for member firms until 2011. In October 2009, the CFO Forum announced changes to the MCEV Principles to allow the inclusion of a liquidity premium. The changes to the Principles were high level, with little detail included on how the liquidity premium should be determined or which products it should be applied to. The CFO Forum is currently conducting further work in these areas.

BASIS OF PREPARATION, METHODOLOGY AND ACCOUNTING PRESENTATION

The EEV basis results have been prepared in accordance with the EEV Principles issued by the CFO Forum of European Insurance Companies in May 2004 and expanded by the Additional Guidance on EEV Disclosures published in October 2005. Where appropriate, the EEV basis results include the effects of adoption of IFRS.

Covered business

The EEV results for the Prudential Group are prepared for 'covered business', as defined by the EEV Principles. Covered business represents the Prudential Group's long-term insurance business for which the value of new and in-force contracts is attributable to shareholders. The EEV basis results for the Prudential Group's covered business are then combined with the IFRS basis results of the Prudential Group's other operations.

The definition of long-term business operations comprises those contracts falling under the definition of long-term insurance business for regulatory purposes together with, for US operations, contracts that are in substance the same as guaranteed investment contracts ("GICs") but do not fall within the technical definition. Under the EEV Principles, the results for covered business incorporate the projected margins of attaching internal asset management.

With two principal exceptions, covered business comprises the Prudential Group's long-term business operations. The principal exceptions are for the closed Scottish Amicable Insurance Fund ("SAIF") and for the presentational treatment of the financial position of the Prudential Group's principal defined benefit pension scheme, the Prudential Staff Pension Scheme ("PSPS"). A small amount of UK group pensions business is also not modelled for EEV reporting purposes.

SAIF is a ring-fenced sub-fund of the PAC long-term fund, established by a Court approved Scheme of Arrangement in October 1997. SAIF is closed to new business and the assets and liabilities of the fund are wholly attributable to the policyholders of the fund.

As regards PSPS, the deficit funding liability attaching to the shareholder-backed business is included in the total for other operations, reflecting the fact that the deficit funding is being paid for by Prudential.

Methodology

(i) Embedded value

Overview

The embedded value is the present value of the shareholders' interest in the earnings distributable from assets allocated to covered business after sufficient allowance has been made for the aggregate risks in that business. The shareholders' interest in the Prudential Group's long-term business comprises:

- present value of future shareholder cash flows from in-force covered business (value of in-force business), less a deduction for the cost of locked-in (encumbered) capital;
- locked-in (encumbered) capital; and
- shareholders' net worth in excess of encumbered capital (free surplus).

The value of future new business is excluded from the embedded value.

Notwithstanding the basis of presentation of results (as explained below) no smoothing of market or account balance values, unrealised gains or investment return is applied in determining the embedded value or profit before tax. Separately, the analysis of profit is delineated between operating profit based on longer-term investment returns and other constituent items, as explained below.

Valuation of new business

The contribution from new business represents profits determined by applying non-economic assumptions as at the end of the year.

In determining the new business contribution for UK immediate annuity and lifetime mortgage business, which is interest rate sensitive, it is appropriate to use assumptions reflecting point of sale market condition consistent with how the business is priced. For other business within the Prudential Group end-of-period economic assumptions are used.

Valuation movements on investments

With the exception of debt securities held by Jackson, investment gains and losses during the period (to the extent that changes in capital values do not directly match changes in liabilities) are included directly in the profit for the period and shareholders' equity as they arise.

The results for any covered business conceptually reflects the aggregate of the IFRS results and the movements on the additional shareholders' interest recognised on the EEV basis. Thus the starting point for the calculation of the EEV results for Jackson, as for other businesses, reflects the market value movements recognised on the IFRS basis.

However, in determining the movements on the additional shareholders' interest, the basis for calculating the Jackson EEV result acknowledges that for debt securities backing liabilities the aggregate EEV results reflect the fact that the value of in-force business instead incorporates the discounted value of future spread earnings. This value is not affected generally by short-term market movements on securities that are broadly speaking held for the longer term.

Fixed income securities backing the free surplus and required capital for Jackson are accounted for at fair value. However, consistent with the treatment applied under IFRS for Jackson securities classified as available-for-sale, movements in unrealised appreciation on these securities are accounted for in equity rather than in the income statement, as shown in the movement in shareholders' equity.

Value of in-force business

The embedded value results are prepared incorporating best estimate assumptions about all relevant factors including levels of future investment returns, expenses, persistency and mortality. These assumptions are used to project future cash flows. The present value of the future cash flows is then calculated using a discount rate which reflects both the time value of money and the non-diversifiable risks associated with the cash flows that are not otherwise allowed for.

The total profit that emerges over the lifetime of an individual contract as calculated using the embedded value basis is the same as that calculated under the IFRS basis. Since the embedded value basis reflects discounted future cash flows, under this methodology the profit emergence is advanced thus more closely aligning the timing of the recognition of profits with the efforts and risks of current management actions, particularly with regard to business sold during the year.

Cost of capital

A charge is deducted from the embedded value for the cost of capital supporting the Prudential Group's long-term business. This capital is referred to as encumbered capital. The cost is the difference between the nominal value of the capital and the discounted value of the projected releases of this capital allowing for investment earnings (net of tax) on the capital.

The annual result is affected by the movement in this cost from year to year which comprises a charge against new business profit and generally a release in respect of the reduction in capital requirements for business in force as this runs off.

Where encumbered capital is held within a with-profits long-term fund, the value placed on surplus assets in the fund is already discounted to reflect its release over time and no further adjustment is necessary in respect of encumbered capital.

Financial options and guarantees

(a) Nature of options and guarantees in Prudential Group's long-term business

(1) Asian operations

Subject to local market circumstances and regulatory requirements, the guarantee features described below in respect of UK business broadly apply to similar types of participating contracts principally written in the PAC 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. Whole of life contracts with floor levels of policyholder benefits that accrue at rates set at inception and do not subsequently vary with market conditions are written in the Korean life operations. This is to a much lesser extent than the policies written by the Taiwan Life business which was sold in the first half of 2009.

(2) US operations (Jackson)

The principal options and guarantees in Jackson are associated with the fixed annuity and variable annuity (VA) lines of business.

Fixed annuities provide that, at Jackson's discretion, it may reset the interest rate credited to policyholders' accounts, subject to a guaranteed minimum. The guaranteed minimum return varied from 1.5% to 5.5% in 2009 (2008: 1.5% to 5.5%), depending on the particular product, jurisdiction where issued, and date of issue. As at 31 December 2009, 82% (2008: 83 %) of the account values on fixed annuities related to policies with guarantees of 3% or less. The average guarantee rate was 3% as at 31 December 2009 (2008: 3%).

Fixed annuities also present a risk that policyholders will exercise their option to surrender their contracts in periods of rapidly rising interest rates, possibly requiring Jackson to liquidate assets at an inopportune time.

Jackson issues VA contracts where it contractually guarantees to the contract holder 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 specified contract anniversary. These guarantees include benefits that are payable at specified dates during the accumulation period (Guaranteed Minimum Withdrawal Benefit ("GMWB")) and minimum accumulation, death and income benefits. Jackson hedges these risks using equity options and futures contracts.

These guarantees generally protect the policyholder's value in the event of poor equity market performance.

Jackson also issues fixed index annuities that enable policyholders to obtain a portion of an equity-linked return while providing a guaranteed minimum return. The guaranteed minimum returns would be of a similar nature to those described above for fixed annuities.

(3) UK insurance operations

The only significant financial options and guarantees in the UK insurance operations arise in the with-profits fund and SAIF.

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. The with-profits fund held a provision on the Pillar I Peak 2 basis of £31 million as at 31 December 2009 (2008: £42 million) to honour guarantees on a small amount of guaranteed annuity option products.

Beyond the generic features and the provisions held in respect of guaranteed annuities described above, there are very few explicit options or guarantees of the with-profits fund such as minimum investment returns, surrender values, or annuity values at retirement and any granted have generally been at very low levels.

The Prudential Group's main exposure to guaranteed annuity options in the UK is through SAIF and a provision on the Pillar I Peak 2 basis of £284 million was held in SAIF as at 31 December 2009 (2008: £391 million) to honour the guarantees.

(4) Time value

The value of financial options and guarantees comprises two parts. One is given by a deterministic valuation on best estimate assumptions (the intrinsic value). The other part arises from the variability of economic outcomes in the future (the time value).

Where appropriate, a full stochastic valuation has been undertaken to determine the value of the in-force business including the cost of capital. A deterministic valuation of the in-force business is also derived using consistent assumptions and the time value of the financial options and guarantees is derived as the difference between the two.

The economic assumptions used for the stochastic calculations are consistent with those used for the deterministic calculations. Assumptions specific to the stochastic calculations reflect local market conditions and are based on a combination of actual market data, historic market data and an assessment of long-term economic conditions. Common principles have been adopted across the Prudential Group for the stochastic asset models, for example, separate modelling of individual asset classes but with an allowance for correlation between the various asset classes.

(II) Level of encumbered capital

In adopting the EEV Principles, Prudential Group has based encumbered capital on its internal targets for economic capital subject to it fulfilling at least the local statutory minimum requirements. Economic capital is assessed using internal models but, when applying the EEV Principles, Prudential does not take credit for the significant diversification benefits that exist within the Prudential Group. For with-profits business written in a segregated life fund, as is the case in Asia and the UK, the capital available in the fund is sufficient to meet the encumbered capital requirements. For shareholder-backed business, the following capital requirements apply:

- Asian operations: the level of encumbered capital has been set at the higher of local statutory requirements and the economic capital requirement;
- US operations: the level of encumbered capital has been set to an amount at least equal to 235% of the risk-based capital required by the National Association of Insurance Commissioners (“NAIC”) at the Company Action Level (“CAL”); and
- UK insurance operations: the capital requirements are set at the higher of Pillar I and Pillar II requirements for shareholder-backed business of UK insurance operations as a whole, which for 2009 and 2008 was Pillar I.

(III) Allowance for risk and risk discount rates

Overview

Under the EEV Principles, discount rates used to determine the present value of future cash flows are set equal to risk-free rates plus a risk margin. The risk margin should reflect any non-diversifiable risk associated with the emergence of distributable earnings that is not allowed for elsewhere in the valuation. Prudential has selected a granular approach to better reflect differences in market risk inherent in each product group. The risk discount rate so derived does not reflect an overall Prudential Group market beta but instead reflects the expected volatility associated with the cash flows for each product category in the embedded value model.

Since financial options and guarantees are explicitly valued under the EEV methodology, discount rates under EEV are set excluding the effect of these product features.

The risk margin represents the aggregate of the allowance for market risk, additional allowance for credit risk where appropriate, and allowance for non-diversifiable non-market risk. No allowance is required for non-market risks where these are assumed to be fully diversifiable. The majority of non-market and non-credit risks are considered to be diversifiable.

Market risk allowance

The allowance for market risk represents the multiple of beta x equity risk premium. Except for UK shareholder-backed annuity business such an approach has been used for all of the Prudential Group’s businesses.

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. These are determined by considering how the profits from each product are affected by changes in expected returns on various asset classes. By converting this into a relative rate of return, it is possible to derive a product-specific beta.

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.

Additional credit risk allowance

The Prudential Group's methodology is to allow appropriately for credit risk. The allowance for credit risk is to cover:

- expected long-term defaults;
- credit risk premium (to reflect the volatility in default levels); and
- short-term downgrades and defaults.

These allowances are initially reflected in determining best-estimate returns and through the market risk allowance described above. However, for those businesses which are largely backed by holdings of debt securities these allowances in the projected returns and market risk allowances may not be sufficient and an additional allowance may be appropriate.

The practical application of the allowance for credit risk varies depending upon the type of business as described below.

Asian operations

For Asian operations, the allowance for credit risk incorporated in the projected rates of return and the market risk allowance are sufficient. Accordingly, no additional allowance for credit risk is required.

US business

For Jackson business, the allowance for long-term defaults is reflected in the risk margin reserve charge which is deducted in determining the projected spread margin between the earned rate on the investments and the policyholder crediting rate.

For 2009, the risk discount rate incorporates an additional allowance for credit risk premium and short-term defaults. The allowance for 2009 is 150 basis points for spread-based business and 30 basis points for variable annuity business to reflect the fact that a proportion of the variable annuity business is allocated to the general account.

The level of allowance differs from that for UK annuity business for investment portfolio differences and to take account of the management actions available in adverse economic scenarios to reduce crediting rates to policyholders, subject to guarantee features of the products. For 2008 and previously, allowance for these elements of credit risk was recognised only in the risk margin reserve charge and to the extent implicit within the market risk allowance.

UK business

(a) Shareholder-backed annuity business

For the Prudential Group's UK shareholder-backed annuity business, Prudential Group has used a market consistent embedded value ("MCEV") approach to derive an implied risk discount rate which is then applied to the projected best estimate cash flows.

In the annuity MCEV calculations, the future cash flows are discounted using the swap yield curve plus an allowance for liquidity premium based on Prudential Group's assessment of the expected return on the assets backing the annuity liabilities after allowing for expected long-term defaults, credit risk premium and short-term downgrades and defaults. For the purposes of presentation in the EEV results, the results on this basis are reconfigured. Under this approach the projected earned rate of return on the debt securities held is determined after allowing for expected long-term defaults and, where necessary, an additional allowance for an element of short-term downgrades and defaults to bring the allowance in the earned rate up to best estimate levels. The allowances for credit risk premium and additional short-term default allowance are incorporated into the risk margin included in the discount rate.

(b) With-profits fund PAL annuity business

For UK annuity business written by PAL for 2008, the allowance for credit risk was for best estimate defaults. For 2009, the basis for determining the appropriate aggregate allowance for credit risk has been aligned with that of UK shareholder-backed annuity business so as also to include provision for short-term defaults. The allowance for credit risk in PAL is taken into account in determining the projected cash flows to the with-profits fund, which are in turn discounted at the risk discount rate applicable to all of the projected cash flows of the fund.

(c) With-profits fund holdings of debt securities

The UK with-profits fund holds debt securities as part of its investment portfolio backing policyholder liabilities and unallocated surplus. For 2008, given the expectation that the widening of credit spreads observed in 2008 would not be maintained, the Prudential Group considered it appropriate to assume an unchanged level of credit spreads, an unchanged level of default allowance and an unchanged risk discount rate methodology relative to those used as at 31 December 2007. For 2009, the approach for with-profits holdings has been refined. For equities and properties the projected earned rate is defined as the risk-free rate plus a long-term risk premium. Under the revised methodology a similar approach is adopted for corporate bonds i.e. the assumed earned rate is defined as the risk-free rate plus an assessment of the long-term spread over gilts, net of expected long-term defaults.

Allowance for non-diversifiable non-market risks

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 applied.

For UK shareholder-backed annuity business, a margin of 100 basis points is used to cover the non-diversifiable non-market risks associated with the business. For the Prudential Group's other business a margin of 50 basis points is applied with, where necessary, an additional allowance for emerging market risk. The additional 50 basis points for UK annuities business reflects the longevity risk which is of particular relevance.

(IV) Management actions

In deriving the time value of financial options and guarantees, management actions in response to emerging investment and fund solvency conditions have been modelled. Management actions encompass, but are not confined to, the following areas:

- investment allocation decisions;
- levels of reversionary bonuses and credited rates; and
- total claim values.

Bonus rates are projected from current levels and varied in accordance with assumed management actions applying in the emerging investment and fund solvency conditions.

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 fund, the actions assumed are consistent with those set out in the Principles and Practices of Financial Management.

(V) With-profits business and the treatment of the estate

The proportion of surplus allocated to shareholders from the PAC with-profits fund has been based on the present level of 10%. The value attributed to the shareholders' interest in the estate is derived by increasing final bonus rates (and related shareholder transfers) so as to exhaust the estate over the lifetime of the in-force with-profits business. In those few extreme scenarios where the total assets of the life fund are insufficient to meet policyholder claims in full, the excess cost is fully attributed to shareholders. Similar principles apply, where appropriate, for other with-profits funds of the Prudential Group's Asian operations.

(VI) Pension costs

The Prudential Group operates three defined benefit schemes in the UK. The principal scheme is the Prudential Staff Pension Scheme ("PSPS"). The other two, much smaller, schemes are the Scottish Amicable and M&G schemes. There is also a small scheme in Taiwan but as part of the sale of the Taiwan agency business completed in June 2009, the Prudential Group settled the majority of the obligations under the scheme as a significant number of employees were transferred out.

Under IFRS the surpluses or deficits attaching to these schemes are accounted for in accordance with the provisions of IAS 19 that apply the principles of IFRIC 14, which was adopted in 2008 providing guidance on assessing the limit in IAS 19 on the amount of surplus in a defined benefit pension scheme that can be recognised as an asset.

Under the EEV basis the IAS 19 basis surpluses (to the extent not restricted under IFRIC 14) or deficits are initially allocated in the same manner. The shareholders' 10% interest in the PAC with-profits fund estate is determined after inclusion of the portion of the IAS 19 basis surpluses or deficits attributable to the fund. Adjustments under EEV in respect of accounting for surpluses or deficits on the Scottish Amicable Pension Scheme are reflected as part of UK operations and for other defined benefit schemes the adjustments are reflected as part of 'Other operations', as shown in note 7 of the EEV Basis Supplementary Information set out in Appendix IV to this listing document.

Separately, the projected cash flows of in-force covered business include the cost of contributions to the defined benefit schemes for future service based on the contribution basis applying to the schemes at the time of the preparation of the results.

(VII) Debt capital

Core structural debt liabilities are carried at market value. As the liabilities are generally held to maturity or for the long-term, no deferred tax asset or liability has been established on the difference, compared to the IFRS carrying value. Accordingly, no deferred tax credit or charge is recorded in the results for the reporting period in respect of the mark to market value adjustment.

(VIII) Foreign currency translation

Foreign currency profits and losses have been translated at average exchange rates for the year. Foreign currency assets and liabilities have been translated at year-end rates of exchange. The purpose of translating the profits and losses at average exchange rates, notwithstanding the fact that EEV profit represents the incremental value added on a discounted cash flow basis, is to maintain consistency with the methodology applied for IFRS basis reporting.

Accounting presentation

(i) Analysis of profit before tax

To the extent applicable, presentation of the EEV profit for the year is consistent with the basis that the Prudential Group applies for analysis of IFRS basis profits before shareholder taxes between operating and non-operating results. Operating results reflect the underlying results including longer-term investment returns and, except as explained in note (iv) below, the unwind of discount on the value of in-force business. Operating results include the impact of routine changes of estimates and non-economic assumptions. Non-operating results comprise short-term fluctuations in investment returns, the shareholders' share of actuarial and other gains and losses on defined benefit pension schemes, the mark to market value movements on core borrowings and the effect of changes in economic assumptions and changes in the time value of cost of options and guarantees arising from changes in economic factors. During the severe equity market conditions experienced in the first quarter of 2009, coupled with historically high equity volatility, the Prudential Group incurred non-recurrent costs from an exceptional short dated hedge to protect against tail events on the Prudential Group IGD capital position in addition to regular operational hedging programmes. These costs have been shown separately within short-term fluctuations in investment returns. Also, in June 2009, the Group completed the disposal of the Taiwan agency business. The effect of this disposal and the results of the Taiwan agency business have been presented separately outside of the operating result.

(ii) Operating profit

For the investment element of the assets covering the net worth of long-term insurance business, investment returns are recognised in operating results at the expected long-term rate of return. These expected returns are calculated by reference to the asset mix of the portfolio. For the purposes of calculating the longer-term investment return to be included in the operating results of the PAC with-profits fund of UK operations, where assets backing the liabilities and unallocated surplus are subject to market volatility, values of assets at the beginning of the reporting period are adjusted to remove the effects of short-term market movements.

For the purposes of determining the long-term returns for debt securities of US operations and for fixed annuity and other general account business, a risk margin charge is included which reflects the expected long-term rate of default based on the credit quality of the portfolio. For Jackson, interest-related realised gains and losses are amortised to the operating results over the maturity period of the sold bonds, and for equity-related investments a long-term rate of return is assumed, which reflects the aggregation of year-end risk-free rates and equity risk premium. For US variable annuity separate account business, operating profit includes the unwind of discount on the opening value of in-force adjusted to reflect year-end projected rates of return with the excess or deficit of the actual return recognised within non-operating profit, together with the related hedging activity.

For UK annuity business, rebalancing of the asset portfolio backing the liabilities to policyholders may from time to time take place to align it more closely with the internal benchmark of credit quality that management applies. Such rebalancing will result in a change in the projected yield on the asset portfolio and the allowance for default risk. The net effect of these changes is reflected in the result for the year. In general, the effect is booked in operating results. However, in 2008 the element due to the exceptional spread widening in the market since 31 December 2006 was booked in the effect of change in economic assumptions.

(iii) Effect of changes in operating assumptions

Operating profits include the effect of changes to operating assumptions on the value of in-force business at the end of the period. For presentational purposes, the effect of change is delineated to show the effect on the opening value of in-force business with the experience variance being determined by reference to the end of period assumptions.

(iv) Unwind of discount and other expected returns

The unwind of discount and other expected returns is determined by reference to the value of in-force business, required capital and surplus assets at the start of the period as adjusted for the effect of changes in economic and operating assumptions reflected in the current period. For UK insurance operations the amount included within operating results based on longer-term returns represents the unwind of discount on the value of in-force business at the beginning of the period (adjusted for the effect of current period assumption changes), the unwind of discount on additional value representing the shareholders' share of smoothed surplus assets retained within the PAC with-profits fund, and the expected return on shareholders' assets held in other UK long-term business operations. Surplus assets retained within the PAC with-profits fund are smoothed for this purpose to remove the effects of short-term investment volatility from operating results. In the summary statement of financial position and for total profit reporting, asset values and investment returns are not smoothed.

(v) Pension costs

Profit before tax

Movements on the shareholders' share of surplus (to the extent not restricted by IFRIC 14) and deficits of the Prudential Group's defined benefit pension schemes adjusted for contributions paid in the year are recorded within the income statement. Consistent with the basis of distribution of bonuses and the treatment of the estate described above, the shareholders' share incorporates 10% of the proportion of the financial position attributable to the PAC with-profits fund. The financial position is determined by applying the requirements of IAS 19.

Actuarial and other gains and losses

For pension schemes in which the IAS 19 position reflects the difference between the assets and liabilities of the scheme, actuarial and other gains and losses comprise:

- the difference between actual and expected return on the scheme assets;
- experience gains and losses on scheme liabilities;
- the impact of altered economic and other assumptions on the discounted value of scheme liabilities; and
- for pension schemes where the IAS 19 position reflects a deficit funding obligation, actuarial and other gains and losses reflect the movement in estimates of deficit funding requirements.

These items are recorded in the income statement but, consistent with the IFRS basis of presentation, are excluded from operating results.

(vi) Effect of changes in economic assumptions and time value of cost of options and guarantees

Movements in the value of in-force business at the beginning of the period caused by changes in economic assumptions and the time value of cost of options and guarantees resulting from changes in economic factors are recorded in non-operating results.

(vii) Taxation

The EEV profit for the year for covered business is in most cases calculated initially at the post-tax level. The post-tax profit is then grossed up for presentation purposes at the effective rate of tax. In general, the effective rate corresponds to the corporation tax rate on shareholder profits of the business concerned.

Results of operations

The following table sets forth a summary of the Prudential Group's EEV basis results for the years ended 31 December 2008 and 2009.

EEV basis operating profit

	2008	2009
	£m	£m
Long-term insurance business		
Asia	1,213	1,105
US	586	1,233
UK	1,037	870
Development expenses	(26)	(6)
Long-term business profit	2,810	3,202
UK general insurance commission	44	51
Asset management business:		
M&G	286	238
Asia asset management	52	55
Curian	(3)	(6)
US broker dealer and asset management	10	10
	345	297
Other income and expenditure	(302)	(433)
Restructuring costs	(32)	(27)
Total EEV basis operating profit	2,865	3,090
Short-term fluctuations in investment returns	(4,967)	351
Mark to market value movements on core borrowings	656	(795)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	(14)	(84)
Effect of changes in economic assumptions and time value of cost of options and guarantees	(398)	(910)
Profit on sale and results of Taiwan agency business	(248)	91
Profit (loss) from continuing operations before tax	(2,106)	1,743
Tax attributable to shareholders' profit (loss)	771	(481)
Discontinued operations (net of tax)	—	(14)
Minority interests	(3)	(3)
Profit (loss) after minority interests	(1,338)	1,245

Overview

In 2009, total EEV basis operating profits based on longer-term investment returns of £3,090 million were up 8% from £2,865 million in 2008, primarily due to an increase in the profitability from the Prudential Group's long-term business operations, which was up 14% to £3,202 million, comprising new business profit of £1,607 million, in-force profits of £1,601 million and development expenses of £6 million. New business profits, at £1,607 million, were 34% higher than in 2008, with higher margins in all businesses, particularly the US, and a 1% increase in sales volumes year-on-year. The average Prudential Group new business profit margin was 56% (2008: 42%) on an APE basis and 8% (2008: 6%) on a present value of new business premiums (PVNBP) basis. This rise reflected increased average margins across the businesses as the Prudential Group concentrated on maximising sales of its most profitable products.

Overall, there was a 2% decrease in the contribution from in-force business (before development expenses) in 2009, down by £35 million to £1,601 million. The movement reflected a growing level of unwind of discount, up by £210 million, reflecting the increased in-force business offset by a reduction in the level of contribution from changes to operating assumptions, experience variances and other items of, in aggregate, £245 million. The growth in the Prudential Group's EEV operating profit was held back by a lower contribution from the asset management businesses (down £48 million to £297 million) reflecting reduced market values in 2009. There was also a negative impact on Prudential Group EEV operating profit from other income and expenditure of £131 million due to lower returns on central funds and higher interest payable on core structural borrowings.

The total EEV profit before tax for 2009 of £1,743 million compared with a loss of £2,106 million for 2008. The increase of £3,849 million reflected the growth in operating profit of £225 million and an increase in the aggregate effect of non-operating items of £3,624 million which mostly arose from the net effects of improved financial markets. Within the non-operating items of negative £1,347 million, there were positive contributions of £351 million for short-term fluctuations in investment returns and the £91 million from the profit on sale and results of the Taiwan agency business that was sold in June 2009. However, these amounts were offset by reductions of £795 million for the change in the mark to market value of the Prudential Group's borrowings as credit spreads normalised, a charge of £910 million for the effect of changes in economic assumptions and time value of cost of options and guarantees arising from increasing interest rates and the application of higher risk discount rates across the businesses and an £84 million charge for actuarial and other losses for the Prudential Group's defined benefit pension schemes.

EEV basis operating profit — insurance operations

Asia

Total EEV operating profit for the Prudential Group's Asia insurance operations before development expenses was £1,105 million in 2009 (2008: £1,213 million), including £713 million of new business profit (2008: £634 million).

Average new business profit margins increased from 52% for 2008 to 57% for 2009. The major drivers of this increase were a shift in average country mix where the Prudential Group has seen lower proportions of new business from the lower margin markets of Korea and India and the positive impact of the shift in product mix towards higher margin health and protection products. Total new business profits of £713 million in 2009 were up 12% over 2008. Despite the unforeseen and very challenging environment, the Prudential Group exceeded the target it set itself in December 2006 of doubling 2005 new business profits by 2009 by £39 million.

During the first half of 2009 the Prudential Group did see a deterioration of persistency, principally in Korea, and it reported adverse assumption changes and experience variances to reflect this. During the second half of 2009, the situation improved as a result of management actions and an improvement in market conditions. During the second half only an additional £47 million of assumption changes and experience variances relating to persistency were incurred, resulting in a full-year charge of £154 million. Overall assumption changes and experience variances for 2009 netted out at a charge of £97 million, representing an improvement from the charge of £124 million reported at the half year. Given the scale of the EEV shareholder funds of the long-term business at £5.8 billion, these experience variances and assumption changes remain small. The contribution to in-force earnings arising from the unwind of the discount rate and other operating investment returns amounted to £489 million, up 20% on the prior year, reflecting the growing scale of the business.

United States

Total EEV basis operating profit for the long-term business in 2009 was £1,233 million, compared to £586 million in 2008. In-force EEV profits of £569 million in 2009 were 94% higher than the 2008 profit of £293 million, reflecting both the greater contribution to earnings from the unwind of the discount rate and the beneficial impact of updating the assumption relating to GMWB utilisation rates to reflect recent experience studies.

United Kingdom

EEV total operating profit based on longer-term investment returns of £921 million, including £51 million from general insurance commission, was down 15% on 2008. This was mainly due to the £118 million benefit arising in 2008 from rebalancing the credit portfolio that supports the shareholder-backed annuity business compared with £22 million in 2009. The 2009 in-force operating result included £588 million from the unwind of the discount rate on the value of in-force business, which was 3% higher than 2008.

Prudential UK continues to manage actively the retention of the in-force book. During 2009, the experience at an aggregate level was in line with long-term assumptions.

EEV basis operating profit — other items

Operating profit from the asset management business decreased to £297 million, down 14% from £345 million in 2008, reflecting reduced market values in 2009 compared to 2008.

Other income and expenditure totalled a net expense of £433 million in 2009 compared with £302 million in 2008, a difference of negative £131 million of which £47 million was due to the impact of the non-recurrence in 2009 of a positive one-off 2008 item of profit on the sale of a seed capital investment in an Indian mutual fund. The remaining difference principally related to lower interest received on central shareholders' funds as a result of falling interest rates and an increase in interest payable on core structural borrowings.

EEV basis non-operating profit items

Short-term fluctuations in investment returns

In the Prudential Group's calculation of EEV operating profit, it uses longer-term investment return assumptions rather than actual investment returns achieved. Short-term fluctuations represent the difference between the actual investment return and the unwind of discount on the value of in-force business and expected returns on net worth.

Short-term fluctuations in investment returns for insurance operations of positive £481 million in 2009 comprised a positive £437 million for Asia, negative £401 million for the Prudential Group's US operations and positive £445 million in the UK.

For the Prudential Group's Asian business, short-term fluctuations of positive £437 million in 2009 (versus negative £903 million in 2008) primarily reflected the effect of strong equity market performance, in particular for participating business and unit linked business where the in-force value benefits from increases in shareholder transfers and from the capitalisation of increased projected fees due to the higher asset base at the end of the year.

For the Prudential Group's US business, short-term fluctuations in investment returns were negative £401 million versus negative £1,344 million in 2008, and primarily reflected the excess of impairment losses for fixed income securities incurred in the year over the long-term charge included within operating profit.

For the Prudential Group's UK business, the short-term fluctuations in investment returns were positive £445 million in 2009 (versus negative £2,407 million in 2008), including positive £430 million relating to with-profits business, primarily reflecting the difference between the 15.5% investment return arising in the year on the investments of the with-profits life fund (covering policyholder liabilities and unallocated surplus) and the long-term assumed return of 6.9%.

For other operations, the principal component of short-term fluctuations in investment returns in 2009 was a one-off £235 million cost arising from the hedge temporarily put in place during the first quarter, to protect the Prudential Group IGD capital surplus in the light of exceptional market conditions. During the severe equity market conditions experienced in the first quarter of 2009, coupled with historically high equity volatility, the Prudential Group entered into exceptional short-dated hedging contracts to protect against potential tail-events on the IGD capital position, in addition to its regular operational hedging programmes. The residual short-term fluctuations in investment returns for other operations of positive £105 million in 2009 included £66 million for unrealised appreciation on Prudential Capital's debt securities portfolio and £28 million on swaps held centrally to manage the Prudential Group assets and liabilities.

Mark to market movement on core borrowings

The mark to market movement on core borrowings was negative £795 million in 2009, as credit spreads incorporated in the market value of the debt narrowed to more normal levels.

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

The shareholders' share of actuarial and other gains and losses on defined benefit pension schemes of a negative £84 million in 2009 reflected the impact of a reduced discount rate and other assumption changes on the measurement of the liabilities of the Scottish Amicable and M&G schemes and an increase in the deficit funding provision for the Prudential Staff Pension Scheme.

Effect of changes in economic assumptions and time value of cost of options and guarantees

The effect of changes in economic assumptions and time value of cost of options and guarantees of negative £910 million in 2009 comprised negative £963 million for the effect of changes in economic assumptions partially offset by positive £53 million for the change in the time value of cost of options and guarantees arising from changes in economic factors. In the Prudential Group's Asian business, economic assumption changes were negative £165 million, primarily driven by increases in risk discount and fund earned rates across a number of territories. In the Prudential Group's US business, economic assumption changes were negative £528 million, primarily reflecting an increase in the risk discount rates following an increase in the US 10-year Treasury rate and an increase in the allowance for credit risk for fixed annuity and variable annuity business of 1.5% and 0.3% respectively, partially offset by the effect of an increase in the separate account return assumption from 5.8% to 7.4% arising from the increase in risk-free rates. In the Prudential Group's UK business, economic assumption changes were negative £270 million, primarily relating to with-profits business, reflecting the fact that the risk discount rate has increased by significantly more than the earned rate as a result of revised correlation assumptions, a lower equity backing ratio and very low cash return.

Profit on sale and results of Taiwan agency business

In June 2009, the Prudential Group completed the sale of its Taiwan agency business. The 2009 result of £91 million reflected the profit on sale. The 2008 loss of £248 million was the total result for this business, including short-term fluctuations in investment returns.

EEV shareholder funds

The following table sets forth a summary of the movement in the Prudential Group's EEV shareholders' funds for the years ended 31 December 2008 and 2009:

	2008	2009
	£m	£m
Operating profit based on longer-term investment returns	2,865	3,090
Items excluded from operating profit	(4,971)	(1,347)
Total profit (loss) before tax	(2,106)	1,743
Tax, discontinued operations and minority interests	768	(498)
Profit (loss) for the period	(1,338)	1,245
Exchange movements, net of related tax	2,129	(750)
Dividends	(453)	(481)
New share capital subscribed	170	141
Other	(152)	162
Net increase in shareholders' funds	356	317
Shareholders' funds at beginning of period	14,600	14,956
Shareholders' funds at end of period	14,956	15,273
Comprising		
Long-term business		
Free surplus	447	2,065
Required capital	4,117	2,994
Net worth	4,564	5,059
Value of in-force business	9,958	10,283
Total	14,522	15,342
Other business	434	(69)
Total	14,956	15,273

On an EEV basis, which recognises the shareholders' interest in long-term business, shareholder funds as at 31 December 2009 were £15.3 billion, an increase of £0.3 billion from the 2008 year-end level. This increased level of shareholders' funds reflected the profit after tax of £1.2 billion, the adverse effects of exchange movements of £0.7 billion and dividend payments of £0.5 billion, which were partially offset by new share capital subscribed of £0.1 billion and other movements of £0.2 billion.

The shareholders' funds at the end of 2009 relating to long-term business of £15.3 billion comprised £5.8 billion for the Prudential Group's Asian long-term business operations, £4.1 billion for the Prudential Group's US long-term business operations and £5.4 billion for the Prudential Group's UK long-term business operations.

As at 31 December 2009, the embedded value for the Prudential Group's Asian long-term business operations was £5.8 billion. The embedded value for the established markets of Hong Kong, Singapore and Malaysia was £3.8 billion. There was also substantial embedded value in Indonesia (£584 million), Korea (£408 million), and Vietnam (£199 million).

For the Prudential Group's other Asian markets, following the sale of the Taiwan agency business, the embedded value was £848 million in aggregate as at 31 December 2009.

FREE SURPLUS GENERATION

The Prudential Group free surplus at the end of the period comprises free surplus for the insurance businesses, representing the excess of the net worth over the required capital included in the EEV results, and IFRS net assets for the asset management businesses excluding goodwill. The free surplus generated during the period comprises the movement in this balance excluding foreign exchange, capital movements, and other reserve movements. Specifically it includes amounts maturing from the in-force operations during the period less the investment in new business, the effect of market movements and other one-off items.

For asset management operations the Prudential Group has defined free surplus generation to be total post-tax IFRS profit for the period. The Prudential Group free surplus generated also includes the general insurance commission earned during the period and excludes restructuring and shareholders' centrally arising other income and expenditure.

The total movement in free surplus net of tax in the period can be analysed as follows:

	2008	2009
	£m	£m
Free surplus generation		
Expected in-force cash flows (including expected return on net assets)	1,623	1,914
Changes in operating assumptions and variances	(65)	175
Underlying free surplus generated in the period	1,558	2,089
Provisions for additional allowance for credit risk	(770)	—
Market-related items	(689)	(198)
Investment in new business	(806)	(675)
Free surplus generated in the period from retained businesses	(707)	1,216
Effect of disposal and trading results of Taiwan agency business	(276)	987
Net cash remitted by the business units	(515)	(688)
Other movements and timing differences	442	157
Total movement during the period	(1,056)	1,672
Free surplus at 1 January	1,915	859
Free surplus at 31 December	859	2,531
Comprises:		
Free surplus relating to long-term insurance business	447	2,065
Free surplus of other insurance business	—	37
IFRS net assets of asset management businesses excluding goodwill	412	429
Total free surplus	859	2,531

During 2009, the Prudential Group generated total free surplus from the retained businesses of £1,216 million (2008: negative £707 million). Underlying free surplus generated from the in-force book increased 34% from £1,558 million in 2008 to £2,089 million in 2009, reflecting favourable exchange rates, the underlying growth of the portfolio, and positive changes in operating assumptions and variances of £175 million for the life businesses (2008: negative £65 million). These positive changes included £158 million arising in the UK (2008: £118 million) and £115 million arising in the US (2008: negative £1 million), consistent with management's ongoing focus on capital preservation, and were offset by the negative changes in Asia of £98 million (2008: negative £182 million) principally arising from adopting higher required capital level assumptions in a number of businesses.

Underlying free surplus generated has been used by the life businesses to invest in new business. Investment in new business fell by £131 million to £675 million in 2009. This reduction reflected the Prudential Group's deliberate focus on conserving capital and was in part due to the substantially reduced levels of wholesale business sales in the UK and the US.

Market-related movements improved from negative £689 million in 2008 to negative £198 million in 2009. These improvements were driven by higher equity returns in Asia, and improved market performance in the US, offset by the one-off profit in 2008 arising from the rebalancing of the credit portfolio in the UK not being repeated in 2009.

In June 2009, the Prudential Group completed the sale of the Taiwan agency business. As anticipated, this gave rise to an increase in free surplus of £987 million, representing the release of negative free surplus that previously applied. This compared to an increase in IGD capital of £800 million. The difference arose predominantly because the calibrations underpinning the capital requirements on a regulatory (IGD) basis are different from those applied on an economic capital (EEV) basis.