Notes on the EEV basis results

1 Basis of preparation, methodology and accounting presentation

The EEV basis results have been prepared in accordance with the EEV Principles issued by the European Insurance CFO Forum in May 2004. Where appropriate, the EEV basis results include the effects of adoption of International Financial Reporting Standards (IFRS). The EEV basis results have been prepared on the basis of the current EU solvency regime.

The directors are responsible for the preparation of the supplementary information in accordance with the EEV Principles. The EEV basis results for 2013 and 2012 half years are unaudited. Except for the presentational change for the results of the held for sale Japan Life business and the consequential effects of the changes in accounting policies for IFRS reporting in respect of employee benefits and joint venture operations, as described below, the 2012 full year results have been derived from the EEV basis results supplement to the Company's statutory accounts for 2012. The supplement included an unqualified audit report from the auditors.

Adjustment to the presentation of the 2012 comparative results for the effect of the agreement to sell Japan Life business and IFRS accounting pronouncements adopted in 2013

In July 2013, the Group agreed to sell, dependent on regulatory approval, its life insurance business in Japan, which we closed to new business in 2010. Also, in half year 2013, the Group has adopted new accounting standards on 'Joint arrangements' (IFRS 11) and amendments to IAS 19 'Employee benefits', from 1 January 2013. Accordingly, the half year and full year 2012 comparative EEV basis results have been retrospectively adjusted from those previously published for the application of the IFRS standards and for the effect of the Japan Life business sale agreement. The tables below show the results on the previous and revised basis of reporting.

	Half year 2013 £m			
	Under previous basis note (i)	Effect of change IFRS 11 note (ii)	Effect of change IAS 19 note (iii)	Under new policies
Operating profit based on longer-term investment returns				
Asia operations:				
Long-term business:				
Before reclassification of held for sale Japan Life business	1,087	–	–	1,087
Reclassification of Japan Life business	(8)	–	–	(8)
	1,079	–	–	1,079
Eastspring investments	42	(4)	–	38
Other results	1,362	–	–	1,362
Total operating profit based on longer-term investment returns	2,483	(4)	–	2,479
Short-term fluctuations in investment returns:				
Before reclassification of held for sale Japan Life business	(791)	–	(4)	(795)
Reclassification of Japan Life business	(13)	–	–	(13)
	(804)	–	(4)	(808)
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	(38)	–	38	–
Effect of changes in economic assumptions:				
Before reclassification of held for sale Japan Life business	687	–	–	687
Reclassification of Japan Life business	(3)	–	–	(3)
	684	–	–	684
Loss attaching to held for sale Japan Life business:				
Reclassification from operating profit based on longer-term investment returns	8	–	–	8
Reclassification from short-term fluctuations in investment returns	13	–	–	13
Reclassification from effect of changes in economic assumptions	3	–	–	3
Remeasurement of carrying value of Japan Life business classified as held for sale	(71)	–	–	(71)
	(47)	–	–	(47)
Mark to market value movements on core borrowings	203	–	–	203
Profit before tax	2,481	(4)	34	2,511
Tax attributable to shareholders' profit	(583)	4	(8)	(587)
Profit for the period attributable to shareholders	1,898	–	26	1,924
Items taken directly to shareholders' equity	181	–	(26)	155
Net increase in shareholders' equity	2,079	–	–	2,079
Total EPS based on total profit after tax (in pence)	74.5p	–	1.0p	75.5p

Notes on the EEV basis results continued

1 Basis of preparation, methodology and accounting presentation continued

Summary statement of financial position

	30 Jun 2013 £m			
	Under previous basis note (i)	Effect of change IFRS 11 note (ii)	Effect of change IAS 19	Under new policies
Total net assets				
Total assets less liabilities, before deduction for insurance funds:				
Before reclassification of held for sale Japan Life business	290,883	(3,330)	–	287,553
Reclassification of Japan Life business	(970)	–	–	(970)
	289,913	(3,330)	–	286,583
Less insurance funds:				
Policyholder liabilities (net of reinsurers' share) and unallocated surplus of with-profits funds:				
Before reclassification of held for sale Japan Life business	(281,258)	3,330	–	(277,928)
Reclassification of Japan Life business	970	–	–	970
	(280,288)	3,330	–	(276,958)
Less shareholders' accrued interest in the long-term business	14,897	–	–	14,897
Total net assets	24,522	–	–	24,522

	Half year 2012 £m			
	As reported under previous basis note (i)	Effect of change IFRS 11 note (ii)	Effect of change IAS 19 note (iii)	Under new policies
Operating profit based on longer-term investment returns				
Asia operations:				
Long-term business:				
Before reclassification of held for sale Japan Life business	872	–	–	872
Reclassification of Japan Life business	2	–	–	2
	874	–	–	874
Eastspring investments	34	(2)	–	32
Other results	1,203	–	–	1,203
Total operating profit based on longer-term investment returns	2,111	(2)	–	2,109
Short-term fluctuations in investment returns:				
Before reclassification of held for sale Japan Life business	225	–	1	226
Reclassification of Japan Life business	(17)	–	–	(17)
	208	–	1	209
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	103	–	(103)	–
Effect of changes in economic assumptions:				
Before reclassification of held for sale Japan Life business	(371)	–	–	(371)
Reclassification of Japan Life business	10	–	–	10
	(361)	–	–	(361)
Profit attaching to held for sale Japan Life business:				
Reclassification from operating profit based on longer-term investment returns	(2)	–	–	(2)
Reclassification from short-term fluctuations in investment returns	17	–	–	17
Reclassification from effect of changes in economic assumptions	(10)	–	–	(10)
	5	–	–	5
Other items	(71)	–	–	(71)
Profit before tax	1,995	(2)	(102)	1,891
Tax attributable to shareholders' profit	(554)	2	25	(527)
Profit for the period attributable to shareholders	1,441	–	(77)	1,364
Items taken directly to shareholders' equity	(473)	–	77	(396)
Net increase in shareholders' equity	968	–	–	968
Total EPS based on total profit after tax (in pence)	56.8p	–	(3.0)p	53.8p

Summary statement of financial position

	30 Jun 2012 £m			
	As reported under previous basis	Effect of change IFRS 11 note (ii)	Effect of change IAS 19	Under new policies
Total net assets				
Total assets less liabilities, before deduction for insurance funds	253,810	(2,907)	–	250,903
Less insurance funds:				
Policyholder liabilities (net of reinsurers' share) and unallocated surplus of with-profits funds	(244,518)	2,907	–	(241,611)
Less shareholders' accrued interest in the long-term business	11,313	–	–	11,313
Total net assets	20,605	–	–	20,605

	Full year 2012 £m			
	As reported under previous basis note (i)	Effect of change IFRS 11 note (ii)	Effect of change IAS 19 note (iii)	Under new policies
Operating profit based on longer-term investment returns				
Asia operations:				
Long-term business:				
Before reclassification of held for sale Japan Life business	1,960	–	–	1,960
Reclassification of Japan Life business	(2)	–	–	(2)
	1,958	–	–	1,958
Eastspring investments	75	(6)	–	69
Other results	2,286	–	–	2,286
Total operating profit based on longer-term investment returns	4,319	(6)	–	4,313
Short-term fluctuations in investment returns:				
Before reclassification of held for sale Japan Life business	538	–	5	543
Reclassification of Japan Life business	(33)	–	–	(33)
	505	–	5	510
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes	62	–	(62)	–
Effect of changes in economic assumptions:				
Before reclassification of held for sale Japan Life business	(16)	–	–	(16)
Reclassification of Japan Life business	14	–	–	14
	(2)	–	–	(2)
Profit attaching to held for sale Japan Life business:				
Reclassification from operating profit based on longer-term investment returns	2	–	–	2
Reclassification from short-term fluctuations in investment returns	33	–	–	33
Reclassification from effect of changes in economic assumptions	(14)	–	–	(14)
	21	–	–	21
Other items	115	–	–	115
Profit before tax	5,020	(6)	(57)	4,957
Tax attributable to shareholders' profit	(1,207)	6	13	(1,188)
Profit for the year attributable to shareholders	3,813	–	(44)	3,769
Items taken directly to shareholders' equity	(1,007)	–	44	(963)
Net increase in shareholders' equity	2,806	–	–	2,806

Total EPS based on total profit after tax (in pence)	150.1p	–	(1.8)p	148.3p

Notes on the EEV basis results continued

1 Basis of preparation, methodology and accounting presentation continued

Summary statement of financial position

	31 Dec 2012 £m			
	As reported under previous basis	Effect of change		Under new policies
		IFRS 11 note (ii)	IAS 19	
Total net assets				
Total assets less liabilities, before deduction for insurance funds	274,863	(3,095)	–	271,768
Less insurance funds:				
Policyholder liabilities (net of reinsurers' share) and unallocated surplus of with-profits funds	(264,504)	3,095	–	(261,409)
Less shareholders' accrued interest in the long-term business	12,084	–	–	12,084
Total net assets	22,443	–	–	22,443

Notes

(i) Following the agreement in July 2013 to sell the Group's life insurance business in Japan, the results for the Japan Life business have been shown separately in the Group's analysis of profit – see note 7.

(ii) Consistent with the requirements of IFRS 11, the Group's EEV pre-tax results now incorporate the post-tax results for asset management joint venture operations. For life insurance joint venture operations, the EEV results continue to be presented on a pre-tax basis, ie as for the Group's other insurance businesses.

(iii) Under the amended IAS 19, all actuarial gains and losses and related tax are recognised in the movement in shareholders' equity, rather than in the summarised consolidated income statement.

a Covered business

The EEV results for the Group are prepared for 'covered business', as defined by the EEV Principles. Covered business represents the Group's long-term insurance business for which the value of new and in-force contracts is attributable to shareholders. The results for covered business, including the Group's investments in joint venture insurance operations, are presented on a pre-tax basis, with tax reported separately. The EEV basis results for the Group's covered business are then combined with the IFRS basis results of the Group's other operations. Under the EEV Principles, the results for covered business incorporate the projected margins of attaching internal asset management.

The definition of long-term business operations is consistent with previous practice and comprises those contracts falling under the definition 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.

With two principal exceptions, covered business comprises the Group's long-term business operations. The principal exceptions are as follows:

- The closed Scottish Amicable Insurance Fund (SAIF), which is a ring-fenced sub-fund of the Prudential Assurance Company (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; and
- The presentational treatment of the Group's principal defined benefit pension scheme, the Prudential Staff Pension Scheme (PSPS). The partial recognition of the surplus for PSPS is recognised in 'Other' operations, as described in note 1(c)(vi).

A small amount of UK group pensions business is also not modelled for EEV reporting purposes.

b 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 Group's long-term business comprises:

- Present value of future shareholder cash flows from in-force covered business (value of in-force business), less deductions for:
  – the cost of locked-in required capital;
  – the time value of cost of options and guarantees;
- Locked-in required capital; and
- Shareholders' net worth in excess of required capital (free surplus).

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

Notwithstanding the basis of presentation of results (as explained in note 1(c)(iv)) 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 in note 1(c)(i)).

Valuation of in-force and new 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.

Best estimate assumptions
Best estimate assumptions are used for the cash flow projections, where best estimate is defined as the mean of the distribution of future possible outcomes. The assumptions are reviewed actively and changes are made when evidence exists that material changes in future experience are reasonably certain.

Assumptions required in the calculation of the value of options and guarantees, for example relating to volatilities and correlations, or dynamic algorithms linking liabilities to assets, have been set equal to the best estimates and, wherever material and practical, reflect any dynamic relationships between the assumptions and the stochastic variables.

Principal economic assumptions
The EEV basis results for the Group's operations have been determined using economic assumptions where the long-term expected rates of return on investments and risk discount rates are set by reference to period end rates of return on government bonds.

Expected returns on equity and property asset classes and corporate bonds are derived by adding a risk premium, based on the Group's long-term view, to the risk-free rate.

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 period.

New business
In determining the EEV basis value of new business, premiums are included in projected cash flows on the same basis of distinguishing annual and single premium business as set out for statutory basis reporting.

New business premiums reflect those premiums attaching to covered business, including premiums for contracts classified as investment products for IFRS basis reporting. New business premiums for regular premium products are shown on an annualised basis. Internal vesting business is classified as new business where the contracts include an open market option.

The contribution from new business represents profits determined by applying operating assumptions as at the end of the period.

For UK immediate annuity business and single premium Universal Life products in Asia, primarily Singapore, the new business contribution is determined by applying economic assumptions reflecting point of sale market conditions. This is consistent with how the business is priced as crediting rates are linked to yields on specific assets and the yield is locked-in when the assets are purchased at the point of sale of the policy. For other business within the Group, end of period economic assumptions are used.

New business profitability is a key metric for the Group's management of the development of the business. In addition, new business margins are shown by reference to annual premium equivalents (APE) and the present value of new business premiums (PVNBP). These margins are calculated as the percentage of the value of new business profit to APE and PVNBP. APE is calculated as the aggregate of regular new business amounts and one-tenth of single new business amounts. PVNBP is calculated as equalling single premiums plus the present value of expected premiums of new regular premium business, allowing for lapses and other assumptions made in determining the EEV new business contribution.

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 reflect the aggregate of the IFRS results and the movements on the additional shareholders' interest recognised on the EEV basis. Thus the start 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 broadly speaking, are 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.

Notes on the EEV basis results continued

1 Basis of preparation, methodology and accounting presentation continued

Cost of capital

A charge is deducted from the embedded value for the cost of capital supporting the Group's long-term business. This capital is referred to as required 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 required 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 required capital.

Financial options and guarantees

Nature of financial options and guarantees in Prudential's long-term business

- *Asia 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.

There are also various non-participating long-term products with guarantees. The principal guarantees are those for whole of life contracts with floor levels of policyholder benefits that accrue at rates set at inception and do not vary subsequently with market conditions.

- *US operations (Jackson)*

The principal financial 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 varies from 1.0 per cent to 5.5 per cent for all periods throughout these results, depending on the particular product, jurisdiction where issued, and date of issue. For half year 2013, 86 per cent (half year 2012: 85 per cent; full year 2012: 86 per cent) of the account values on fixed annuities are for policies with guarantees of 3 per cent or less. The average guarantee rate is 2.8 per cent for all periods throughout these results.

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)), as death benefits (Guaranteed Minimum Death Benefits (GMDB)) or as income benefits (Guaranteed Minimum Income Benefits (GMIB)). These guarantees generally protect the policyholder's value in the event of poor equity market performance. Jackson hedges the GMDB and GMWB guarantees through the use of equity options and futures contracts, and fully reinsures the GMIB guarantees.

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.

- *UK insurance operations*

For covered business the only significant financial options and guarantees in the UK insurance operations arise in the with-profits fund.

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 also held a provision on the Pillar I Peak 2 basis of £47 million at 30 June 2013 (30 June 2012: £90 million; 31 December 2012: £47 million) to honour guarantees on a small number of guaranteed annuity option products.

The only material guaranteed surrender values relate to investments in the PruFund range of with-profits funds. For these products the policyholder can choose to pay an additional management charge. In return, at the selected guarantee date, the fund will be increased if necessary to a guaranteed minimum value (based on the initial investment adjusted for any prior withdrawals). The with-profits fund held a reserve of £52 million at 30 June 2013 (30 June 2012: £65 million; 31 December 2012: £52 million) in respect of this guarantee.

The Group's main exposure to guaranteed annuity options in the UK is through the non-covered business of SAIF. A provision on the Pillar I Peak 2 basis of £325 million was held in SAIF at half year 2013 (half year 2012: £403 million; full year 2012: £371 million) to honour the guarantees. As described in note 1(a) above, the assets and liabilities are wholly attributable to the policyholders of the fund. Therefore, the movement in the provision has no direct impact on shareholders.

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 time value of the financial options and guarantees.

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 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. Details of the key characteristics of each model are given in notes 15(iv),(v) and (vi).

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 investment allocation decisions, levels of reversionary and terminal bonuses and credited rates. 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 which explains how regular and final bonus rates within the discretionary framework are determined, subject to the general legislative requirements applicable.

(ii) Level of required capital

In adopting the EEV Principles, Prudential has based required capital on its internal targets for economic capital, subject to it being at least the local statutory minimum requirements. 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 required capital requirements. For shareholder-backed business the following capital requirements apply:

- Asia operations: the level of required capital has been set to an amount at least equal to higher of local statutory requirements and the economic capital requirement;
- US operations: the level of required capital has been set at 250 per cent (half year and full year 2012: 235 per cent) 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.

(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 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.

Market risk allowance

The allowance for market risk represents the beta multiplied by an equity risk premium. Except for UK shareholder-backed annuity business (as explained below) such an approach has been used for all of the 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 reflect the most recent product mix to produce appropriate betas and risk discount rates for each major product grouping.

Additional credit risk allowance

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

- Expected long-term defaults;
- Credit risk premium (to reflect the volatility in downgrade and default levels); and
- Short-term downgrades and defaults.

Notes on the EEV basis results continued

1 Basis of preparation, methodology and accounting presentation continued

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.

Asia operations

For Asia 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.

In half year 2013 and full year 2012, projected rates of return for holdings of corporate bonds comprise the risk-free rate plus an assessment of long-term spread over the risk-free rate. This basis aligns with the approach for UK with-profit holdings of corporate bonds and, more generally, is consistent with the use of long-term risk premiums for holdings of other categories of investments across the Group's operations. For half year 2012 market spreads at the reporting date, rather than long-term spreads, were applied. The main effects of the change are for holdings in Hong Kong, Korea, Malaysia and Singapore.

US operations (Jackson)

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

The risk discount rate incorporates an additional allowance for credit risk premium and short-term downgrades and defaults. In determining this allowance a number of factors have been considered. These factors, in particular, include:

- How much of the credit spread on debt securities represents an increased credit risk not reflected in the RMR long-term default assumptions, and how much is liquidity premium (which is the premium required by investors to compensate for the risk of longer-term investments which cannot be easily converted into cash, and converted at the fair market value). In assessing this effect, consideration has been given to a number of approaches to estimating the liquidity premium by considering recent statistical data; and
- Policyholder benefits for Jackson fixed annuity business are not fixed. It is possible in adverse economic scenarios to pass on a component of credit losses to policyholders (subject to guarantee features) through lower investment return rates credited to policyholders. Consequently, it is only necessary to allow for the balance of the credit risk in the risk discount rate.

After taking these and related factors into account and based on market conditions, the risk discount rate for general account business includes an additional allowance of 150 basis points (half year 2012: 200 basis points; full year 2012: 150 basis points) for credit risk. For VA business, the additional allowance has been set at one-fifth (equivalent to 30 basis points (half year 2012: 40 basis points; full year 2012: 30 basis points)) of the non-VA business to reflect the proportion of the VA business that is allocated to holdings of general account debt securities. The level of the additional allowance is assessed at each reporting period to take account of prevailing credit conditions and as the business in force alters over time.

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.

UK operations

(1) Shareholder-backed annuity business

For Prudential's UK shareholder-backed annuity business, Prudential 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's assessment of the expected return on the assets backing the annuity liabilities after allowing for expected long-term defaults, a credit risk premium, an allowance for a 1 notch downgrade of the portfolio subject to credit risk and an allowance for short-term 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, 1 notch downgrade and the remaining element of short-term downgrade and default allowances are incorporated into the risk margin included in the discount rate, as shown in note 15(iii).

(2) With-profits fund non-profit annuity business

For UK non-profit annuity business, including that written by Prudential Annuities Limited (PAL), the basis for determining the aggregate allowance for credit risk is consistent with that applied for UK shareholder-backed annuity business (as described above). 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.

(3) 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. The assumed earned rate for with-profit holdings of corporate bonds is defined as the risk-free rate plus an assessment of the long-term spread over gilts, net of expected long-term defaults. This approach is similar to that applied for equities and properties for which the projected earned rate is defined as the risk-free rate plus a long-term risk premium.

Allowance for non-diversifiable non-market risks

The majority of non-market and non-credit risks are considered to be diversifiable. Finance theory cannot be used to determine the appropriate component of beta for non-diversifiable non-market risks, since there is no observable risk premium associated with it that is akin to the equity risk premium. Recognising this, a pragmatic approach has been applied.

A base level allowance of 50 basis points is applied to cover the non-diversifiable non-market risks associated with the Group's businesses. For the Group's US business and UK business other than shareholder-backed annuity, no additional allowance is necessary. For UK shareholder-backed annuity business a further allowance of 50 basis points is used to reflect the longevity risk which is of particular relevance. For the Group's Asia operations in China, India, Indonesia, Philippines, Taiwan, Thailand and Vietnam, additional allowances are applied for emerging market risk ranging from 100 to 250 basis points.

(iv) 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 per cent. 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 any 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 Group's Asia operations.

(v) 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.

(vi) Foreign currency translation

Foreign currency profits and losses have been translated at average exchange rates for the period. Foreign currency assets and liabilities have been translated at period 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.

c Accounting presentation

(i) Analysis of profit before tax

To the extent applicable, the presentation of the EEV profit for the period is consistent with the basis that the 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 (which are determined as described in note 1(c)(ii) below) and incorporate the following:

- New business contribution, as defined in note 1(b)(i);
- Unwind of discount on the value of in-force business and other expected returns, as described in note 1(c)(iv) below;
- The impact of routine changes of estimates relating to non-economic assumptions, as described in note 1(c)(iii) below; and
- Non-economic experience variances, as described in note 1(c)(v) below.

Non-operating results comprise the recurrent items of short-term fluctuations in investment returns, the mark to market value movements on core borrowings and the effect of changes in economic assumptions.

On 16 July 2013, the Group agreed, dependent on regulatory approval, to sell its Japan Life business. For half year 2013, the effect of the change in carrying value and the results for the business have been presented separately in the Group's analysis of profit. For half year and full year 2012, operating profits based on longer-term investment returns excluded the gain on dilution of the Group holding's in PPM South Africa and in full year 2012 excluded the gain recognised on the acquisition of REALIC.

(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 purpose of calculating the longer-term investment return to be included in the operating result of the PAC with-profits fund of UK operations, where assets backing the liabilities and unallocated surplus are subject to market volatility, asset values at the beginning of the reporting period are adjusted to remove the effects of short-term market movements, as explained in note 1(c)(iv) below.

For the purpose of determining the long-term returns for debt securities of US operations 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 end of period 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 end of period 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 included in the result for the period.

Notes on the EEV basis results continued

1 Basis of preparation, methodology and accounting presentation continued

(iii) Effect of changes in operating assumptions

Operating profit includes the effect of changes to operating assumptions on the value of in-force 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 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 investment 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 the additional value representing the shareholders' share of smoothed surplus assets retained within the PAC with-profits fund (as explained in note 1(c)(ii) above), 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. At 30 June 2013 the shareholders' interest in the smoothed surplus assets used for this purpose only, were £25 million lower (30 June 2012: £9 million higher; 31 December 2012: £121 million lower) than the surplus assets carried in the statement of financial position.

(v) Operating experience variances

Operating profits include the effect of experience variances on non-economic assumptions, which are calculated with reference to the embedded value assumptions at the end of the reporting period, such as persistency, mortality and morbidity, expenses and other factors. Further details of these assumptions are shown in notes 15(vii),(viii) and (ix).

(vi) Pension costs

Profit before tax

Movements on the shareholders' share of surpluses (to the extent not restricted by IFRIC 14) and deficits of the Group's defined benefit pension schemes adjusted for contributions paid in the period are recorded within Other Comprehensive Income. Consistent with the basis of distribution of bonuses and the treatment of the estate described in notes 1(b)(i) and (iv), the shareholders' share incorporates 10 per cent 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 of defined benefit pension schemes

For the Group's defined benefit pension schemes the EEV results reflect the IAS 19 position booked for IFRS reporting. Consistent with this approach, to the extent of recognition of any surplus, the actuarial and other gains and losses include:

- 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 includes the movement in estimates of deficit funding requirements.

In addition, this item includes the effect of partial recognition of the Prudential Staff Pension Scheme surplus that arose at full year 2012. This partial recognition reflects the impact of the 5 April 2011 triennial valuation that was completed in 2012. Under that valuation, there was sufficient actuarial surplus to permit a reduction in employer contributions to the minimum level under the trust deed rules, thereby allowing recoverability of part of the surplus in future periods.

These items are recorded net of tax in the movement in shareholders' equity, consistent with the IFRS basis of presentation under the revised IAS 19.

(vii) Effect of changes in economic assumptions

Movements in the value of in-force business at the beginning of the period caused by changes in economic assumptions, net of the related change in the time value of cost of option and guarantees, are recorded in non-operating results.

(viii) Taxation

The profit for the period for covered business is in most cases calculated initially at the post-tax level. The post-tax profit for covered business is then grossed up for presentation purposes at the rates of tax applicable to the countries and periods concerned. In the UK, the rate applied for half year 2013 is 23 per cent (half year 2012: 24 per cent; full year 2012: 23 per cent). For Jackson, the US federal tax rate of 35 per cent is applied to gross up movements on the value of in-force business. The overall tax rate includes the impact of tax effects determined on a local regulatory basis. For Asia, similar principles apply subject to the availability of taxable profits. Tax payments and receipts included in the projected cash flows to determine the value of in-force business are calculated using rates that have been substantively enacted by the end of the reporting period. Possible future changes of rate are not anticipated. See note 15(ix) for further details.

(ix) Inter-company arrangements

The EEV results for covered business incorporate the effect of the reinsurance arrangement of non-profit immediate pension annuity liabilities of SAIF (which is not covered business) to PRIL. In addition, the free surplus and value of in-force business are calculated after taking account of the impact of contingent loan arrangements between Group companies (movements in the contingent loan liability are reflected via the projected cash flows in the value of in-force and the related funding is reflected in free surplus).

(x) Foreign exchange rates

Foreign currency results have been translated as discussed in note 1(b)(vi), for which the principal exchange rates are as follows:

Local currency: £	Closing rate at 30 Jun 2013	Average rate for the 6 months to 30 Jun 2013	Closing rate at 30 Jun 2012	Average rate for the 6 months to 30 Jun 2012	Closing rate at 31 Dec 2012	Average rate for the 12 months to 31 Dec 2012
China	9.31	9.56	9.97	9.97	10.13	10.00
Hong Kong	11.76	11.98	12.17	12.24	12.60	12.29
India	90.13	84.94	87.57	82.27	89.06	84.70
Indonesia	15,053.25	15,024.12	14,731.67	14,460.30	15,665.76	14,842.01
Korea	1,732.15	1,703.47	1,796.42	1,800.16	1,740.22	1,785.07
Malaysia	4.79	4.75	4.98	4.87	4.97	4.89
Singapore	1.92	1.92	1.99	1.99	1.99	1.98
Taiwan	45.46	45.78	46.87	46.77	47.20	46.88
Thailand	47.04	46.07	49.81	49.11	49.72	49.26
Vietnam	32,161.63	32,305.17	32,788.45	32,937.67	33,875.42	33,083.59
US	1.52	1.54	1.57	1.58	1.63	1.58

2 Analysis of new business contribution

	Half year 2013						
	New business premiums		Annual premium and contribution equivalents (APE)	Present value of new business premiums (PVNBP)	Pre-tax new business contribution	New business margin	
	Single £m	Regular £m	£m	£m	£m	APE %	PVNBP %
Asia operations	1,097	899	1,010	5,524	659	65	11.9
US operations	7,957	1	797	7,957	479	60	6.0
UK insurance operations	2,435	112	355	2,943	130	37	4.4
Total	11,489	1,012	2,162	16,424	1,268	59	7.7

	Half year 2012						
	New business premiums		Annual premium and contribution equivalents	Present value of new business premiums	Pre-tax new business contribution	New business margin	
	Single £m	Regular £m	£m	£m	£m	APE %	PVNBP %
Asia operations	669	832	899	4,725	547	61	11.6
US operations	7,119	8	719	7,180	442	61	6.2
UK insurance operations	2,960	116	412	3,495	152	37	4.3
Total	10,748	956	2,030	15,400	1,141	56	7.4