Notes on the IFRS basis results continued

D: Profit before tax – asset management operations continued

(ii) M&G operating profit based on longer-term investment returns:

	2013 £m	2012 £m	
	Half year	Half year	Full year
Asset management fee income	418	351	728
Other income	3	3	6
Staff costs	(149)	(120)	(289)
Other costs	(77)	(66)	(147)
Underlying profit before performance-related fees	195	168	298
Share of associate results	5	6	13
Performance-related fees	4	1	9
Operating profit from asset management operations	204	175	320
Operating profit from Prudential Capital	21	24	51
Total M&G operating profit based on longer-term investment returns	225	199	371

The difference between the fees and other income shown above in respect of asset management operations, and the revenue figure for M&G shown (excluding consolidated investment funds) in the main table primarily relates to total revenue of Prudential Capital (including short-term fluctuations in investment returns) of £51 million (half year 2012: £99 million; full year 2012: £218 million) and commissions which have been netted off in arriving at the fee income of £418 million (half year 2012: £351 million; full year 2012: £728 million) in the table above. The difference in the presentation of commission is aligned with how management reviews the business.

(iii) Short-term fluctuations in investment returns for M&G are primarily in respect of unrealised fair value movements on Prudential Capital's bond portfolio.

E: Insurance assets and liabilities – key results features

In addition to the effect of the new accounting pronouncements for 2013 as disclosed in note B, the following features are of particular relevance to the determination of the 2013 results in respect of the measurement of insurance assets and liabilities.

i Asia insurance operations – non-recurrent items

In half year 2013, the IFRS operating profit based on longer-term investment returns for Asia insurance operations included a net £31 million credit (half year 2012: £17 million credit; full year 2012: £48 million credit) representing a small number of non-recurring items that are not anticipated to reoccur in subsequent periods. The full year 2012 operating profit also included the £51 million gain on sale of the stake in China Life of Taiwan.

ii US insurance operations – amortisation of deferred acquisition costs

Under the Group's basis of applying IFRS 4, the insurance assets and liabilities of Jackson's life and annuity business are accounted for under US GAAP. In line with industry practice, Jackson applies the mean reversion technique for amortisation of deferred acquisition costs on variable annuity business which dampens the effects of short-term market movements on expected gross profits against which deferred acquisition costs are amortised. To the extent that the mean reversion methodology does not fully dampen the effects of market returns there is a charge or credit for accelerated or decelerated amortisation. For half year 2013, reflecting the positive market returns in the period, there was a credit for decelerated amortisation of £20 million (half year 2012: £25 million; full year 2012: £56 million, as explained in note N).

iii UK insurance operations – allowance for credit risk of the annuity business

For IFRS reporting, the results for UK shareholder-backed annuity business are sensitive to the allowances made for credit risk. The allowance is reflected in the deduction from the valuation rate of interest for discounting projected future annuity payments to policyholders that would have otherwise applied. Since mid-2007 there has been a significant increase in the actual and perceived credit risk associated with corporate bonds as reflected in the significant widening that has occurred in corporate bond spreads. Although bond spreads over swap rates have narrowed from their peak in March 2009, they are still high compared with the levels seen in the years immediately preceding the start of the dislocated markets in 2007. The allowance that should therefore be made for credit risk remains a particular area of judgement.

The additional yield received on corporate bonds relative to swaps can be broken into the following constituent parts:

(a) the expected level of future defaults;
(b) the credit risk premium that is required to compensate for the potential volatility in default levels;
(c) the liquidity premium that is required to compensate for the lower liquidity of corporate bonds relative to swaps; and
(d) the mark to market risk premium that is required to compensate for the potential volatility in corporate bond spreads (and hence market values) at the time of sale.

The sum of (c) and (d) is often referred to as 'liquidity premium'.

The allowance for credit risk comprises (i) an amount for long-term best estimate defaults, and (ii) additional provisions for credit risk premium, downgrade resilience and short-term defaults.

Prudential Retirement Income Limited (PRIL) is the principal company which writes the UK's shareholder-backed business.

The weighted components of the bond spread over swap rates for shareholder-backed fixed and linked annuity business for PRIL at 30 June 2013, 30 June 2012 and 31 December 2012, based on the asset mix at the relevant balance sheet date are shown below.

	30 Jun 2013 bps		
	Pillar 1 regulatory basis	Adjustment from regulatory to IFRS basis	IFRS basis
Bond spread over swap rates note (i)	157	–	157
Credit risk allowance:			
Long-term expected defaults note (ii)	15	–	15
Additional provisions note (iii)	49	(22)	27
Total credit risk allowance	64	(22)	42
Liquidity premium	93	22	115

	30 Jun 2012 bps		
	Pillar 1 regulatory basis	Adjustment from regulatory to IFRS basis	IFRS basis
Bond spread over swap rates note (i)	191	–	191
Credit risk allowance:			
Long-term expected defaults note (ii)	16	–	16
Additional provisions note (iii)	50	(23)	27
Total credit risk allowance	66	(23)	43
Liquidity premium	125	23	148

	31 Dec 2012 bps		
	Pillar 1 regulatory basis	Adjustment from regulatory to IFRS basis	IFRS basis
Bond spread over swap rates note (i)	161	–	161
Credit risk allowance:			
Long-term expected defaults note (ii)	15	–	15
Additional provisions note (iii)	50	(23)	27
Total credit risk allowance	65	(23)	42
Liquidity premium	96	23	119

Notes

(i) Bond spread over swap rates reflect market observed data.

(ii) Long-term expected defaults are derived by applying Moody's data from 1970 to 2009 and the definition of the credit rating used is the second highest credit rating published by Moody's, Standard & Poor's and Fitch.

(iii) Additional provisions comprise credit risk premium, which is derived from Moody's data from 1970 to 2009, an allowance for a one notch downgrade of the portfolio subject to credit risk, and an additional allowance for short-term defaults.

The prudent Pillar 1 regulatory basis reflects the overriding objective of maintaining sufficient provisions and capital to ensure payments to policyholders can be made. The approach for IFRS aims to establish liabilities that are closer to 'best estimate'.

Notes on the IFRS basis results continued

E: Insurance assets and liabilities – key results features continued

The movement in the first half of 2013 of the average basis points allowance for PRIL on the IFRS basis is as follows:

	Pillar 1 regulatory basis bps Total	IFRS basis bps Total
Total allowance for credit risk at 31 December 2012	65	42
Credit rating changes	1	1
Asset trading	(1)	(1)
Asset mix (effect of market value movements)	–	–
New business and other	(1)	–
Total allowance for credit risk at 30 June 2013	64	42

The methodology applied is to retain favourable credit experience in short-term allowances for credit risk on the IFRS basis but such surplus experience is not retained in the Pillar 1 credit provisions.

Overall the movement has led to the credit allowance for Pillar 1 purposes to be 41 per cent (30 June 2012: 35 per cent; 31 December 2012: 40 per cent) of the bond spread over swap rates. For IFRS purposes it represents 27 per cent (30 June 2012: 22 per cent; 31 December 2012: 26 per cent) of the bond spread over swap rates.

The reserves for credit risk allowance at 30 June 2013 for the UK shareholder annuity fund were as follows:

	Pillar 1 regulatory basis £bn Total	IFRS basis £bn Total
PRIL	1.8	1.1
PAC non-profit sub-fund	0.2	0.1
Total – 30 June 2013	2.0	1.2
Total – 31 December 2012	2.1	1.3
Total – 30 June 2012	2.1	1.3