

Principles and Practices of Financial Management

Report to With-Profits Policyholders on Prudential's Compliance for 2010

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Summary

In the opinion of the Board ("the Board") of The Prudential Assurance Company Limited ("the Company") the Company has complied with its obligations in relation to the Principles and Practices of Financial Management (PPFM) over the period 1 January 2010 to 31 December 2010 and at the bonus declaration in respect of the year 2010, announced on 25 February 2011.

These obligations are that the Company should maintain governance arrangements that are designed to ensure that, in the conduct of with-profits business, it complies with, maintains and records any applicable PPFM.

The following pages set out the Board's reasons for its opinion.

1. Introduction

Each year, the Board of The Prudential Assurance Company Limited (the Company) must report to with-profits policyholders on compliance with the obligations of the PPFM.

These obligations are that the Company should maintain governance arrangements that are designed to ensure that, in the conduct of with-profits business, it complies with, maintains and records any applicable PPFM.

The report covers the period from 1 January 2010 to 31 December 2010 (inclusive), and includes the bonus declaration in respect of the year 2010 which was announced on 25 February 2011. It describes:

- › governance arrangements for with-profits business,
- › how the Company has complied with the PPFM in exercising discretion in managing its with-profits business,
- › competing or conflicting rights, interests and expectations,
- › changes to the PPFM and communications to with-profits policyholders, and
- › maintenance and recording of the PPFM.

The majority of the Company's with-profits business is in the With-Profits Sub-Fund (WPSF). This includes the with-profits business previously written in Prudential (AN) Limited (PANL) which was transferred into the WPSF on 31 October 2010.

There is also a substantial amount of business in the Scottish Amicable Insurance Fund (SAIF) and in the Defined Charge Participating Sub-Fund (DCPSF). SAIF consists solely of policies written by Scottish Amicable Life Assurance Society before 1 October 1997 together with SAIF's inherited estate. The DCPSF contains the investment content of business reassured into the Company from Prudential International Assurance plc (PIA), business historically written through the Company's French branch and with-profits annuities business transferred from Equitable Life Assurance Society (ELAS) on 31 December 2007.

Any terms used in this report have the meaning set out in the PPFM which can be found on www.pru.co.uk/ppfm

2. Governance arrangements for with-profits business

There are two specific roles which have been set up to ensure that the Company is managing its with-profits business in accordance with the PPFM – the With-Profits Committee (WPC) and the With-Profits Actuary (WPA). In addition, for SAIF, there is the Scottish Amicable Board and an independent Monitoring Actuary.

2.1 The role of the With-Profits Committee (WPC)

The WPC provides an independent assessment of the way in which the Company manages its with-profits business, how the Company balances the rights and interests of policyholders and shareholders in relation to its with-profits funds, and whether the Company complies with the PPFM.

The Committee comprises three members, all of whom are independent of the Company. They are:

- › Andreas Whittam Smith, First Church Estates Commissioner and the founding Editor of The Independent newspaper (now retired),
- › Michael Arnold, a former Head of the Life Practice at Milliman (now retired), and
- › Paul Thornton, a past-President of the Institute of Actuaries.

The WPC met regularly in 2010 and reviewed the bonus declarations announced in February 2010 and February 2011, and the interim declaration which came into force on 1 January 2011. The WPC also reviewed the equivalent declarations in respect of SAIF and ELAS business.

The WPC were consulted during the year on all significant matters concerning with-profits business, and provided an independent view to the Boards on all matters referred to them. The opinions provided addressed the treatment of conflicting rights and interests of policyholders and shareholders, where relevant, as well as compliance with the PPFM.

2.2 The role of the With-Profits Actuary (WPA)

Gerry Gallagher (a Prudential employee) was appointed as the WPA in December 2004. The WPA reviews material relevant to the operation of the with-profits business, including communications to with-profits policyholders, and advises the Company on compliance with the PPFM, on the interests of with-profits policyholders, on areas of discretion and on potential conflicts of interests.

The WPA's report to with-profits policyholders in respect of 2010 can be found in the Appendix.

2.3 The role of the Scottish Amicable Board and the Monitoring Actuary for SAIF

The Scottish Amicable Board reviews the management of SAIF to ensure it is managed in accordance with the Scheme under which policies were transferred to PAC.

The Monitoring Actuary advises the Scottish Amicable Board on the operation of SAIF to protect the interests of SAIF policyholders. The Monitoring Actuary is John McKenzie, a Principal in the Life Practice at Milliman.

2.4 Governance of ex-ELAS policies

The business transferred from ELAS to the Company on 31 December 2007 is operated in accordance with the terms of the Scheme that effected the transfer. The WPC review the operation of the transferred ELAS business to ensure compliance with the Scheme.

3. How the Company has complied with the PPFM in exercising discretion in managing its with-profits business

There are a number of important areas where the Company has exercised discretion in managing its with-profits business.

3.1 Bonus rates

This is probably the single most important item of discretion that the Company has affecting its with-profits policyholders.

The annual bonus declaration in respect of 2009 was made on 26 February 2010. The Board was supplied with sufficient information for it to be comfortable that the declaration was consistent with the PPFM. At the 26 February 2010 declaration, at least 90% of claim payments were expected to fall in the range 80% to 120% of asset shares.

The annual bonus declaration in respect of 2010 was made on 25 February 2011. The Board was supplied with sufficient information for it to be comfortable that the declaration was consistent with the PPFM. At the 25 February 2011 declaration, at least 90% of claim payments were expected to fall in the range 80% to 120% of asset shares.

The bonus declarations were also reviewed by both the WPA and the WPC.

3.2 Surrender values

Surrender values were regularly monitored during 2010 to ensure that they remained appropriate.

Although Market Value Reductions (MVRs) were kept under review, no change was made to the overall approach to MVRs during 2010. Surrender value bases remained unchanged during 2010, except for changes to some of the parameters in the formulae used to calculate surrender values.

3.3 Investment strategy

The investment strategy for the WPSF and for SAIF is regularly monitored by the Board and any proposals for changes in investment strategy are put before the Board for approval.

The investment strategy of SAIF is also monitored by the Scottish Amicable Board.

Following the stockmarket recovery in 2009 and the uncertainty regarding the future direction of global investment markets at the time, the Board concluded that it was prudent to increase the proportion of funds which were invested in cash and fixed interest in 2009 (with a corresponding reduction in the proportion of funds invested in higher risk assets such as equities and property).

During 2010, the proportion of funds invested in cash and fixed interest remained consistent with the position at the end of 2009.

Given continuing economic uncertainties, the Board believes that the current asset mix reflects an appropriate balance between risk and return which is consistent with the stated objectives of the fund.

The regulation of the European insurance industry is undergoing a fundamental review as EU regulators aim to establish a revised set of EU-wide capital requirements and risk management standards designed to enhance the security of policyholders' benefits. Whilst the final specification of the new regime is not complete, it is expected that there will be a greater need for insurers to make sure that the investment and bonus policies adopted are consistent with the risks accepted and the amount of capital available.

We expect that the reduced levels of equity and property investment will continue for the foreseeable future and are likely to produce slightly lower but less volatile returns than if a greater proportion of the fund was invested in equities and property.

The Board, and the Scottish Amicable Board for SAIF, will continue to keep investment strategy under review and ensure that it achieves an appropriate balance between risk and return, having regard to regulatory changes, the attractiveness of the expected returns available on different asset classes and the ongoing volatility in investment markets.

3.4 Charges and expenses

The way the Company apportions expenses to funds, and then to products, is regularly monitored and reviewed for fairness.

In addition to the expenses of administering with-profits policies, the Company pay fees to the WPSF and SAIF asset managers for the investment management of the Company's assets.

Investment fee rates for asset classes other than property remained unchanged from the 2009 rates. Basic investment fee rates for property were reviewed and updated from 1 January 2010. The WPC and WPA agreed with the basic property fee rates proposed. The WPC are in continuing discussion with the Company regarding the proposed performance related component of the fees.

The expense apportionment was also reviewed during the year by the WPA and the WPC. It was agreed that expenses were allocated in an appropriate and fair manner, and with an appropriate control environment.

The Scottish Amicable Board also reviewed, and was content with, the expenses charged to SAIF.

3.5 Management of the inherited estate

The WPSF contains an amount of money in excess of the amount expected to be paid to existing policyholders. This is known as the inherited estate. It has built up over many years from a number of sources and it provides working capital, to support current and future business.

The Board has regard to the current and projected financial position of the inherited estate in its financial management of the WPSF.

Terms for new with-profits business were reviewed, including any potential support from the inherited estate for expenses or costs of shareholder transfer, and the financial effect of this support was reported to, and agreed by, the Board.

A number of separate asset pools are maintained within the WPSF. In particular, there are separate asset pools for the assets backing asset shares and those backing the inherited estate. This enables the inherited estate to follow a different investment strategy to that for the assets supporting asset shares. The inherited estate may have a different investment strategy to that for the assets supporting asset shares in order to help meet guarantees and maintain regulatory solvency in adverse market conditions. Currently the assets backing the inherited estate are mainly invested in fixed interest securities and cash.

SAIF's inherited estate is being distributed under the terms of the Scheme of Arrangement as an addition to the payments to its policyholders.

As for the WPSF, SAIF's inherited estate now follows a different investment strategy to that supporting the asset shares. Currently the assets backing the SAIF inherited estate are mainly invested in fixed interest securities and cash.

3.6 Volumes of new business and arrangements on stopping new business

The Company ensures that there is enough capital in the fund to support new sales without adversely affecting the existing with-profits policyholders. This continued to be the case in 2010.

The Company has no current intention to close the WPSF to new business and has had no such intention during the period. SAIF is closed to new business.

4. Competing or conflicting rights, interests and expectations

4.1 Equity between with-profits policyholders and shareholders

Inequity between with-profits policyholders and shareholders could arise in tax and in expense apportionment.

4.1.1 Tax

The WPSF is part of the Company's long-term fund, which also includes other funds, including some owned by the Company's shareholders. To ensure that the tax charged to the WPSF is fair, the Company:

1. charged tax to SAIF as if it were a UK mutual life assurance company,
2. charged tax to the DCPSF and Non-Profit Sub-Fund (NPSF) as if these were stand-alone entities,
3. charged the remainder of the tax charge for the PAC long-term fund to the WPSF, and
4. confirmed that the amount allocated to the WPSF was no more than the amount that would have been charged if the WPSF tax had been calculated on a stand-alone basis.

The Company is, therefore, satisfied that the allocation of the overall tax charge for 2010 was fair to both with-profits policyholders and shareholders.

4.1.2 Expenses

Audited expense apportionment processes are in place, so that a fair and appropriate split of expenses between the WPSF, SAIF, other funds and shareholder-owned funds can be achieved.

4.2 Equity between different groups of with-profits policyholders

Different groups of with-profits policyholders have potentially competing or conflicting interests. Such groups comprise, for example, holders of:

- › different products,
- › policies of different sizes or policy terms,
- › policies with different entry dates or maturity dates or with-profits policyholders of different ages,
- › policies claiming for different reasons (e.g. maturity, death, surrender), and
- › policies exercising different policy options, who could receive different benefits relative to each other depending on how discretion is exercised.

The main areas in which judgement and discretion are exercised in balancing the interests of these groups are:

- › smoothing of policy benefits, and
- › grouping of policies for setting bonus rates and surrender values and sharing of investment and other experience, such as surrender, expense and mortality profits or losses.

The approach taken to smoothing during 2010/11 was as described in the PPFM. The annual declarations made on 26 February 2010 and on 25 February 2011 were within the normal smoothing rules.

The approach to grouping of policies has evolved gradually. It varies for different purposes (for example investment returns, expenses and mortality). For a particular purpose, policies judged to have similar characteristics were grouped together, in order that a practical and equitable approach to the sharing of experience could be achieved.

5. Changes to the PPFM and communications to with-profits policyholders

A number of changes were made to the PPFM over the period covered by this report.

Changes were made in November 2010 covering:

- › the Part VII transfer of the business of PANL and Prudential Holborn Life Limited (PHL) business into the Company,
- › a change in the approach to charging for guarantees on Income Choice Annuity (ICA), and
- › amendments to the description of approach to "Target Ranges" on maturity payouts and surrender payouts to better reflect actual practice.

Changes were also made to the PPFM in April 2010 to remove explicit reference to the level of charges levied under ICA for guarantees and smoothing. These charges are fully detailed in new business literature and the level of disclosure in the PPFM is consistent with that for other products.

Further minor changes were also made over the course of the year in line with the general maintenance of the PPFM.

Statements sent to with-profits policyholders set out details of the bonuses added to their investments following the 26 February 2010 bonus declaration.

Customer Friendly versions of the PPFM are available on Prudential's website at <http://www.pru.co.uk/ppfm>, as is current information regarding the asset mix and the investment returns of the WPSF and SAIF.

6. Maintenance and recording of the PPFM

Formal reviews were carried out quarterly throughout 2010 to confirm that the PPFM remained up-to-date.

During the period covered by this report (2010), full compliance with the processes and controls for the maintenance and recording of the PPFM was signed off, with no exceptions noted.

This confirms that the Company has maintained and recorded its PPFM over 2010.

Appendix

Report from the With-Profits Actuary

As With-Profits Actuary, I advise The Prudential Assurance Company Limited on key aspects of the discretion that they exercise on with-profits business.

I have been involved in consideration of all the matters referred to in the attached report on Prudential's compliance with its Principles and Practices of Financial Management. This covers the period from 1 January 2010 to 31 December 2010 inclusive, together with the bonus declaration for the year ending 31 December 2010 which was announced on 25 February 2011. In my opinion, based on the information and explanations provided to me by the Company, the discretion exercised by Prudential over the period took your interests into account in a reasonable and proportionate manner.

In arriving at my opinion, I have taken into account the relevant rules and guidance issued by the Financial Services Authority and the Board for Actuarial Standards.



Gerry Gallagher
With-Profits Actuary

Prudential Assurance Company Limited

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