

12.4 per cent in 2006, and over the last five years the fund has achieved a total return of 63.8 per cent against 41.1 per cent for the FTSE 100 total return and 50.2 per cent for the FTSE All-Share (Total Return) index (figures are to 31 December 2006, before tax and charges). Much of this investment performance was achieved through the active asset allocation process. Prudential constantly evaluates prospects for different markets and asset classes. During 2006, Prudential decreased its exposure to equities while increasing its exposure to corporate bonds and alternative assets, reflecting Prudential's view that increased diversification in the assets of the with-profits sub-fund was appropriate.

The table below shows the recent changes in the investment mix of Prudential's main with-profits fund:

	Full Year 2006 per cent	Full Year 2005 per cent	Full Year 2004 per cent
UK Equities	36	40	33
International			
equities	17	19	15
Property	15	15	18
Bonds	26	21	29
Cash and other assets classes	6	5	5

In 2005, Prudential UK established a with-profits committee (WPC) which acts as the with-profits committee for PAC and for each of the subsidiaries writing with-profits business in the UK. The WPC provides an independent assessment of the way in which Prudential 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 Prudential complies with its Principles and Practices of Financial Management. The WPC comprises three members, all of whom are independent of Prudential.

Equitable Life's with-profits annuity business will be transferred into the Defined Charges Participating Sub-Fund (DCPSF) of the Prudential with-profits fund. The DCPSF is used by Prudential for business which has a fixed level of charges.

The proposal in detail

Background

After some difficult years, the Society is now stable and secure and we expect to be able to run the business until all of the current policies eventually mature or lapse.

However, although the financial position of the Society is much stronger, the new regulatory requirements mean that we must still invest very cautiously; predominantly in fixed interest investments. Although such investments give us security, the with-profits fund is unlikely to perform in the medium and long term as well as a fund which has the freedom to invest a significant proportion of its assets in equities.

It is because the investment constraints are likely to result in modest returns from the Society's fund for the medium term that your Board has been searching for strategic alternatives. *Without a strategic change, bonus rates are likely to remain close to current levels for years to come.* In particular, this would mean that the income paid from most with-profits annuities would continue to reduce each year.

The Board's search for strategic alternatives started by addressing the fundamental uncertainties created by the guaranteed annuity rates issue and by the large scale claims against the Society. Then we used the agreement with Canada Life to remove most of the mortality risk associated with the non-profit pension annuity business. Now, this proposal from Prudential can allow the with-profits annuity policies to move to a fund which has greater investment freedom and greater bonus earning potential. If the with-profits annuities are transferred to Prudential, the Society's remaining business will be simpler and more attractive to a significant number of third parties. This will increase the prospects of finding a strategic opportunity to improve the outlook for the rest of the with-profits policyholders.

How Prudential's proposal works

In order to invest actively in shares and property a life insurance company needs capital support. A mutual society like Equitable

Life can only obtain such capital support from its existing business. We call this capital 'Excess Realistic Assets.' Excess Realistic Assets are the difference between the value of the liabilities (including final bonus) and the value of the assets. The financial condition of the Society, whilst stable and secure and much stronger than before, is such that it cannot currently provide the capital to support a more active investment policy under the new regulatory regime - the Excess Realistic Assets are too low. Prudential, on the other hand, is a large, strong proprietary company and it has access to much greater capital resources in its with-profits fund. This will allow Prudential to provide active investment management for the with-profits annuity business.

Prudential will take an 'up front' charge to cover the cost of guarantees within the with-profits annuity business. However, that charge will be less than the with-profits annuities' share of the Society's Excess Realistic Assets which will be released when the annuities transfer. Consequently, there will be no impact on policy values. From then on, Prudential will be adequately compensated (for the capital support it will provide) by the current level of charges made by Equitable Life - that is, there will be no increase in the level of charges for with-profits annuities to pay for the use of capital and Prudential has committed to maintain charges at no higher than the level currently levied by Equitable Life. We cannot give such a guarantee.

Equitable Life is closed to new business and the number of policies is gradually reducing over time. As the company reduces in size the cost of administration per policy ('unit cost') can be expected to increase. The Society allows for the effect of those expected increasing unit costs in managing the business. For this reason, the transfer of with-profits annuitants to Prudential (representing about 20% of the Society's with-profits fund) could be expected to increase the unit costs for the remaining business. To compensate for this, part of the with-profits annuitants' share of the Society's Excess Realistic Assets will be retained so that remaining policyholders can expect no change to the effective unit costs of their policies as a result of the transfer.

Special bonus

The with-profits annuitants' share of the Excess Realistic Assets will not be required once the business transfers to Prudential. Part of the with-profits annuitants' share of the Society's Excess Realistic Assets will be used to cover the one-off payment to Prudential in respect of the cost of guarantees within with-profits annuities. Part of their share of the Society's Excess Realistic Assets will be used to cover the with-profits annuitants' share of the implementation costs of the transfer. Another part of the Excess Realistic Assets will be used to compensate the remaining policyholders in respect of the potential increase in unit costs. The balance of the with-profits annuitants' share of the Society's Excess Realistic Assets will be returned to with-profits annuitants in the form of a special bonus. As a proportion of the total liabilities the Excess Realistic Assets are small and can be volatile. For these reasons it is not possible to forecast the size of any special bonus at this stage and the special bonus will only be determined after the transfer (based on the financial position at the transfer date). The special bonus, if any, is not expected to be significant. We think the deal would be right for with-profits annuitants even if there is nothing available as a special bonus.

Other policyholders including group pension schemes

- The remaining business of the Society will have improved opportunities for future strategic change.
- It will also remove the risk that the cost of paying the with-profits annuities will increase (if the annuitants live longer than expected).

Prudential

- Prudential will receive a large block of business from which they expect to make a profit (with no increase in current levels of administration charges).
- Equitable Life's with-profits annuities will create opportunities for synergies within Prudential in terms of costs, investment management and administration.
- The transaction represents a significant increase in Prudential's with-profits business, which is an area of its strategic focus.

Costs

We estimate the total pre-tax cost of the transfer covering the data audit, the systems development, the legal process and the communications, to be in the region of £35 million which will be met from the Society's Excess Realistic Assets. The majority of the costs will be covered by the with-profits annuitants' share of Excess Realistic Assets as they will see the most significant benefits if the transfer proceeds.

The benefits

We believe the proposal will be beneficial for with-profits annuitants, for our other policyholders and for Prudential:

With-profits annuitants

- With-profits annuitants will transfer to a large, growing company and into an actively invested with-profits fund with significantly greater investment freedom than Equitable Life can provide.
- The terms of the with-profits annuity policies will be unchanged (so, for example, the existing minimum payment levels will continue to apply).
- Prudential has committed to maintain charges at no higher than the level currently levied by Equitable Life.
- With-profits annuities may receive a special bonus when they transfer (paid for out of their share of the Society's Excess Realistic Assets).

Alternatives

We have considered a number of internal strategies and external approaches relating to with-profits annuities and compared them to the proposal from Prudential. The Board is clear that the Prudential proposal represents the best approach for all policyholders - giving with-profits annuitants something much closer to what they originally purchased (a pension which depends on the returns from a broadly based investment fund), whilst providing to the remaining with-profits policyholders the benefits of a simplified business and improved prospects for strategic options in the future. Based on our discussions and research with thousands of policyholders over several years, none of the other alternatives which the Board has considered would have been as attractive to policyholders as the Prudential proposal.

In particular, effecting changes which would allow significantly greater investment freedom without involving a third party would be much more complex, involve significant changes to policy terms, create greater risks for policyholders and would be expected to be much less likely to appeal to a broad range of policyholders than the Prudential proposal. Policyholders have told us that they have little enthusiasm for options involving converting with-profits annuities to non-profit policies (for example, to provide fixed reducing pensions).

The Board also considered rejecting strategic change in favour of continuing to run all of the Society's business within the current framework. That would leave with-profits annuitants in a fund with continuing limited bonus earning potential and would increase the difficulties of finding a strategic opportunity which might benefit the other policyholders.

Safeguards

There are five key safeguards for policyholders in the transfer process:

- The Board believes strongly that the proposal represents the best way forward for the Society. To reach that conclusion the Board has taken legal advice from Lovells, actuarial advice from Deloitte and financial advice from Lexicon respectively. In due course, the Board expects to

recommend that members vote in favour of the agreement with Prudential.

- The Financial Services Authority (FSA) is the regulator for both Equitable Life and Prudential. Part of its remit is investor protection. The FSA has a right to be heard by the Court before a transfer can be sanctioned.

- An Independent Expert will be appointed with a duty to advise the Court of the potential impact of the proposal on policyholders, including those who will transfer to Prudential, those who will stay with Equitable Life and also Prudential's policyholders. The FSA will approve the appointment of the Independent Expert and will also approve the form of his report to the Court. Although the Independent Expert will be approved by the FSA and his fee will be paid jointly by Equitable Life and Prudential, his duty is to the Court alone.

- The Board will not implement the transfer unless the members approve the proposal at a vote which will be arranged for later in the year.

- Finally, the Court will not sanction the transfer unless it considers that the proposal as a whole is fair to all those involved. Anyone who believes the scheme may adversely affect them will have the right to be heard by the Court in due course.

Prudential

Prudential is a leading life and pensions provider to approximately 7 million customers in the United Kingdom.

The long-term fund of The Prudential Assurance Company Limited (PAC) remains very strong. On a realistic valuation basis, with liabilities recorded on a market consistent basis, the free assets are valued at approximately £8.7 billion at 31 December 2006, before a deduction for the risk capital margin. The fund is rated AA+ by Standard & Poor's and Aa1 by Moody's and AA+ by Fitch Ratings.

The Prudential with-profits sub-fund, which had total assets of £71.9 billion as at 31 December 2006, delivered a pre-tax return of