Half Year Results

Thursday 14 August 2014

Steve Groves, Chief Executive Officer

Good morning and thank you for attending Partnership's 2014 half year results. I'm Steve Groves, CEO of Partnership. I'm joined here today by David Richardson, our CFO, who I suspect you all know, and our Chairman, Chris Gibson-Smith, is also in the audience down at the front here. I'm going to kick off and just have a look at a brief summary of the first half financials which David will cover in more detail shortly.

In a disrupted market, we generated individual annuity sales of £334m, and in total £409m of new business sales. Our commitment to continue to write only new business which is capital generative, means sales have been impacted, although the new business margin has been protected as much we possibly could, at 4.4%. We do remain very focused on the strategic goals of leveraging our unique IP, improving customer access, supporting sales and maximising risk adjusted returns for shareholders. Over the next few slides I'm going to go through the targeted actions we've identified to diversify and grow the business post the Budget. In the first half and despite the Budget, these priorities have allowed us to deliver total operating profit of £33m, to increase the market consistent embedded value per share to 136p, and maintain a robust economic capital position with coverage of 153%.

I'm going to move on now and just have a look at the market context. Research carried out by Partnership post-Budget of a sample of people aged between 45 and 70, revealed that a guaranteed income for life was the most important feature of a new retirement product. The second most important aspect was getting as much income as possible. These requirements are of course key features in enhanced annuity. However, feedback from our top 100 annuity brokers indicates that in this period of uncertainty, until there is clarity on the rules, advisors are wary of advising clients incorrectly. They're therefore advising them not to purchase an annuity unless the client is 100% certain on that purchase. They are therefore using other solutions, and in the near term they're deferring decisions. As a result, the market is in limbo. We're awaiting confirmation of the new rules around pensions, and as we observed from customer behaviour around A-day and indeed the Dilnot review, as implementation nears there is the potential for the propensity to defer to increase until the new regime is in place. Why do I say that? Well, there's actually fewer months to self-finance retirement as we approach April, which makes the cost of deferring a decision lower.

As has been widely reported across the industry, activity levels are down by around 50%, and for Partnership this is no different. Quotes, which are our best guide to the future level of sales, are currently below 50% of the same period last year, and that's very much indicative of this trend we're seeing of people delaying the decision around their retirement income. From what we have seen, it appears that there is no material difference in the impact on the quotes by the size of the pension pot, so I think there was a lot of speculation that what we would see is small cases, large cases. We're actually seeing that 50% as relatively uniform across all pot sizes. Conversion of quotes issued since the Budget is lower than quotes issued before the Budget, and the indications are that customers are just maintaining flexibility in the period of uncertainty and they're waiting for clarity on the new regulations and the new product landscape.

So, what does this mean for Partnership? Annuity purchases are down as people choose to defer during this period of uncertainty, and while we would expect greater flexibility to mean that fewer people overall will buy an annuity, with impartial guidance encouraging more people to shop around at retirement, that could actually significantly increase the addressable market available to Partnership. Regardless of what people choose to do at retirement, the size of the DC market is forecast to grow six-fold by 2030, and that's a result of the shift we've seen from DB to DC saving, driven by factors such as auto-enrolment, Government initiatives to encourage people to save more, and I genuinely hope that in time we'll be able to add the intended consequence of the Budget proposals to that list.

Finally, I think it's worth saying that the new regulations will create the opportunity to develop new products. So, despite the disruption caused by the Budget proposals, the long-term opportunity for Partnership to leverage its unique intellectual property, remains. Our other product lines, namely DB, Care and Protection, remain unaffected following the Budget proposals.

I want to now move on to look at how we're reacting to the changes, and we've got very much a focus here of delivering a stronger and more diversified business model. Our strategy is targeted around five key strands, two of which are existing today, namely individual annuities and our care and protection products. Three are in development, namely our medically underwritten DB proposition, new products, and the international opportunities, each of which I will talk about in more detail now.

Starting with individual annuities and turning first to guidance. The form in which this is delivered and the structure of it is key to the future shape of the individual annuity market. The Government response to the consultation does contain many of the themes we recommended, not least the recognition of the need for strong and impartial guidance, which I've said before should lead to more people shopping around. It's also encouraging to see the acknowledgement in the consultation that annuities will remain the right product for some, and that those who want the security of an annuity will still be able to purchase one. The proposed announcements to the regulations around annuities should also allow the creation of a new range of products that leverage Partnership's unique IP, yet more closely meet certain customer needs.

In addition to this, the awareness generated through the Budget of an individual's right to transfer from DB to DC, may increase the universe of customers looking to purchase an enhanced product. For customers currently in a DB scheme with medical conditions, for many it may be attractive to transfer to DC and buy an enhanced or impaired annuity. There is still a significant amount of detail regarding the new regulations yet to be confirmed, but Partnership will continue to work with the Government as the detail underpinning the reforms is developed.

Turning now to our DB proposition. The UK DB market is estimated to comprise around £1.8 trillion of pension liabilities on a buy-out basis. Within this market, Partnership's focus is on smaller schemes with liabilities of up to around £100m, and that's because this is the area where the prevalence of medical conditions or lifestyle factors are most pronounced, and therefore our IP is the most effective in allowing us to win the schemes. This core target market contains around £180bn of pension liabilities. However, of the 208 deals done in this space in 2013, and they were worth £3.2bn of premiums, only 3% were medically underwritten, and that reflects the fact that medical underwriting in DB de-risking is still relatively new.

We are focused on trying to gradually move the market to a position where for these smaller schemes medically underwritten buy-out and buy-in processes just become the norm. We expect that to take some time. There are a number of ways that we're doing this. The key things we're working on at the moment are advisor education, increasing awareness of scheme sponsors and trustees, and I would add actually that wider distribution is developing as more players enter the market, so we have welcomed other players into this market, and I think it's accelerated the development of the market.

The result of all of this will be that more schemes can benefit directly from medical underwriting. In time we would also expect the more normally distributed schemes to move down this route. Ultimately they'll be penalised and offered less favourable terms on standard bulk annuities if they don't. The reason for that? As medical underwriting takes off, standard bulks will have to start pricing on the assumption that the members of schemes not opting for medical underwriting must have a better than average life expectancy, and that then increases the universe of schemes where medical underwriting can benefit us.

So what is it we're doing in this space? In 2014 we've strengthened our proposition through a number of experienced new hires from the DB industry. This has given us increased credibility and it's allowed us to closely align ourselves with the key advisory firms. In addition to that, we've strengthened our relationships with the employee benefit consultants by broadening our offer, and we're now including selective annuitisation within larger schemes, and extending our offering to include deferred pensioners in a buy-out proposition. The result is a strong and growing pipeline. The number of pipeline deals is now up 50% in the last three months. However, I would sound a word of caution here. This is still a nascent market and trustees are still adjusting to the proposition, deals take time to realise and sales in effect are lumpy. It's a phrase we've used before and I think it describes this DB market.

I want to turn now and look at opportunities in the product development space. I've said before, and I said immediately following the Budget, that customers need to manage longevity risk through a highly uncertain future lifetime. That hasn't changed. What is often overlooked though is that people who focus on average life expectancy, miss the distribution around that. People's distribution around their life expectancy can vary to leave them living 10-15 years beyond the norm. This risk can't be managed effectively on an individual basis, it's not possible. The new regulations around annuities, such as allowing payments to decrease, the withdrawal of lump sums, extending the period over which death benefits apply, all allow greater flexibility to develop new products within what is a currently polarised spectrum with savings contracts which are called drawdown, and an insurance contract which is called an annuity. We think that the changes will allow us to develop contracts which more closely meet customer needs going forward.

The applicability of our IP and the ability to innovate rapidly, was demonstrated through the launch of the Enhanced Choice Annuity, and we did that within eight weeks of Budget. It's worth saying here as well that although we have had to manage our cost base in the face of lower sales, we have targeted investment in our underwriting and product development expertise, because we think it's really important to ensure our capability is maintained through this period in this area. However, there is still uncertainty over the details of the new rules, and even once implemented, what we've seen in the past in these kind of changes is a lag between the implementation of the rules and the adoption of new behaviours, new products by advisors and customers, so there is often a period where actually you get a catch up with the regulatory change from the behaviour of customers and advisors.

I just want to talk briefly now about international. We've talked before about the relevance of Partnership's IP globally, and today we're taking the opportunity just to give you a little bit more detail on the progress we're making. We have now identified a significant opportunity in the US to leverage our intellectual property, and to support this we have a dedicated management team based out in the US, all of whom have significant experience in business development and many of whom have experience of international business development.

To date we've been through a three phrase process. Phase one, we've evaluated our IP in the context of the US, we've looked at the validity of the dataset for the market, and we've looked at whether there are technical barriers to developing the proposition we want to develop out there, so tax barriers, regulatory barriers. We've actually completed that phase now and we're comfortable that there is an opportunity out there. We're now into what we would term phase two, so we are currently assessing the most economically attractive entry model, we're looking at the balance between the level of capital required, the risk, and the rewards that travel with those combinations. Of course it goes without saying that the timing around this opportunity remains uncertain, but we will update the market as and when appropriate.

In summary, I'm optimistic about the significant longer-term opportunities for Partnership to leverage its unique IP through new products, and that's within our core market, within the DB space, and also internationally. However, clearly the 2013 final dividend was set pre-Budget. Given the current uncertainty, the Board has decided to review the interim dividend. In order to maintain the financial flexibility we want and to support targeted investment in opportunities to grow and diversify the business, the Board has decided it appropriate to declare an interim dividend of 0.5p per share. The Board will next consider the dividend at the time of the 2014 full year results in early 2015.

Thank you, and at that point I'm going to hand over to David.

David Richardson, Chief Financial Officer

Thanks Steve and good morning everybody. I'll start off with some financial highlights before going into each of those in detail in the subsequent slides.

First of all, as expected, new business premiums have fallen in the first half of the year by approximately 35% to £409m due to the impact of the Budget. We delivered total operating profit of £33m versus £59m last year, reflecting this lower level of sales. The new business margin came in at 4.4%, and this has been supported by our continued focus on pricing discipline and securing high quality business, together with the cost actions taken immediately following the Budget. The economic capital ratio remains strong at 153%, and since the start of the year, MCEV per share has increased by 6p to 136p. Finally, assets under management which are a proxy for the size of our balance sheet, grew by approximately 9% to £4.4bn.

Looking at new business volumes first of all, we generated individual annuity sales of £334m in the first half, split £200m in the first quarter and £135m in the second quarter. The decrease in sales in the second quarter reflects the impact of the Budget, partially mitigated by good conversion of sales during April on business that was already in the pipeline before the Budget was announced on 19 March. It is unlikely that the impact of the Budget will settle down for some time, as Steve has already indicated, but current sales are below half of Q1 levels. And as Steve highlighted earlier, there is a risk that as the implementation date of the new pension reforms in April next year approaches, that deferral rates increase further.

In DB we achieved sales of £37m in the first half, which was helped by a strong start to the year. However more importantly, in 2014 we have extended our proposition to trustees, and strengthened and deepened our relationships with employee benefit consultants who advise trustees on these matters. This has led to the development of a high quality and growing pipeline of future potential opportunity. However I'll echo what Steve said, and I apologise if we labour the point, but DB sales are lumpy generally, and that's particularly the case in a nascent market such as the medically underwritten DB market. This means the timing of transactions can be difficult to predict, and we will not chase volume at the expense of margins. However, based on current pipeline activity, we would expect completion of those opportunities in the pipeline to be more weighted towards the fourth quarter of this year or the first quarter of next year, rather than during Q3.

In care, sales were up 29% to £36m, as the market is starting to show tentative signs of recovery following the disruption from RDR last year. It does represent a long-term opportunity for us, however we do see unlikely that there's going to be significant growth in the short-term just as the ongoing funding of care remains uncertain. Finally, protection brings our sales up to £409m.

On expenses, the actions we took following the Budget, including freezing recruitment and removing contractors from the business where possible, helped contain costs in the first half of the year at £42m, slightly below the second half of last year, and more than offset the increase from PLC costs along with natural inflation in the cost base. In combination with the cost management actions that we announced in June, we are targeting cost savings of £21m compared to our planned cost base for 2015, resulting in anticipated operating expenses of approximately £80m next year. With that in mind, we would expect costs in the second half of 2014 to be slightly lower than they were in the first half of the year, and with over 90% of our operating expenses allocated to new business, it's really important that we take this action to protect our new business profitability.

So moving onto that new business profitability, the gross margin, that is our margin pre-expenses, has been maintained during the first half of the year by our ongoing disciplined approach to pricing, despite the market disruption. However because over 90% of our operating expenses are allocated to new business, the lower level of sales that we saw in the first half resulted in a decrease in the new business operating profit of £18m and a margin of 4.4%.

While we will continue to maintain that pricing discipline in the second half, it is still too early to predict where sales levels will land for the second half of the year, and hence the resulting impact on the new business margin. However we do expect directionally new business margins to be lower in the second half of the year than they were at the first half, as the impact of the cost management actions that we've taken will only begin to feed through during the fourth quarter.

Turning to existing business and in-force operating profit, this comprises of two elements. You see the green bar, which is the natural release of prudent margins in our IFRS reserves over time, together with variances around our best estimate assumptions, and the yellow bar which is the impact of assumption changes and other changes to our IFRS reserves. What we've seen in the first half of the year is underlying profits of £6m, down slightly on the same period last year, as we flagged at the full year, because of the impact of credit spreads narrowing. As credit spreads narrow the PADS that are released on investment margins reduce. Underlying experience itself was very close to best estimate assumptions.

Looking at the assumptions and other changes, those amount to just £1m in the first half of the year with no significant items, and this contrasts to last year where there were significant non-recurring expense savings.

The final component of operating profit is the expected return on surplus assets so these are the assets we hold in excess of our IFRS reserves. The return in the first half of £9m represents a yield of approximately 4.6% on those surplus assets, which is broadly in line with the second half of last year. This is actually higher than expected as a result of both equity release assets that we acquired last year being more slowly deployed to support new business, as a result of the drop in new business volumes following the Budget. Over time these equity release assets will be deployed to support new business and the return on surplus assets we would expect to revert closer to 3% over time.

Completing the analysis of IFRS profits let's look at below the line items. Taking investment variances first, those were a negative of 9m in the first half of the year. Economically we aim to minimise our interest rate risk and our credit rate risk exposure. However, market movements will cause fluctuations from period to period. And what we've seen in the first half of this year is a negative impact from falling interest rates, offset partially by tightening of credit spreads.

On non-recurring expenditure of -£10m, the single biggest component there was an impairment of £6m that we took against investment that we'd made in IT sales infrastructure, which we've reassessed following the Budget and the drop in individual retirement annuity sales. There was also a provision of £1m for restructuring costs associated with the cost management actions that we've announced, and also approximately £2m on Solvency II related costs.

Having repaid all of the Group's debt following the IPO last year, the interest expense was nil for the first half of the year, and that gets you to the IFRS profit before tax of £15m.

Looking forward, as we flagged at the time of the June cost management announcement, we do expect to incur non-recurring costs of approximately £5m over the balance of this year and next year on new initiatives and product development. There is a possibility of further restructuring costs in the second half of the year. And Solvency II costs will remain with us in the run up to the implementation date at the end of next year.

Moving to the balance sheet. Partnership's capital position remains robust. We manage the business on an economic capital basis. And after the payment of the final dividend of £12m the economical capital surplus remained broadly unchanged from the year-end position at £170m. And that represents the capital coverage ratio of 153%.

Within that required capital increased by £28m primarily to the new business written in the period, and available capital has been primarily driven by the margins on that new business, together with return on surplus assets and positive capital management actions taken during the period.

We will continue to maintain our pricing discipline, but given the lower new business premiums following the Budget the cost base is currently spread across fewer sales and so that will have an impact on the capital coverage ratio in the short term until the cost management actions start to flow through.

On the right-hand side you can see that the balance sheet remains robust to the key stress scenarios that the balance sheet is exposed to, namely credit spreads, longevity and property risk. In all cases, after some pretty extreme shocks, the capital coverage ratio stands above the Board's stated target minimum of 125% under normal market conditions.

Finally the IGD position is included for completeness, but at coverage ratio of 227% it is not the biting capital requirement for the Group and we do not manage the business on an IGD basis.

Looking at the asset portfolio, our investment strategy remains unchanged. We aim to closely match our asset and liability cash flows, aiming to enhance risk-adjusted returns in a capital efficient manner. Since the start of the year the asset portfolio has grown by approximately 9% to £4.4bn, primarily due to new business premiums. And the allocation across different asset classes has remained broadly unchanged.

We continue to look for ways to optimise risk-adjusted returns through exploring new asset classes. As an example of that we have recently signed an agreement with Rothschild to invest in commercial mortgages, to take advantage of the illiquid nature of our annuity liabilities.

The next slide on MCEV shows how the MCEV has developed from the start of the period to the end of the period. As I mentioned earlier, it is up 6p to 136p per share; that is driven by a new business profit of £18m and positive other operating variances of a similar amount in the first half. The latter includes £7m of after-tax expected return on surplus assets and £10m following refinements of our methodology for calculating frictional cost of capital. These positive contributions were broadly offset by the post-tax impact of the non-recurring expenses, which were approximately £8m, and the payment of the final dividend of £12m, which is shown here as a closing adjustment.

So in summary from me, sales of individual annuities are down and future uncertainty remains following the disruption to the market from the Budget. However we will continue to maintain our pricing discipline and the market disruption will not deflect us from that course. The growth in the DB pipeline is encouraging, but as we flagged, sales are lumpy and we will only write the new business on economically attractive terms to us. We have taken decisive action to manage our costs base and our capital position remains robust.

With that I will hand back to Steve for some final comments.

Steve Groves

Thank you, David. I guess all I wanted to say was that in conclusion we have seen significant disruption in the core retirement market. We have a targeted strategy, and we are very focused on leveraging our intellectual property and indeed other core competencies, which over time I am confident will deliver a stronger, more diversified and growing business.

I'd actually now like to move on to the Q&A session. Would you please wait for the mic to be brought to you, and state your name and institution before you ask your question? Thank you.

Question 1

Andrew Sinclair, Bank of America Merrill Lynch

Firstly, of the DB de-risking deals in your key segment you say that about 3% were medically underwritten. What proportion of those that weren't do you you'd have got a significant uplift if they had been medically underwritten?

Secondly, I just wondered if you could talk a bit about the guidance process. The guidance is going to be impartial; but I expect that most vesting pension providers will be contacting their customers before and after the guidance. When it comes down to it do you think we will see more people shopping around than we have done historically?

Thirdly, clearly there is still upfront uncertainty on volumes and margins. I just wanted to see how flexible is your cost base; and is it now the right size for your best estimate expectations?

Steve Groves

Thanks Andy. I'll take the first one on guidance and then pass the questions on DB and the volumes and margin to David.

I think it's unclear the extent to which guidance will drive an increase in shopping around. We saw two or three key things that were needed for it to happen. The first is that it would need to be an independent provider; we felt that if it was provided by the existing providers that wouldn't help. The second one is how strong the actual guidance is in terms of what it says. And I think the final one which will determine the extent to which the existing provider's ability to communicate with the customers and sell product into them will be determined by the actions actually the FCA takes and how the FCA monitors whether customer outcomes are being put at the heart of what's happening, or whether inertia is being used to enable existing providers to sell products to customers because they haven't shopped around or followed the guidance process.

So, what we've said is we think guidance creates the potential for more customers to shop around. We think it should lead to more customers shopping around. The extent to which it does I think there are too many open questions until we have a clearer view on the guidance and the regulatory environment.

David Richardson

On your first question on DB deals and our target segment, how many of them may benefit from a medically underwritten approach, it's early days so it is very difficult to be precise on that. However if you look at our experience in the individual annuity market we actually see that more than 50% of people shopping around benefit from enhanced annuities. Now, obviously that evens out a bit within a pension scheme but the smaller the pension scheme the higher the proportion of people are going to benefit from that more granular and detailed underwriting approach. The 3% you saw last year is not a reflection of the proportion who might benefit from that but just simply it was really the first year in this nascent market, and awareness and penetration was at its very early stages.

On the cost base ultimately our cost base is flexible to just about any plausible level of new business premiums. It takes time to get there. What we've done at the moment is we've taken a view on where we expect the individual annuity market to settle at or range in 2015. We then looked at the markets which we expect not to be impacted by the Budget, so Care and DB. And then we've also looked at what particularly specialist technical expertise and skills are needed in the business to support a developer of the new initiatives. We add all that up together and that is the cost base we've aimed for in 2015, the approximately £80m that we've communicated.

However if we deviate from that course, if our view of the market is going to deviate from those assumptions, we have the ability to flex the cost base further.

<u>Question 2</u>

Jon Hocking, Morgan Stanley

Earlier on in the year you were talking a lot about online distribution and your efforts to get involved there. Do you think the viability of any those businesses is being threatened post-Budget? So, does your original distribution strategy potentially need to change there?

Second question on the DB side: you mentioned partnering in the past, and I think on the slide you had a comment about looking to deploy the IP. Is it possible that you actually medically underwrite a sleeve of some of the bigger DB schemes that we're doing? How does that dovetail with some of those providers' own efforts to develop medically underwritten annuities? Did they get to the point pre-Budget where they could do it or not?

And then finally some of the new products that you might develop post-Budget, some of the flexible drawdown products etc. do you think your current distribution footprint is optimised for some of the channels that might emerge for those new products?

Steve Groves

I'll take the questions on online distribution and new products and then pass to David for DB and top slicing.

Taking the first question on online distribution I think there are potential regulatory changes coming for some distribution. I don't think for most of it affects its viability. So, if you look at the large online distributors they have advised and non-advised arms. In essence I think what may happen is if the non-advised area gets targeted they will be able to provide the same service as an advised service; they simply provide it as a non-advised service currently. They could be big beneficiaries of the pressure that the FCA is under to allow the development of guidance processes; and there's somewhere between the two as well. I think if you'd asked many of those businesses what they wanted at the time of the RDR – you don't need to ask them – they wrote about it, they commented on it – what they wanted was somewhere between advised and non-advised which allowed them to guide people to the right outcome but with a limited scope of that guidance and advice process.

So, it's hard to tell the effect that it will have on them until we see where the regulations settle. But overall I wouldn't say I'm seeing anything that makes me think they won't be viable. I think they might have to change their operating model on it; it could be positive or negative.

In terms of new products, we said before we see the world today as a bit polarised, with drawdowns, which is a savings contract, and annuities which are an insurance contract. We think the new rules will allow flexibility to develop a whole load of stuff in between those two polarised ends. And ultimately I think I come back to we have a fundamental competitive advantage for a certain group of customers, which is our intellectual property. Those customers still exist. Their need to de-cumulate their funds over an uncertain future period is unchanged. Therefore I think there is a huge spectrum of potential attractive products that we can deliver that will better meet their needs.

The challenge we have in the short term is until the rules as to what we're allowed to do become clearer we can't firm up on the propositions we want to launch. So, we've done quite a lot of the thought piece around what are the boundaries, how might it look, how might you develop it, what is likely to be important to customers but we can't firm up any further than that until the rules are more advanced.

David Richardson

On DB there are a few facets to your question there. First of all, yes we do have a proposition for larger schemes as well but we call it top slicing. So, this could be a £1bn plus deal. What we do is have a conversation with the trustees and effectively pick a layer of management that they want to get a buy-out quote on. That might be a much smaller proportion of the total; it might be a £50m, £100m deal, but it's targeted on a much smaller pool of individuals with large pensions. Again, if you adopt that approach you can see that medically underwritten approach can give a much more attractive price to certain schemes.

More generally what we're seeing is medically underwritten approach to DB risking is rapidly establishing itself in the market. Steve mentioned that the current pipeline is being sourced by 12 different employee benefit consultants last year that was probably two or three. That has attracted interest in the area beyond the likes of ourselves and JR. But frankly we welcome that because trustees do need a bit of competitive tension to be comfortable to actually execute. And frankly the scale of the opportunity is such that we're not afraid of that competition.

Finally, there was always going to be a good number of schemes where our intellectual property does give us that competitive edge; just like it does in the individual annuity market.

Question 3

Oliver Steel, Deutsche Bank

I wonder if you could just give us a little bit more clarity on the DB pipeline, up 50% but where there's no base figure it's not a very useful indicator. So, perhaps you could put it in the context of the 30 something million that you did in the second quarter

Secondly, the US – I appreciate you don't want to talk about it – but can you fund that organically? That's the main question at the moment.

Thirdly, I'm struggling to work out how you can get back to anywhere close to your original new business margin. You are targeting £80m of costs going forward. You've said that the vast majority of those are new business related. That £80m is only fractionally less than the run-rate in the first half of 2013. So, by implication, to get back to the old margining you're targeting sales in 2015 that are roughly level with twice first-half 2013 levels. That doesn't sound likely at the moment, so I wonder if you can just square that circle.

Steve Groves

Okay I'll take the question on the US and pass the DB pipeline and the new business margin across to David. So it's very hard to say what the funding requirements for the US business will be at the moment. I said in the slide that the first phase was is there an opportunity and does it technically work? The answer is yes. The phase we are in at the moment is looking at how do you go about monetising that opportunity and there is a whole range of models open to us. So if you think at one extreme you could have the capitalisation of an entity to write business in that market, at the other extreme, and just for the purpose of illustrating the range you could have a simple agreement where you licence the IP to an incumbent player. So there are solutions where I think you could say categorically you could do it without the need for external capital, there are solutions where you could say actually if we went that way then you might need to raise external capital: what we're doing at the moment is working through the balance of risk and return for shareholders as to which is the optimal one to choose.

David Richardson

On the DB pipeline we're not giving specific guidance on the size of it at this stage because as we've been at pains to emphasise it is going to be lumpy, it's a nascent market and so you've got to be very careful about extrapolating from that into new business sales.

However, what I can say is we are talking about meaningful volumes of transactions. Steve's outlined that the total target market here for us of £180bn is vast. And it's a real long-term story here which is why we're not going to chase volume in the short-term. That £180bn, a large proportion of that will de-risk over the next 20 to 30 years, that's the whole direction of travel in the DB space. And so actually the most important thing for us is to develop and establish medically underwritten DB as the norm in that target market and that people consider it as a matter of default and then the volumes will flow in time in a much reliable and predictable way.

On your question on new business margin we've not given specific guidance on when we expect margins to get back up towards the levels they were in 2013, I think that's a really difficult thing to call at the moment but what we see, and I wouldn't lose sight of the fact, is there's still a long-term flow of increasing DC money that's going to be coming to at retirement in the next couple of years. There is actually some deferral that we're seeing in the run-up to the new rules which, at some stage, will annuitise, it won't all be on the 6th April but over time that will start to drift through and we've got our cost base level which will support and deliver good margins as that volume starts to come back online.

<u>Question 4</u>

Fahad Changazi, Nomura International plc

Could i just follow up on the margin question you did say that it's a very, very flexible cost base so what you're saying is you're going to get to a level in 2015 and you will see increasing sales but the cost base will not grow that much from that level and then the margin will expand or will grow less versus the new business sales?

David Richardson

That's essentially the model that we're setting up. There is a certain element of directly volume-related expenses which as the volumes come back will start to tick up but the heart of the cost base and Steve's mentioned in particular protecting our technical core, the technical expertise we have in the business, that is something which is not volume-related, strictly speaking, and that would not drift up as the volumes come back online.

<u>Question 5</u>

Barry Cornes, Panmure Gordon Co. Ltd

A couple of questions. First of all in terms of the products you look further forward, I just wonder what sort of timescale you've got in terms of giving clarity or you think you might have some clarity and what will those new products look like? Will they all be very similar? I think everyone seems to be burrowing away I just wonder if they were going to pop up looking exactly the same?

And the second question I had was in terms of the timelines on new products coming out and new rules being clarified and demand picking up, I think Steve you mentioned that there's some sort of time lag is there not a question of pent up demand simply wanting to get the new products rather than there being a time lag where people feel comfortable and start buying again?

Steve Groves

Okay I guess if I start with the second question which is probably the easy one, the time lag I referred to is what we've seen in the past is you get people deferring awaiting clarity and probably the best example to look at of this was the A-Day changes in 2005/2006, so we saw lots of people defer making any decision on retirement until the rules were actually implemented. When the rules were implemented there was then a period, so it wasn't like everybody who had deferred came through on day one, what we saw was a period over probably three to four months where the people who had deferred came to markets and made decisions about what they were going to do. So when we talk about a time lag we're not necessarily saying that people won't start to come back once the rules are clear in April we're simply saying you can't assume that everybody will come back in April.

I suspect, and again it's anecdotal based on research we've done, that what we're seeing is that the number of people who are deferring making a decision by deferring retiring because we don't have normal retirement ages, and I suspect they will make the decision at the point they now retire which may be April, it may be June, it may be September, so that's the point we're making there.

In terms of new products I can see a range of products emerging, whether they all look similar I can't really help you with because I don't know what everybody else is working on, but I think if you look at the fundamental needs I think there will be a flexible contract somewhere between drawdown and annuities that will emerge which will allow customers to take investment risk, to remain some control of the funds for their estate should they die, but to remove some of the longevity risk. And then I think there will be a fertile area of development which will look at transferring the tail longevity risk for customers who want to stay in more invested solutions such as buy-to-let etc. So in terms of broad categories they're the two that are obviously most attractive to us given our IP bent but I think it's hard to say what others are working on.

Question 6

Andrew Crean, Autonomous

Three questions. In your 'risks and uncertainties' section you say the group reduced the level of longevity risk, it transfers to reinsurers during the first half of 2014, could you explain a bit more about that? Was it material and was it at your behest or the reinsurer's behest?

Secondly on the dividend policy you had indicated historically that it was a one thirds/two thirds policy is that policy still in place?

And thirdly your economic capital how does that stack up against the PRA's views for ICA plus ICG buffers or from a Solvency II standard model position?

Steve Groves

I'll take the first question on dividend and then pass to David for the other two. I don't think it's fair to say the one thirds/two thirds split necessarily remains. So what we've said in announcing the interim is that we will review the dividend again at the full year. I think given the levels of uncertainty in the market we're operating in, and given the decisions we have to make around particularly the US opportunity, we're keen to maximise our flexibility through this period.

David Richardson

On your two questions Andrew, first of all on longevity risk transfer we have increased our retention on certain lines of business, it's not significant increase in retention, we still on balance probably cede over 50% of our longevity risk and it was a decision that we made based on economic analysis rather than any other factor.

On economic capital as we explained when we first laid out the economic capital framework it is very close to, but not identical to, but very close to our ICA, so one in 200 year risk-based approach to capital. We can't, and I don't believe any company can comment on ICG or private discussions that they have about the regulator so I'm afraid I've just got to give you the same stock answer on that.

But in terms of Solvency II and standard formula the initial work, and in its early stages, but the initial work we've shown is that on a standard formula basis that would be actually favourable relative to our economic capital basis.

<u>Question 7</u>

Oliver Steel, Deutsche Bank

I've one more question, the opportunity that you've cited which struck me the most was the DB transfers, I was wondering what progress or what interest has been shown in that so far and any timescale for seeing some material sales pick-up on the back of that?

Steve Groves

Yeah I think it's in essence too early so at the moment I think the government is effectively setting out its proposals for what that will look like.

There has always been, we've believed, an opportunity for customers with medical conditions in DB schemes to transfer out and buy non-standard annuities, however the vast majority of customers with medical conditions in DB schemes just defaulted into taking the pension and never even thought about it. So the fact that they now have the flexibility and what the government has said in its proposals is that anyone who wants to transfer out of DB into DC will need to take advice, which again I think plays relatively well for our proposition, means that there is the potential for a decent opportunity to emerge. Again the difficulty is it's so early in the process at the moment that I think what we're flagging is there's the potential for that to be quite attractive but we need to work through the consultations and get the finalised guidance and rules around what they can and can't do and what it looks like to quantify it.

<u>Question 8</u>

Jon Hocking, Morgan Stanley

Just on Solvency II are you going to go down the standard formula route or are you going to do an internal model?

Then secondly just on Oliver's point about transferring out of DB I may have misunderstood this but I thought the government were effectively just reiterating an historic right that it was always there, so I didn't think anything has actually changed apart from potential awareness of it, am I wrong on that?

David Richardson

So Solvency II Jon, as I said it's still relatively early days but we're leaving both options open at the moment. If we were to go down an internal model approach it would be a partial internal model, we're not going to enter into an over-engineered process for what's a relatively straightforward business so there's a bit of a cost/benefit analysis to do there and that will come into sharper focus as the rules settle down, and it's not just the rules but the interpretation of the rules by the regulator, settles down. However we've got both options available to us at this stage.

Steve Groves

And then on the DB space I think you're absolutely correct Jon I think people could transfer out of DB to DC before the issue is that they never thought about it and I think what's happened is you now have widespread publicity about the flexibility they might be able to get if they did and I think it's likely to cause people to think about it.

Question 9

Andrew Crean, Autonomous

Given the fact that our regulator is concerned by longevity re: insurance and credit risk is it really plausible for you to decide to go down a standard formula route when the PRA encourage you to go down an internal model route?

David Richardson

So our preference would certainly be to go down an internal model route because on longevity risk we clearly feel we've got unique insight into that and feel like a standard formula doesn't capture those risks very well.

So I think we and the regulator are aligned there but as I said it depends how onerous the process is that travels with that.

Question 10

Blair Stewart, Bank of America Merrill Lynch

Just one follow up on the new product opportunities Steve you talked about flexible contract between drawdown and annuities clearly you're an expert on annuities but on the drawdown side do you feel you've got sufficient or can you develop sufficient propositions there or would you partner with someone else who can perhaps provide a platform service and you come in with the annuity as and when or is it something you can do yourself?

Steve Groves

I think it depends on where the final product design settles so we do have expertise on drawdown and it's a little known fact that the enhanced choice annuity we launched shortly following the Budget is actually a drawdown contract so we have the expertise within house, we have lots of people who have worked on drawdown contracts and have developed drawdown contracts in house. I think whether we ended up doing a product solely or in conjunction with someone else would depend on exactly what the shape of the product was and where that trade-off was between speed to market and the need or the reduced investment we would have to make to provide the product versus the share of the economic pie.

Closing Comment: Steve Groves

No more questions so I think that wraps us up for today. Thank you very much everybody.