



Q1 Interim Management Statement Wednesday 14 May 2014

Steve Groves, Chief Executive Officer

Good morning everybody and thank you for attending Partnership's Q1 Interim Management Statement call. I'm Steve Groves, Chief Exec of Partnership, and I'm joined here today by David Richardson, our CFO, Katherine Jones, our Director of IR. We'll be happy to answer your questions in a few minutes, but first I'd like to take you through the highlights of our first quarter announcement which we released this morning.

It goes without saying that since I last formally presented to the market at our 2013 Full Year Results, there have been significant developments within the annuity landscape. Whilst it's not been compulsory for people to annuitise their pension savings since 2011, the unprecedented scale of change announced in the Budget means it's not yet possible for us, nor other market commentators, to assess the likely impact with any degree of accuracy. Our view is that it is still too early to predict the eventual outcome. But this morning I'd like to take you through our Q1 numbers and then comment on what we've seen since the Budget, and how we see Partnership's positioned to respond to the evolving At Retirement market.

So starting with Quarter 1 sales, which of course primarily relate to the period before the Budget environment. We generated total new business sales of £254m in Q1, of which £200m related to sales of individual annuities. This is in line with our previous guidance that Q1 2014 sales were likely to be below those generated in Q4 2013, reflecting the impact on the distribution market of the implementation of RDR.

We also generated £34m of Defined Benefit bulk annuity sales, compared with £2m in the first quarter of last year. This is evidence of the development of our market-leading capability in the underwritten DB space, which we believe has the potential to be a significant market for us. Sales of Care annuities and Protection were £20m and £1m respectively.

And now turning to look at what we've seen in terms of individual annuities since the Budget. I think the first point to make is that since the Budget we have continued to see meaningful activity levels. The market has not stopped and quotations continue to be made, albeit at reduced levels. The guaranteed income provided by an annuity was valued by customers prior to the Budget and it continues to be attractive for many customers. This is borne out by the fact that of the cases in the pipeline at the time of the Budget, after further discussion with their adviser, over 70% of individuals have so far decided to continue with their Partnership annuity purchase. Although we saw an increase in cancellations in the weeks following the Budget, the level of cancellations has now returned to its previous negligible level.

The most relevant indicator of potential future sales is our quote volume data, and in the eight weeks since the Budget we have seen average daily individual annuity quote levels at around 50% of the level seen in the month prior to the Budget, although it is clearly still early days. We continue to focus on pricing discipline and have taken immediate action to manage the cost base by freezing recruitment, removing contractors, and requiring CFO approval for all capital spend. But given the lower levels of sales, as you would expect, our new business sales are currently making a smaller contribution to overheads, which will reduce the new business margin while the market disruption remains.

And now moving on to look ahead. We're a mere eight weeks into the post-Budget world and it will be some time before there is clarity around the guidance process and the new regulations. It is therefore too early to assess the eventual impact on Partnership. For example, at this stage it is unclear how the prospect of many more people shopping around following the introduction of free financial guidance at the point of retirement, will offset the impact of a lower proportion of the overall market choosing to annuitise.

Partnership's commitment to doing the best for its customers and meeting their retirement income needs has not altered, nor has our customer's need to manage their retirement assets through a highly uncertain future lifetime. The increased flexibility provided by the Budget is allowing us to develop products which were not possible previously. For example, on Monday we launched the new Partnership Enhanced Choice Annuity, our first new product since the Budget, which provides consumers with a guaranteed income for life and immediate access to their tax-free lump sum. But also offers them the choice of either continuing to benefit from that security, or of cashing in their annuity should they have a better option available to them in 12 months' time. This is a genuinely new and pioneering product designed with the customer in mind which we have developed and launched within the space of eight weeks, clearly demonstrate the innovation expertise and agility of this business.

Furthermore, the other areas of the business continued irrespective of the Budget changes. Sales of Care annuities and Protection have been unaffected. We continue to explore the opportunities for developing our growing Defined Benefit proposition, which has a promising pipeline. Although the timing and size of future transactions is uncertain, our market leading experience and track record in medical underwriting, together with our relationships with employee benefit consultants, means we are well positioned to bring the benefits of medical underwriting to this potentially material but nascent market. As you would expect, we are keeping a close eye on the Group's cost base and reviewing this as part of our overall planning process. The cost base is flexible and can be adjusted to support the ongoing levels of new business sales as well as the new product developments and initiatives that we have planned.

It is still early days in the post-Budget world, but I am encouraged by the recognition by customers and advisers that our annuities, which typically pay an annuity rate of between 6% and 7%, continue to represent an attractive retirement option. This, together with our promising pipeline of medically underwritten Defined Benefit transactions, and our ability to utilise our unique intellectual property to develop new products to meet evolving customer preferences as they plan for a highly uncertain future lifetime, allow me to be confident that

Partnership is well positioned to face the challenges ahead and capitalise on the opportunities presented by this changing market.

Thank you for your attention ladies and gentlemen, I'd now like to move onto the question and answer session.

Question 1

Andrew Sinclair, Bank of America Merrill Lynch

Good morning everyone and thank you very much. Firstly, a question on expenses. Could you tell us a bit more about how you can control these going forwards and the likely impact on margins this year and beyond?

Secondly, on the new product could you tell us a bit more about how you protect Partnership against customers selecting against you?

And thirdly, if you could just tell a bit more about your thoughts on the new guidance process at this stage and how you think that will bring more customers to the open market?

David Richardson, Chief Financial Officer

So Andy just to touch on the immediate action we took on expenses, as Steve mentioned as soon as the Budget was announced we immediately took steps to be extremely watchful on expenses. We put in place a recruitment freeze, we removed contractors where possible, and we increased controls on all discretionary expenditure, including capital spend. But looking forward, which I think is more where your question's driving at, we do have a flexible cost base which can be adjusted to reflect new business sales activity, and what we've already done is identified the expense base required to support whatever level the sales of individual annuities settle at, together with our other activities which we expect not to be impacted by the Budget, so for example Defined Benefit of Care and Protection.

However, on top of that we need to bear in mind the new flexibility that was announced in the Budget will allow us to develop products which were just not possible previously, and will also call for us to accelerate product development activity which we already had in mind. So there was a number of new product ideas we've identified, and what we're doing at the moment is we're in a process of prioritising those and working out what the resource requirements are for each.

So putting those two things together, once we know where or have at least a clear idea of where the individual annuity market's going to settle, and the requirements of the new product opportunities that we've identified and wish to focus on, we may well find that our cost base does need to be adjusted and we won't hesitate in taking action to do that. But at this stage what we've done is the preparatory work to identify what it is we may need to do. And we just do need to reflect that cost management, particularly in a business like this, is a critical business judgement, it's a business that's based on its IT and its people, and what we're not going to do is take any short term actions which could damage the business and

its ability to take advantage of the new opportunities which are opened up by the Budget flexibility.

Andrew Sinclair

Sorry, just on margins then do you think it's possible to control the cost base to a level to get back to similar margins that we've seen in the past for the longer term?

David Richardson

Yeah, absolutely over the longer term. As we flagged in the IMS, in the short-term in 2014 we would certainly expect there will be compression of our new business margin relative to the 7% that we saw last year. But at this stage there's no reason to suspect that we can't get back up towards those levels over the medium term once we've got a clearer picture on where the annuity market's going to settle and which new initiatives we wish to follow.

Steve Groves

I guess the second question was around selection in the new product, which again it's probably appropriate for David to cover.

David Richardson

In simple terms there's two forms of selection that can take place here. In the course of one year, those whose health deteriorates are more likely to avail of the surrender option and cash in after 12 months. Whilst those who are I guess healthier and maybe their medical condition does not develop as anticipated, may be more likely to persist with the annuity that they have locked into at inception. And we factor both of those into our pricing of the new contract. We've looked at it by condition and by severity and adjusted our assumed mortality rates accordingly, and that's factored into the annuity rate that we offer and the surrender terms.

Steve Groves

And moving onto the guidance process, it's probably one for me to comment on. We are very actively engaged in the discussions around the guidance process with all stakeholders. We have a very clear view of what we think good will look like on that process both in terms of who should be delivering it, what should they be delivering, and why do we think that's the right outcome for consumers. So our position on the guidance process is exactly what you would expect for Partnership given our history, which is we will work out what guidance process delivers the best outcome for consumers, then we will organise our product to deliver, or our company to deliver the right products to meet the needs of those customers having been given good high quality independent guidance. So our start point is we want customers to receive really strong independent guidance, and that's what we're pushing for.

Question 2

Greig Paterson, KBW

In terms of the new product, could you just give us an idea of the surrender levels that you have factored in, sort of what percentage you think will leave after 12 months? And how you calculate the surrender value, have you got flexibility or is it a guaranteed surrender value?

In terms of the FCA investigation and the potential for your other single tie/limited tie marketing agreements etc. to fall foul of if the IFAs get exemption on this free guidance, so in the new world what's the probability of these deals being unwound or modified because of this free guidance theme?

Then third is cancellations. I wonder if you can give us the sterling amount of the cancellations since the Budget so we can net it off deductibles the other two statistics you gave in terms of the second quarter?

Steve Groves

I'll let David kick off with the first questions around surrender values.

David Richardson

Our approach to setting surrender values, Greig, is we do want to make sure that this is a reasonable proposition to our customers, so we're setting the surrender levels such that they reflect the risk of anti-selection – so the question that Andy just asked – but no more than that, we're not trying to lock in additional profits above and beyond that. And the surrender levels vary by condition, vary by severity, vary by number of variables, so I can't be terribly specific on what level they're going to be at, but they are guaranteed upfront so that the customer knows exactly what they're getting when they buy the product.

Greig Paterson

Well I mean so actually you're saying that you've got a guaranteed surrender value and is it sort of 5%, 10%, 50%? It would just help us with our modelling when we're looking at how the reserves are progressing forward.

David Richardson

So it is guaranteed, I'm not going to be more specific in terms of the level, other than it's going to be good value, so you're not going to be talking about 15% or anything like that, but it's going to reflect the risk of anti-selection.

Steve Groves

I guess moving on to the second part of the question around the single tie...

Greig Paterson

And also multi tie deals, I mean if the IFAs get exemption from the free guidance?

Steve Groves

I mean there was a first point in terms of assumption that there was a connection to the FCA investigation, it's probably worth saying that investigation continues, we remain of the view that our position is robust and our advice remains strong.

In terms of the guidance process, I don't see the guidance process as it's currently structured having any material impact on the distribution agreements we have, so the vast majority of our distribution agreements effectively give us a right to promote to advisers but within a multi tied or whole of market world and fundamentally what we'll be deciding going forward, we'll be thinking about the extent to which we want to spend money promoting. Clearly if advisers are selling fewer annuities then the amount of marketing spend we're likely to spend with them may be lower, but in essence the advantages of having the most effective route to market to those IFAs to the customers selling annuities remains.

So from my point of view I don't see a knock on to the distribution agreement, indeed if we want to go into a world where we are launching new and different products having preferential ability to market, promote and explain products efficiently to distributors is actually a big advantage.

Greig Paterson

Can I just, sorry, interrupt you one second there? If for instance under the new guidance the IFAs get an exemption and then when they are providing the free guidance they have to show independence and the FCA's sort of view is that if they're showing independence and 50% of the enhanced stuff goes off to Partnership that's not independence. I mean the FCA made some utterances around that. I mean that's the risk I'm interested in.

Steve Groves

Yes, I mean I think you have to understand at the moment all of those distribution agreements where the distribution is anything other than a single tie has to show independence today, so those agreements give us the right to promote and market efficiently to the customer, but they don't allow us to win the business if we're not the best rate for that customer. So the value of those distribution agreements is that they're a much lower cost way of delivering our sales and marketing messages, they don't give us an advantage on rate, and we certainly don't win business we shouldn't win as a result of those.

Greig Paterson

Right, so what percentage is single tie of your sales in the first quarter? Individual sales.

Steve Groves

Small, I couldn't give you a number off the cuff but it's a small proportion of our sales.

Greig Paterson

Well, less than 10%?

Steve Groves

Yes, comfortably less than 10%. I guess the third part of your question was on cancellations.

David Richardson

Yes cancellations, they've been relatively small, Greig, so for example in the first quarter post-Budget we saw about £1m of cancellations processed, slightly more than that in the month of April but not material numbers. What's had more of an effect is that some people who had decided they were going to buy an annuity didn't complete their purchase.

Greig Paterson

But that's captured in the 70% stat, yes?

David Richardson

Exactly.

Greig Paterson

Perfect, thank you.

Question 3

Jon Hocking – Morgan Stanley

Morning everybody. I've got three questions please. I realise it's early days but I wonder whether you could comment on what impact you expect to see on gross margin in the annuity market? You've obviously mentioned the new business margin including expense allocation, but pre expense allocation how do you expect that to track this year?

Secondly, what do you think is going to happen in terms of appetite for annuities, standard versus non-standard, because I guess you're highlighting the sort of 6% to 7% you're paying your customers versus, I guess, a much lower rate on the standard annuity?

And then finally I guess you've been doing a lot of product development for the UK business, but where are your thoughts on international at the moment? Thank you.

David Richardson

Yes, just saying to your question, Jon, it's still early days so we've got to be a little bit careful about not making sweeping statements, but what I can say is that so far we've not seen any change in gross margins or any discernible change in gross margins since the Budget was announced. I think you can look at and argue it either way but the evidence so far is not pointing to any systematic change.

Steve Groves

Moving on to the appetite, standard versus non-standard, I mean I said at the time of the Budget and I think the evidence we're seeing supports that my view is that appetites for non-standard will hold up better than the appetite for standard. I believe that for several reasons, one is exactly the point that you've highlighted, Jon, which is I think the higher rates of income are more attractive to customers.

The second is I think people focus on the fact that these individuals have reduced life expectancy, they do have reduced life expectancy, but they also have much greater volatility around the outcomes and therefore advising them on what to do if they don't annuitise is very, very complex. I think it's telling that the independent consultant who was very much

behind a lot of the thinking on removing these rules, Ros Altmann, is very clearly saying to the market that she believes that people with medical conditions should be buying annuities and that's the best option for them.

We've looked at a number of cases from our pipeline and you end up when you look at these cases with a huge spectrum of potential outcomes for each of the individuals that are pretty much impossible to manage using a pure investment technique. So my belief has always been that that part of the market will hold up better. I think it's eminently possible that we will have to communicate much more clearly with customers the uncertainty of the outcome because I think there's at times an unhealthy obsession with life expectancy and life expectancy is one factor you need to take into account in that planning. You also need to understand the range of outcomes around life expectancy, but my belief is that non-standard will hold up significantly better than standard.

Moving on then to international, we said at the time of the last update that we were continuing our work on international, we've continued to progress out there so we have a team working out in the US under Mark Dearsley and they are focused very much on the opportunity in the US, we continue to make good progress. I don't think we're at a point where we can give a fuller update than that, but right now the progress is good and it's confirming our original research.

Question 4

Barrie Cornes, Panmure Gordon Co Ltd

Morning everybody. A couple of questions if I may. First of all your view on new types of products post April 2015 and the product you've launched recently, I just wondered where the demand came from, was it something that you felt the market wanted or was it driven by clients and IFAs?

The second question, a similar question really in terms of the shape of distribution going forward post April 2015, what your view will be on how it's going to look.

Steve Groves

Okay, picking up first on new products, our thinking on this is developing over time as you would imagine, but essentially I'm seeing new products developing from the two ends that we currently have, so you currently have an annuity market and a drawdown market. I think the developments in the more annuity side of the market will be to significantly increase customer flexibility and I think our new product is the first step along that journey, but I think there will be a focus on delivering a balance of the benefits that annuities bring, and particularly the pooling of risk and the sharing of longevity risk with some of the perceived downsides such as the loss of fund on death or the investment in the fixed interest element at an early stage.

So at that side of the market I think what you should do is almost start with the new annuity, look at the things that customers value which is the security and the longevity insurance and expect the things that they find a disincentive to purchase, such as the potential loss of fund and the investment in what they would perceive as lower yielding fixed interest as potentially being things up for grabs as the product starts to develop.

At the other end of the market, and if you start with drawdown today, what you have in drawdown is you have a contract where the client takes all of the investment risk, the client

keeps their fund when they die and the client takes all of their longevity risk. I don't think very many clients go into drawdown because they specifically want to retain their longevity risk, in fact in 15 years plus of working in the annuity market I've never heard a client say that. So I think what you'll see at the drawdown end of the market is you will see contracts emerge that transfer the longevity risk whilst leaving the client with the potential to keep their fund when they die and control of the investment in exchange for which they'll be getting some of the volatility of the investment.

If you plot it out over a very long time as you make annuities more flexible and you build longevity insurance into drawdown it actually all meets up in the middle over a sort of five to ten year timeline, so my suspicion is in the medium term we'll see developments making annuities more flexible and building protection into drawdown, in the long term they'll actually all merge into one and really you'll only ask three questions which is: who takes the investment risk, how much of the fund do they keep when they die and who takes the longevity risk.

In terms of demand for the new product we did a lot of research on the new product, so we surveyed 2,000 customers post Budget and we have done quite a bit of research in the period prior to the Budget on potential options on annuities that would be attractive. The general feedback in the market we were targeting was there are a significant proportion of people out there who believe a guaranteed income for life is the right thing for them, their adviser believes a guaranteed income for life is right for them, but they are concerned that a new product or a new rule change will happen in the next 12 months as we run into the implementation of the Budget measures and that they'll have a regret risk because actually they'd rather have bought that new product or new development.

What we decided to do is to put them in a position where they could proceed with taking a guaranteed income for life but remove that regret risk, and the feedback both from customers and from advisers was very strongly positive on that concept.

And I guess the final component of your question is the shape of distribution and I would caveat my answer to that with the fact that in some ways it depends on how guidance is delivered and what it looks like, but if I started today my best guess on what guidance will look like is it will deliver a prescription but it won't dispense the medication, so I think people will go to independent guidance, they may well be told that the best option for them is probably to buy a non-standard annuity if they've got a health condition but I think if the guidance is delivered by an independent organisation that is not an IFA they're then going to have to find some way to get that prescription fulfilled if you like.

So I think this is likely to play further into the trend of web-based distribution and execution-only distribution where people have guidance that this is the product they should be buying but they're going to have to go and source that product. There is the potential for a sort of third regulatory category to emerge, so at the moment we have execution-only and we have full advice, I think a limited scope advice service might look quite appealing to the regulator once the guidance has been delivered where the adviser doesn't have to consider whether the client should go into drawdown or should go into an annuity because the guidance process has done that, but what they do have to do is say if you buy an annuity this is the type of annuity you should buy and here's the best rate I can get you. So as I look forward that's how I see the distribution landscape evolving.

Question 5

Andrew Crean, Autonomous

Good morning all, I have three questions. Firstly could you give us a bit more detail in monetary terms on how your expense is split and how much is variable and how much is third party and that sort of thing because at some point, and obviously you can't give clarity on the market yet, but it would be interesting to know when you think you will be able to see the market more clearly and be able to give signals on that.

Secondly, in the eight weeks since the Budget where quote volumes are down 50% could you give a sense as to whether they are down more in the severely impaired end relative to the sort of lifestyle end whether there's a tilt there?

And then thirdly, on the new business margins, at what level of margin can you go down to and the business still be self-funding, because obviously if the margin comes down there's a point at which your new business doesn't give you a self-funding proposition.

Steve Groves

Thanks, Andrew. I'll let David take all three of those, I think.

David Richardson

Starting with expenses, Andrew, the significant majority of our expenses are variable. For example, third-party expenses cover things like investment management and third-party administration of our business once it's on the books. So we do have a significant amount of flexibility and are confident that we can adjust the expense base to where the annuity market ultimately settles together with the new activities I described earlier.

Andrew Crean

Could you give some pounds, millions, around how much of your expenses is investment management, how much is distribution, all that sort of thing, and how much is variable?

David Richardson

I think not at this stage, but it is a significant majority. Some of it is directly variable, so for example, investment management and TPA fees literally move up and down with policies or assets under management. Others, new business related activity, requires action but is something which can be flexed. So there are areas of grey here but the bigger picture is that we can get our expense-base to where we need it to be over the medium term.

In terms of your second question on quote variance, we've not seen any evidence of that varying by severity across our conditions or level of severity within those conditions. Clearly there's some variability week to week, but it's been pretty much a uniform 50% fall across the board.

Your third question on new business margins and how far can they fall whilst we're still self-funding, we view it more the other way, which is, we can get the expenses to where they need to be so that the business remains self-funding. So the combination of our pricing discipline on the new business together with risk capital being released on the back book as it runs off can get us back to a position where we're self-funding.

In the short term we're not going to be there until we take any expense action if it is needed, once we finalise our analysis, but we view that as being the variable that gets us to where we need to be.

Steve Groves

If I just come in there actually Andrew, because I think it links to your first and your third question is it's probably important to remember that Partnership is a business that very recently has been the sort of size that would be implied by the current change in the annuity market. So it's not like we have hundreds of years of legacy and fixed costs that we've built up. And we have a management team who know what the business looked like and how it ran at that scale.

So we've been through the exercise. We've got a clear view of what would be needed as the market moves to various levels. But we're waiting for the market to settle down so that we make sure that in taking that action any action that we do take calibrates us to the market that we then find ourselves in.

Andrew Crean

Okay and part of that question was, when do you think you will have enough clarity to communicate with us and take action on your expenses?

David Richardson

I think eight weeks post-Budget it's probably too early to call that, but clearly it's something we're going to keep you very closely briefed on. At the very least you'll have an update at the time of the interims.

Question 6

Greig Paterson, KBW

Bulk pipeline. You were pretty explicit before. You had X amount, about a dozen of £20 million size and then 1 over 50, etc. I wonder if you can give us some more clarity on what the bulk pipeline looks like?

And the second thing, in terms of your product development, it was quite interesting your analogy there, but are you planning in the short to medium term to take any equity risk on your balance sheet? Are you writing against your minimum withdrawal benefit for a drawdown product and then having to hedge all the risks yourselves? Are you going to take any equity risk onto your balance sheet in the short term?

Steve Groves

I'll let David comment on the first one and I'll come in on the second.

David Richardson

In the DB space and, particularly the medically underwritten DB markets we have continued to see good development there, increase in traction and a pipeline continues to grow at a healthy rate. But as we've previously cautioned, the timing of transactions is difficult to predict in the DB buy-out and buy-in market at the best of times, but when you're talking about what is still a nascent market, the medically underwritten buy-out and buy-in, that difficulty is compounded.

So there's still uncertainty over the timing, but we're very encouraged by the pipeline. It is continuing to grow. And what we and others such as Just Retirement are doing is spending a lot of time trying to gradually move the market to a position where for small schemes medically underwritten buy-out and buy-in processes become the norm over time.

At the moment it's new. It's by exception, and what we're trying to do is to gradually shift that market so that it becomes the norm. Then what you'll see is an even bigger pipeline and a more predictable source in new business stream.

Greig Paterson

You haven't seen the likes of Legal & General or Aviva try and start underwriting SME schemes by medical conditions, have you?

David Richardson

We do see Aviva from time to time. They're one of the players in the market who are trying to develop a common process. But the most consistent competitor that we see in the market is Just Retirement.

Greig Paterson

So legals, because legals used to dominate the SME space and are you saying they're not offering this enhanced product?

David Richardson

We, at least to my knowledge, don't tend to see them on medically underwritten processes. Clearly they do traditional buy-outs and buy-ins on small schemes but not medically underwritten ones, at least to my knowledge.

Greig Paterson

This confirms my thinking. Are you going to write effectively a VA rider and take the equity hedge on to your...

Steve Groves

Your question really focused on the short to medium term, which is the context in which I can answer that, because I think how the market develops over the long term it's too early to say. In the short to medium term I think it is highly unlikely. So when I look at the history of these products and the value proposition to customers from these products, I think the regulatory capsule that is required to provide the products and the complexity of the hedging means that actually the real value proposition to customers is relatively modest.

So I think it's an unlikely route for Partnership to take and I would certainly see it as very unlikely in the short and medium term.

Greig Paterson

How are you going to enter the drawdown space? Others have said they're going to write deferred annuities. Are you thinking along those lines?

Steve Groves

We have some interesting product concepts for the drawdown space, some of which we've actually been working on for a little while. You'll have to forgive me if I say, given the rules aren't going to change until April of next year, I wouldn't want to flag to our competitors too far in advance the things we're working on.

Greig Paterson

No, that's fine. I'm just trying to get a mental picture. And then just as a final your cost actions, what does it mean in terms of the cost base next year versus this year, the ones you've done to date? Has the run rate reduced? Does it mean we're going to have flat costs or 5% down, 10%, 15%?

David Richardson

I think it's a bit too early to be that specific, Greig. Clearly what was embedded in the business coming into this year, and we flagged it at the time of the full-year results, is that there was still a significant degree of PLC costs which were not fully reflected in the run rate. We put a number of about £4 million per annum on that as well as underlying ambient expense inflation. So there was definitely a trend for upward expenses through 2014. I think it's too early to give you specific guidance on whether we're going to get it back to '13 levels or not at this stage.

Greig Paterson

Or is it going to go down? Or is it flat? What are you talking, flat, down?

David Richardson

Too early to say. I'm not saying it's capped at where it was in 2013 but it could be.

Steve Groves

Can I encourage you to think about this slightly differently? Because I'm guessing what you're thinking is about how you project this forward. Where David and I have come in is, as we've said, if you take a medium term view, i.e., there is a period where our cost base is likely to be misaligned to our sales and, as we work through the new product developments and see how the annuity market settles, we'll deal with that.

But from a medium term view what we're looking to do is get back to a point where we generate a decent new business margin and the business between the new business and the run-off of capital from the back book goes back to generating sufficient capital. So what expense assumption you should assume is actually very closely correlated to whatever you assume for sales, because expenses will be the thing that flexes to get us back to that position.

Greig Paterson

So what do you call a decent margin?

Steve Groves

I think we've given guidance that over time we see the business getting back towards the margins we were seeing previously.

Greig Paterson

Around 7%, all right thank you.

Question 7

Oliver Steel, Deutsche Bank

Good morning. Two questions. The first is, if we look at the 50% drop in the pipeline of individual sales by distribution, is there anything between distribution types that can help us try and work out whether that 50% gets better or worse over the course of the next six to 12 months?

The second thing, slightly going off the subject of individual annuities, but care annuities have picked up a bit over the last two quarters. Is that just noise or is there actually some sort of genuine improvement in demand there?

Steve Groves

Picking up on the first point and the drop, we haven't seen very clear patterns across distribution. I think there are some areas that appear to have held up slightly better. So as I look at some of the web-based specialists in particular, quote activity from them has probably held up slightly better than the more traditional IFAs.

I suspect that is because customers who were confused by the announcement of the Budget, many of them went on to Google. And when you go on to Google and search around annuities the people who come up are the web-based specialists. So the early indications are their lead activity has probably held up slightly better. But there isn't a very clear discernible trend, and that is something that is at the margins.

David Richardson

On care, I wouldn't read too much into one quarter's numbers, Oliver. We did see a slight improvement in care sales towards the second half of 2013 and into Q1. There were certainly some disruptions in the beginning of 2013 from the Dilnot paper, but I wouldn't read too much into one quarter's numbers at this stage.

Question 8

Jon Hocking, Morgan Stanley

Just one last question on lifetime mortgages, given you've got potentially less flow this year, what is your attitude going to be to originating mortgages?

David Richardson

Good question, Jon. We source equity release from two different channels, as it were. We write what we call flow business through the IFA market and we also look for bulk opportunities where we acquire books of business from other companies that have legacy books of equity release that they no longer want or work for them.

Where we are at the moment is, we're comfortable we can support the flow business as is, but we're going to be cautious about block transactions until we've got greater visibility on where the individual annuity market is, and also the development of the DB market, because DB has very long-tail cash flow that's well suited to equity release.

So we've got a couple of variables on the funding side, i.e. our liabilities, but where we are today is, we're comfortable with the flow volumes that are coming in.

Question 9

Gordon Aitken, RBC

Just a couple of questions, please. First on the bulk market. DB schemes are going to have healthy lives and non-healthy lives. Would you consider tying up with a major insurance company either on a specific DB scheme or have some form of a longer term agreement?

In terms of looking forwards, our view is that certainly people, ones who do buy annuities, would maybe buy them later in life. So what do you think, I mean what is the average age people are buying annuities pre-Budget and what do you think that will move to? Thank you.

David Richardson

I'll take the question on the DB bulk transactions. Our focus at the moment is on developing the medically underwritten market and as was described earlier, trying to move from a position where that is the exception to that is the norm for smaller schemes.

And you're absolutely right, there's going to be a mix of healthy and unhealthy lives in any given scheme, but the potential scale of opportunity is such that, certainly at this stage, we see plenty of opportunity to allow that and to consider tie-ups. Whether that's something we consider further down the road, or maybe consider in the context of larger schemes, where perhaps we take certain lines out of larger schemes is something that may evolve in this market over time. But in the first place, we're going to focus on developing that medically underwritten market.

Steve Groves

And the second question I'll take around the average age of annuity purchase, and I know it's a really interesting area. So I'd start by standing back and saying prior to the Budget what we were seeing was the average age of annuity purchase start to rise, and that reflected a wider social trend that followed the removal of the normal retirement age. So you saw more people working beyond what had previously been the normal retirement age of 65 and that was leading to a gentle drift upwards in the average age of annuity purchase.

Parking that effect, if you take it on to the specifics of what is the Budget likely to mean for people exercising greater choice on annuity purchase, I know this audience knows it, but in reality there are three components to an annuity payment: there's a return of capital, there's some interest, and there's a share of the funds of those who die, split among those who live. The proportion of the payment that is a share of funds of those who die implicit in an annuity rate sold to a healthy life in their early 60s is actually very low, and I think it is likely that the average age of annuity purchase for healthy lives will rise quite significantly. I think probably the intellectually logical place to do it is somewhere between 70 and 75, but that's a matter that will vary for every individual, depending on their risk appetites and their personal circumstances.

For non-standard annuities, and it's why people like Ros Altmann are so clear that non-standard annuities make sense for younger lives, effectively our average customer has a life expectancy which is already in line or below the life expectancy of somebody of age 70. So the mortality cross-subsidy they're getting within their annuity, even buying at our average age, which is around 62/63, is already very significant. So I would expect to see a fairly significant rise in the average age of annuity purchased for standard annuities, and I would expect to see a much smaller rise in the average age of annuity purchased for non-standard annuities.

Question 10

Alan Devlin, Barclays

Hello, thanks guys. I've got a question on DB to DC transfers, and I think a lot of commentators think DB to DC transfers, for the majority of people, don't make any sense, but actually for people in poor lives it could actually make a lot of sense. So I've got a couple of questions. One, where do you think the government will come out in this?

And two, how can you potentially target those people in DB schemes that will be much better off taking the transfer and buying an enhanced annuity from someone like yourself?

Steve Groves

Where do I think the government will come out? Let's start with some of the really clear things. I think they will prevent transfers out of unfunded state schemes, because they won't want to crystallise a balance sheet risk they're not carrying.

On private schemes, my best guess is they will probably allow transfers out from DB to DC; I know they're consulting on it. I think there will be some resistance from the pensions industry because it will lead to a decline in Funds under Management on DB. There will be some concerns from consumer champions, who will say that customers will be dazzled by the size of a large transfer value today and they will accept transfer values which are significantly lower than the economic benefit of the values foregone. But if you go back to the context of the Budget, this was the end of paternalism, and I think if you have that concept at the end of paternalism, you'll take a view that actually being then paternalistic for a group who have DB pensions, but not for those who have DC, is inconsistent. So my best guess is they will allow the transfers out.

I think you're absolutely right, and we've seen it in the past, we've seen people take DB transfers where they have medical conditions, and particularly the more impaired customers, buy impaired annuities and end up with significantly higher benefits than had they remained in the scheme, and potentially also have some better protections around what would happen if the scheme were to fail. So I do think there is a potential opportunity there.

In terms of how we go about targeting, I think we'll wait and see what the results of the consultation are, because I wouldn't want to put significant time and effort at this point into building that proposition if the government comes to a conclusion that I'm not expecting them to on private DB transfers.

Steve Groves, Chief Executive Officer

Okay, I guess that's the point to wrap it up then. Thank you all for joining us and for the questions this morning and we look forward to updating you.