

Q4 2015 Earnings Call

Company Participants

- Alexander Rijn Wynaendts, CEO, Chairman-Executive & Management Board
- Darryl D. Button, Chief Financial Officer
- Willem van den Berg, Head-Investor Relations

Other Participants

- Benoît Pétrarque, Analyst
- Farooq Hanif, Analyst
- Farquhar C. Murray, Analyst
- Mark David Cathcart, Analyst
- Nadine van der Meulen, Analyst
- Nick Holmes, Analyst
- Steven A. Haywood, Analyst
- William H. Elderkin, Analyst
- William Hawkins, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Aegon Q4 Results Conference Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Willem van den Berg. Please go ahead, sir.

Willem van den Berg {BIO 15203834 <GO>}

Thank you. Good morning, everyone, and thank you for joining this conference call on Aegon's fourth quarter 2015 results, as well as a look back on some of the key developments over the last year.

As always, we will keep today's presentation short, leaving plenty of time to address your questions. We would appreciate that if you take a look to review our disclaimer on forward-looking statements, which is at the back of our presentation. Our CEO, Alex Wynaendts, will first provide an overview of our performance, and will then be joined by our CFO, Darryl Button, to answer your questions.

I'll hand it over to Alex now.

Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Good morning, everyone, and thank you for joining us today. Our fourth quarter results closed the year, in which we achieved our highest-ever sales, and accomplished many of our strategic objectives. This quarter, net income increased to €478 million, mainly as a result of net recoveries and lower fair value losses.

However, in terms of underlying earnings, we did not meet our expectations in the U.S. As we shared with you during our Investor Day in January, we're implementing significant expense reduction programs in the U.S. and the Netherlands aimed at improving profitability. We're making good progress, and are well on track to realize the announced cost savings.

I'm pleased that a strong and resilient capital position enables us to return capital to shareholders through both an increased final dividend of €0.13, and through a €400 million share buyback, of which we have already executed 25%.

I will now turn to slide three, to address underlying earnings in more detail. So let me take you through the key points. This quarter's underlying earnings declined 14% compared with last year's results, which included positive one-time items. Excluding these one-time items, underlying earnings declined by 5%, largely as a result of lower earnings from the U.S. Lower earnings in U.S. were driven by the run rate impact of model and assumption updates in Q3, adverse morbidity, and lower earnings from retirement plans and fixed and variable annuities.

Earnings in the Netherlands increased despite losses in our non-life business. And as you know, we recently announced the divestment of our loss-making commercial line non-life business. And results in our other markets were in line with our expectations.

Let me now give you an update on the changes we're making to our organization structure in the U.S., and on our expense reduction programs. We're implementing the new U.S. organization structure that we announced at our recent Investor Day, which will be effective as of March 1, of this year.

As you will recall, our ambition is to create ONE Transamerica in the eyes of all our customers, while at the same time increasing the overall efficiency of the organization. Key to this is to better leverage technology, and to drive operational efficiencies throughout the entire organization.

As I mentioned earlier, I'm pleased that we're well on track and we have made a strong start with expense savings program. The elimination of positions and our voluntary separation offer are important parts of this program, and we anticipate the initial benefits of our expense savings program to become visible as of the second half of this year.

I would now like to spend a few moments on the developments of our net income. Net income increased by 20% this quarter compared with last year. This was due to improved results from fair value items, a large gain from net recoveries and lower taxes. The loss

from fair value items amounted to €65 million. This was driven by losses on macro hedge as a result of the high equity markets in the fourth quarter.

As you can see on slide five, net recoveries were high at €64 million for the quarter, and included a legal settlement on previously impaired structured assets. Gross impairments remained very low at only one basis point of our general account on an annualized basis.

Effective tax rate was low as a result of tax benefits on solar investments in U.S., and a reduction in the corporate tax rate in the UK. When it comes to measuring how customers are placing their trust in Aegon, and in the products and service we offer, there is possibly no better metrics than sales.

On slide six, you can see that in the fourth quarter, we, once again, generated very strong sales in our deposit businesses. We're very satisfied with the strong asset management sales. In particular, our absolute return products in the UK and the Dutch mortgage fund, both attracted a lot of new money. Deposits in our retirement business in the U.S. increased 20% compared with last year, driven by both higher takeover and higher recurring deposits.

The ongoing focus on our platform in the UK, together with the shift from defined benefit to defined contributions in the Netherlands, led to higher deposits at expense of lower new life sales. In the U.S., the withdrawal of our universalized secondary guarantee product also contributed to lower new life sales.

Slide seven shows that 2015 was a year during which we achieved record high revenue-generating investments of €700 billion as all our fee-based business continue to perform very well. Our award-winning platforms, customer-friendly products and excellent customer service are enabling us to attract many new customers, while at the same time retaining existing ones.

Strong growth from our existing franchises is being supplemented by new partnerships, which provide us with extensive distribution networks and access to millions of new customers. As a result, net deposits of the year doubled to €18 billion. Asset management expanded its distribution range and formed a strategic partnership with La Banque Postale in France.

Our U.S. retirement business also continues to grow. And we expect growth in the assets to accelerate now that we have completed the acquisition of Mercer's DC record-keeping business in the U.S. And as a result of this acquisition, Transamerica is now helping nearly 5 million customers prepare for their retirements that makes up the top five DC provider by number of participants with over \$200 billion of assets. The recent market volatility, which was fueled by uncertainty about the world's growth prospects, once again demonstrates the challenging nature of the environment in which we operate.

Let me, therefore on slide eight, remind you of the high quality of our general account investment portfolio, which comprises predominantly of investment grades, fixed income instruments. We expect impairments to increase in 2016 compared to the very benign

levels over the past three years, but to remain below a long-term average of 28 basis points. The sectors where we could see impairments emerging are metals and mining and energy, and especially for those securities that are below investment grade.

On slide 20, we have disclosed our holdings in these sectors by subsector and by rating. And as you can see, securities below investment grade represent only 10% of our metals and mining, and energy portfolio.

Let me now turn to capital on slide nine. I'm today happy to reconfirm that our estimated Solvency II ratio at year-end 2015 remains approximately 160% for the group, at the upper end of our target range. The ratios for the units also remain unchanged with the U.S. at 160%, the Netherlands at 150% and the UK at 140%.

We estimate that the impact of the recent market volatility on our Solvency II ratio in line with our low sensitivities is less than 5 percentage points. While there has clearly been a lot of focus on comparing Solvency ratios, it's important to understand that every company's ratio is unique and the way that is calculated is also unique.

Let me remind you three points to bear in mind. First, our Solvency II ratio does not benefit from transitionals other than in the UK. Second, the sensitivity to market movements is limited as I just shared with you. And third, the capitalization of our country units is strong on a standalone basis.

As a result of our user deduction aggregations for the U.S., we are not able to include diversification benefit at the holding. Our capital position provides us with a strong base and this supports execution of our share buyback as well as the 9% increase in our 2015 dividends.

So, looking ahead we've every reason to be confident about our future. Our capital position is strong; our customer base is growing, standing today at over 30 million customers; and our strategy is both ambitious and achievable. Our company is transforming. By becoming more relevant throughout the customers' lives, I'm confident that we're in a strong position to create value for our shareholders and improve our returns.

Thank you, all, once again for your continued interest in our company, and Darryl and I are now happy to take your questions.

Q&A

Operator

Thank you. We can now take our first question from Nadine van der Meulen from Morgan Stanley. Please go ahead.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

FINAL

Hi. Good morning. Thank you for taking my questions. I was wondering to what extent the recent market turmoil has impacted capital positions in the three main entities. So, if you could give an update on where we are now instead of year-end, so both in the U.S., the Netherlands and the UK. And particularly, I'm interested in the U.S. as with the RBC ratio, assets are not mark-to-market. So I was wondering if you expect charges there from rating migration and cash flow testing like you, for example, saw in 2001 and 2008. So, that's my first question.

The second question is, yeah, whether you can comment on the progress of the sale of the UK annuity business or the planned sale of the UK annuity business.

And lastly, why did you take a morbidity charge in the U.S.? I'm just curious because I haven't really seen this with peers. Wondering if you can talk us through what is behind this, if this is a one-off or if there's a trend behind this.

And then perhaps, maybe final question. Do you have a target for operational free cash flow? You had a target before. I didn't see it recently. And in that light, also, the dividend was around 50% payout ratio of free cash in 2015, whether this is the payout policy and level we should expect going forward. Thank you very much.

A - Darryl D. Button {BIO 7089946 <GO>}

Hi, Nadine. Several questions in there. I'm going to take some of them. On the Solvency II update, yeah, so we had a look at the sensitivities. And taking a look at what we've seen in the market since really December 31 through to here. The short answer is, we see less than 5% impact on the overall group ratio. And in fact, going unit by unit, it is in the low single-digit impact is what we're seeing across all three of the big units.

In terms of, I think, your second question on...

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Nothing more to comment.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. We really have nothing to comment on the UK annuities beyond what we said in January. Your third question was on long-term care. Yeah, I would say what we saw in long-term care would be much more in the one-off varieties and certainly a trend. We did see some higher claims than what we would normally see. Some of that had to do with terminations. And we did take a provision for that in the fourth quarter. So, I do look at that as being a one-off and not a trend.

Finally, I think, on your last question, I missed it. I think it was operating free cash flow related. Yeah. So, we have put some guidance and expectations out on operating free cash flows. And that was on our January message. I don't really have any new messages to update from that actually. I'm just...

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Q - Nadine van der Meulen {BIO 15200446 <GO>}

And with regards to the dividends?

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. So, in terms of the operating free cash, yeah, you were talking about the 50% payout ratio that we had in January, yes. That's still very much in line with our expectation and that was on a free cash flow basis. So that was operating free cash flows across the unit less the holding and funding costs.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

But can we take that as somewhat of a policy going forward?

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. Well, as I said before in January, when you look at the cash flows, actually, there was still €600 million across the three years that was sort of unaccounted for, if you will, where we've said is available for strategic priorities. And that could be additional distribution to shareholders, that could be accelerating growth strategies. And we haven't committed to that extra €600 million over the three-year period.

So, is it a policy of 50%? No. I would say, that's our expectation, but yet to still deliver and decide on what to do with the extra €200 million per year. Of course, obviously, we've committed to and are executing the €400 million share buyback as well.

Q - Nadine van der Meulen {BIO 15200446 <GO>}

Thank you very much.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah.

Operator

Thank you. We can now take our next question from Farooq Hanif from Citi. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, there. Good morning, everybody. I just want to get back to your confidence on impairments. So, I mean, looking at your portfolio, looking what's happened to spreads and sort of below investment grade and even BBB in the U.S. Is your confidence coming through because essentially the market value of the bonds is still very high because the underlying yield is low? Can you sort of explain the confidence, because when you look at commentary in the market from banks and from participants, it appears as a big worry about it. So, are we missing something or is it sort of time delay? If you could just comment on that.

Secondly, I noticed in the U.S. business with Mercer, you had a bit of a dip in your margin. Sorry, not in the U.S., I mean, the retirement businesses, generally, had a dip in margin in Q4. Is this related to Mercer? When will we start seeing the positive benefits, from an earnings point of view, of the Mercer deal?

And, I guess, lastly, can you give us an update on LACDT in the Netherlands? Thanks.

A - Darryl D. Button {BIO 7089946 <GO>}

Hi, Farooq. I'll take the first and third one. On the first one, on the credit portfolio, yeah. Well, I mean, certainly, obviously, when you look at the marks on the asset portfolio, I mean, they're up because of the impact of lower interest rates is higher than the spread widening. But we do look through that, and we take a look and look at more of the credit component, because, obviously, the interest rate component is offset on the liability side.

On the credit side, obviously, credit spreads have been widening here a little bit as of late. But the majority of that widening has come in the energy and commodity side of the business, which is why we put the additional disclosure out. You can see the table on slide 20 in the presentation. So that's the area that we continue to monitor very closely. We have been lightening up actually for a couple years now in the metals and mining area.

On the pure energy side, I would say where our exposure would be, would be more in the independent and oilfield services down in the below investment grade category, sort of at upper-right quadrant of the table that you see there. And that's where you can see the unrealized loss position in and around that €130 million, €140 million range. So, yeah, if there were impairments to come, they would come from sort of that upper-right quadrant.

On the third question on the update on the tax situation from Solvency II in the Netherlands, the short answer is, there is no update actually. We don't have any more information than we had in January. So, we still are putting our Solvency II estimates out there as a midpoint range, slightly conservative I would say, but we're waiting for that to resolve. And it really could be our Q1 results before we really have some more guidance in that area.

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Yeah, on the Mercer acquisition, Farooq. Let me say in more general terms, the pension market in U.S. is an attractive market, but it's a market where we have seen margin compression already for quite some time. And that's why we are focused and been focused and continue to focus on further expense reductions. We have program in place in the retirement business this year to take more expenses out. And after that program is completed, we will bring in the Mercer acquisition. That means that you will see the benefit of the Mercer acquisition going forward in 2017.

What's also important to realize is that the business model, which we are working on is also changing. So we're not also focusing on asset accumulation part of the business, which you're referring to, but, as you know, we're very much focusing on the retention of

customers. We want to have customers that's start saving with us through the 401(k) plan and that stay with us. And that's why we have decency that our asset retention percentage, which was a few years ago, close to 0% has now increased to 15%. And as you know, we stated a target 20% and we're well on track to achieve that.

So when you look at our pension business, we're now looking it in a very more holistic way in the asset accumulation where margins are on the pressure where we need to take expenses out. And that this accumulation phase, which is probably an even bigger opportunity, we spoken many times about that. And we're pleased to see that we're making progress. The organizational changes in the U.S. reflects on the ONE Transamerica in the eyes of the customer regardless of he is in a savor through 401(k) plan or a dis-savor as an individual person that is retiring. So, we need to look at the total picture and that's where we see we're making progress.

Q - Farooq Hanif {BIO 4780978 <GO>}

May I just quickly come back on Solvency II, if I may? One of your peers in the Netherlands talked about shifting down from the 75% potential LACDT pool to 50%. Are you at the 75% level?

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. Farooq, we actually haven't disclosed what level we're actually at, but I would also very highly caution you from comparing those from company to company. It is a function of the individual tax situation of individual company, and most importantly, the sources of future profits that you have to be able to recover those taxes. So, while I'll think there'll be some harmonization of methodology and approaches, and that will bring in issues like what kind of character of sources of income and things like that are available that the end result will be unique to firm by firm.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. Thank you very much.

Operator

Thank you. We can now take our next question from Farooq Murray (sic) [Farquhar Murray] from Autonomous. Please go ahead, sir.

Q - Farquhar C. Murray {BIO 15345435 <GO>}

Good morning, gentlemen. Just two questions if I may. Firstly, on the cash generation figure of €377 million in the quarter. That looks really quite strong. And I think it would kind of run rate to above the €1.3 billion guidance you've given for the full-year 2016 at the Investor Day. I just wondered if you could help us square that this quarter to that guidance. In particular, the new business strain that's quite low in the quarter. I just wondered what's driving that and whether we should extrapolate it.

And then secondly, just coming back to Farooq's question, kind of on the underlying DT assumption. And I kind of take on board what you're saying, which is that this is going to be very, very kind of potentially company specific. I just wondered what would be specific (22:00) in terms of the way you would look at the kind of LACDT outcome. And if you could just maybe give us a bit of sense of how the mechanics work around the kind of the recovery that you can get on that figure? Thanks.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. Hi, Farquhar. I'll do my best on the second one. On the first one, on operational free cash flow, fairly strong. Yeah. I would say that was a good solid quarter for us. I mean, keep in mind, this is under Solvency I still. So, this is sort of the last quarter, if you will, on the old Solvency I basis. But we've seen operational free cash flows move up with the stronger dollar all year. We've moved up into this range for our expectation. So, I don't think there's anything particularly abnormal, if you will, especially when you look at that normalized cash flow in the high €300 million. When we go forward into next year, under Solvency II, we did give the guidance in January for €1.3 billion range in 2016 and having that number grow across the next three years.

On the NL Solvency II tax situation, there's not a lot I can give you to be honest with you. The different characters of income and those are the things that are still - I would say, we're still in discussion across the industry and with the Dutch Central Bank in terms of how many years of profit and what kind of sources of profit that you can take. The only thing I can offer is that it is a very complex subject because you're dealing with an environment where you've taken your shocks to calculate your capital. And so, you're sort of in the hypothetical what if one in 200-year land and then you have to remodel your tax basis in that scenario.

And so you have to figure out what your sources of profit look like in a one in 200-year event to be able to figure out what would be recoverable from a tax position. So, it gets very complex, a lot of modeling. And we're still to see the final guidance, if you will, or from the Dutch Central Bank on that.

Q - Farquhar C. Murray {BIO 15345435 <GO>}

Okay. But just to follow up, I mean, you're saying, okay, one company may come out with, say, 50% recovery. I mean, you're saying, look, actually, this, genuinely, could be quite a substantial range around now, it could be 75% or 25% anybody...

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. It really could, because, again, it depends where you start comparing because if you start comparing the kinds of losses come in different ways, so, hence, the recovery comes in different ways. So, as an example, if you take a lot of losses from spread-driven events and liquidity-driven events that don't materialize themselves in actual paper losses or tax losses, then those recovery profiles can look substantially different than, perhaps, a simpler business model where you're just having one in 200-year claims losses that don't have a recovery profile. So, you get very complex very quickly.

Q - Farquhar C. Murray {BIO 15345435 <GO>}

Okay. Thanks much, indeed.

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Yeah.

Operator

Thank you. We can now take our next question from Mark Cathcart from Jefferies. Please go ahead.

Q - Mark David Cathcart {BIO 19783252 <GO>}

Hi. It's Mark Cathcart from Jefferies. I'd just like to put to you a hypothesis that the following happens. And I'm curious to know what's more important to you. Your observation of the 50% cash payout ratio or your €1.7 billion of dividends will be supported by €600 million. So, the hypothesis is, the dollar goes down, say, another 10%, it's fallen 5% in recent weeks. Yields in the U.S. hover around 1% to 1.5%. They're currently at 1.7%.

And also, as implied by current spreads in the market, you get losses coming through, say, on a two-year horizon, which are significantly above that 20 basis points that you've assumed. And if I can venture to say this that there were some more morbidity and mortality upsets.

Then I'd like to ask, Darryl, what's more important, the 50% payout ratio observation or, I'm sticking to the €1.7 billion of dividends on the assumption that that €600 million from what I think is not a ludicrous scenario is gobbled up quite quickly. I mean, your cash earnings have been significantly bailed out by the dollar over the past three years. I'm just wondering, there's a vulnerability there. So, what happens to your dividend policy on that scenario, which is not that unforeseen?

A - Darryl D. Button {BIO 7089946 <GO>}

Hi, Mark. Well, I mean, that was quite a lot to absorb, but I guess, what I would say is that the 50% payout ratio is not a target in of itself. And as we said before, as we took a look at the cash generation across the group, and what our objectives are, and what we see as an attractive growing dividend profile versus what we want to invest in the business, that is the number that kind of comes out of the projections.

Although, again, I'll repeat what I said before, there is actually capacity for either strategic investment or a payout ratio higher than that, and that should be yet to be decided from the management team as we progress over the next three years in implementing the strategy. So, the 50% is not a target in of itself. And then in terms of the rest of your scenario, yeah, if we get into, I guess, I'm not going to comment too much in terms of trying to do all the numbers on the slide here. But if we get into a deterioration scenario or a credit environment or things where that operating free cash flow is lower, the good

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news is, we have a buffer to go through before we get down to breaching that 50%. If we keep going beyond that, well, then obviously we'll have to have decisions at that point around our capital allocation and whether that be de-risk or hang in there with the capital commitment.

So, there's all kinds of scenarios you can look through from now until a more severe scenario, but the best one I could say is, we have that buffer to blow through or get through before we get down to the point where you're talking about.

Q - Mark David Cathcart {BIO 19783252 <GO>}

Imaginary. Can you just remind us what your 10-year yield assumption is, please? So, over the next, say, three years, and also the assumptions you make on some of your alternative investments, and how that might deviate cash earnings?

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. So, the IFRS assumption that's used is a 10-year assumption of 4.25%, and we get there linearly from now until that point over the next 10 years. So, you can take the 10-year today and 4.25% and divide by 10, and that's the grade. That goes in behind the IFRS results that's not necessarily a cash assumption. What drives cash to the group, of course, are the local regulatory frameworks. And there you have Solvency II, market consistent frameworks in the Netherlands and the UK, and all the majority of the European businesses. And then you have U.S. RBC driving cash out of the U.S. And there you are on a different system, but you are brought to the current levels of interest rates sort of each year-end through the cash flow testing work.

Q - Mark David Cathcart {BIO 19783252 <GO>}

And what about alternative investments?

A - Darryl D. Button {BIO 7089946 <GO>}

Alternative investments for the allocation that we have are on a mark-to-mark basis in the U.S. statutory environment and in the IFRS environment. So, there is a linkage between the reported results that you see every quarter and the fair value results that go by in the capital framework.

Q - Mark David Cathcart {BIO 19783252 <GO>}

Okay. Thank you very much, Darryl. Thank you.

Operator

Thank you. We can now take our next question from Nick Holmes from Société Générale. Please go ahead. Your line is open.

Q - Nick Holmes {BIO 3387435 <GO>}

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Hi, there. Thank you very much. Two questions; first is, just going back on your guidance on impairments; wondered, if you could talk us through a bit more, your process? And what would I mean by this is, you've got the unrealized losses. When do those unrealized losses become impairments? Do you have a rule, say, 20% fall in market value becomes an impairment? Or is it your own analysis? Or maybe credit rating migration?

And then the second question is on the Department of Labor proposal. Wondered if you could just give us an update on where you think that's going in terms of impact? And also timing, when you think this will start to affect your business?

A - Darryl D. Button {BIO 7089946 <GO>}

Hi, Nick. Let me take the first one on impairments. The short answer is, we go through our process other-than-temporary impairments, OTTI. We do a security-by-security analysis. Obviously, we do screens that sort of flag our various watch lists and securities that go under a more in-depth review. Those screens would have things like - looking at the marks - the market values versus the book values, and things like that.

But at the end of the day, there's no set fixed rule in terms of - if the price gets to this, then we do that. We have to go through an assessment that takes a look at whether or not we believe we will receive all of our principal back, and we do that security-by-security. And if we feel we will not or there's a reasonable probability that we will not receive all of our principal, at that point, we impair down to the market value of the security. That's our official process and policy.

Q - Nick Holmes {BIO 3387435 <GO>}

And - sorry...

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

I wanted to give you an answer to your question, Department of Labor.

Q - Nick Holmes {BIO 3387435 <GO>}

Yeah.

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

In fact, we do not know much more right now than we knew in January. We do actually expect that the Department of Labor will come out with their proposals within the next two months to three months. And of course, the question is, what will these proposal entail? To what extent will the Department of Labor have taken into account all the suggestions, recommendations and appeals the industry has made.

As you know, the answer is particularly concerned to the fact that, it is important to maintain a system that allows products to be sold to customers. Customers that need financial protection, customers that need annuities to have an income stream in the future.

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And once these proposals are being announced, we do understand that the implementation period would be relatively short. That of course is also something we need to get confirmed, and it would mean that, maybe within six months, that's one of the things we've been hearing too. So, a lot of questions unanswered, but hopefully, the next time that we have our quarterly update, we'll be able to give you more information.

What I would like to say on this subject is that, we're well aware of the directions and where this is going. And although do - we do support, we've always supported commitment to do the right thing for our customers, ensuring that our customers buy the right products, and the products that they need for their specific situation. It's also important to take into account that, a lot of customers also need to be sold the product, because on their own, they might not react to it. And that's where the balance has to be found.

And we said it earlier, we see a lot of these regulatory changes taking place in other parts of the world, and Nick, you in the UK know exactly what's happened in the UK with RDR. So, it's also a question of them trying to see, how can we best adapt our product offering, how can we best adapt the way we sell products to our customer to make sure that we, within the new rules, continue to provide them the product and services they need.

Q - Nick Holmes {BIO 3387435 <GO>}

Now, just two very quick follow-ups. Firstly, Alex, do you think it will, the DOL will affect sales practices this year? And I'm thinking, could there actually be an increase in sales as advisors want to get them done before the rules change?

And then just second very quick follow-up, Darryl, you said, I think in the past that, you don't expect defaults this year in the energy book. Is that still your view?

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

On the first question, to - going on, the Department of Labor, I think that, advisors will obviously - specifically those that operate in qualified area, which is the one that is now being affected by Department of Labor, I would expect, advisors not to try to sell product before the change of rule, so on the contrary. So, I would not expect increase in sales before a change of regulation.

As I said, we do expect that these rules will be implemented relatively soon, that's what we know the aim of the Department of Labor. So that could be somewhere in the beginning of next year.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah, on the second part, Nick, I don't think I've ever said, I don't expect impairments this year. I think that, we continue to see impairments in line or better than what our long-term expectations would be for the portfolio. I think you have to keep in mind with the size of the general account that we have across the group to have no impairments, which is - although that's been factual over the last two years or three years, right. That should not be anyone's expectations going forward.

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Q - Nick Holmes {BIO 3387435 <GO>}

Sorry. Darryl, let me just correct. When I said defaults, not impairments, I meant actual companies defaulting. I mean, obviously, as you've guided, you will have impairments, which anticipate possible default. But I think you said or maybe it was another member of the management, that there wasn't a likelihood of actual companies defaulting this year.

A - Darryl D. Button {BIO 7089946 <GO>}

Well, there's a high correlation between our impairments and defaults, I mean, over time. I mean, impairments, you just are fronting (36:17) a little bit, if all you have are impairments and never any defaults, then you'll have lots of recoveries down the road.

So, I think there are - we would expect impairment/defaults as a normal course off the credit portfolio over time. Of course, that's why we take a yield, and that's why we take a spread and help to compensate for that.

I think what we're saying is that, our long term - if I look at the U.S. credit portfolio, our long-term average defaults have been around 27 basis points. I see us at or better than that certainly for this year. But we'll have to see. But if there were defaults to come, I think, what we're saying is that they would - in the short-term, we would think they tend to be focused in the energy spaces, which is why we've given the disclosure in the slide presentation. So, I hope that helps.

Q - Nick Holmes {BIO 3387435 <GO>}

Yeah. That's very clear. Thank you very much.

Operator

Thank you. We can now take our next question comes from William Elderkin from Goldman Sachs. Please go ahead.

Q - William H. Elderkin {BIO 3349136 <GO>}

Thank you. Good morning, everybody. One question and - one clarification and a couple of questions on the UK business. Just a clarification, the guided or target level of capital generation that you've given going forward, am I correct in thinking that, that number is effectively net of an assumed through-the-cycle level of defaults?

And then just going to the UK business, on the revenue side, talking about the UK pensions business, in previous quarterly releases, you've sort of cautioned to expect further revenue compression, I think, both from the transition to the platform, but also from DWP-related effects and so on. Can you just give us an update of how you see that proceeding through?

And then sticking with the UK pension business, can we expect commission-related payments to drop fairly sharply over the next year, two years as - in line with some regulation changes? And also, more broadly, I've seen the operating expenses of the

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overall UK businesses have really stabilized nicely over this year. Is the ambition from here to keep those operating expenses, if you like, flat or can we expect further reductions, particularly if the legacy portfolio starts to run down? Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Hey, William. I'll take the first one. The short answer is - on the operating free cash flow is, yes, that we would look at that as sort of through-the-cycle kind of long-term default assumption, and that's how we look at and give our sort of forward guidance on things like the operating free cash flows.

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Yeah. In the UK, you're right, William, just to mention the fact, there's a number of different elements that is contributing to margin compression. First of all, DWP, that's one. The second one is the ban on active member discount, which you know does not allow us anymore to differentiate pricing between active member paying and non-paying term (39:31) participants, and we're upgrading customers into our new platform.

However, I think it's also good to remember here that, those customers that are upgraded to a new platform are customers that are very keen to stay with us and take a choice, so therefore we also at the same time reduce our - less risk, that is to some extent an offset.

I think we've made it very clear that we need to continue to adjust our operating model, and ensure that the expense base of our new platform is in line with what we can earn on the platform. And while in the past, in the old world, we were talking about 100 basis points - 80 basis points to 100 basis points environment. The new world on the platform is probably more 40 basis points to 50 basis points environment, and that requires us to take our expenses further down. And we will continue to do so going forward.

As we have announced in January, we're looking at the different options we have available on our UK annuity business, but we're also effectively separating the old business, and the new business, and ensuring that we're moving as much customers from the old environment to the new environment as we can, because these are customers for which we have already paid an acquisition price, and that process continues going forward. And we will therefore, also, end up with a platform, which will have scale, and which will have a cost base that is adjusted and adapted to the new - reality of the new world, and that means lower expenses.

Q - William H. Elderkin {BIO 3349136 <GO>}

Can I just follow-up on that, the last part? The - just in terms of the revenue margins. I mean, the movements I'm really trying to understand is the - how much further compression can we expect, if you like, in the margin on the legacy portfolio?

And then secondly, I still don't have a good feel of the extent to which commission expenses particularly will fall away again on the legacy portfolio, and I was just wondering if you can help me with that?

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Yeah. In terms of the legacy book, clearly, we are trying to adjust our expense as much as we can. There comes a point that you cannot take your fixed expenses down, and I think we've been very clear that - at that point, which would be also the point that we would have exhausted all the opportunity we have to move customers from the old world to the new world, we will look at what options are available for us to optimize the value. I think that is quite clear.

Now, in terms of the platform, if you look at the margins, the margins for pure administrative platform, these margins like we're seeing in the U.S., are clearly compressing. And that is exactly why we are trying to do two things. First of all, we are consolidating assets. What we're seeing today is that 50% of the customers that we have on the platform consolidate assets from outside. So we are able to offset some of the margin compression by additional assets, all towards achieving scale on the platform. So, that's an important point.

The second point is also - is that we try to expand the range of products, because many of the customers on the platform will be served by financial advisers, but also quite a number of customers on the platform are not served by financial advisers, and are customers to whom we can expand our products and services in a broader range. And that's why we try to improve the margins by providing them investment advice or guidance, and other services. That is really what our objective is.

So in terms of purely administrative margins, I think you're right to say that, it will be driven by scale and as such, margins will compress. But the strategy we have is to add assets, and then to expand the products and services, and I'm pleased to see, as I said earlier, 50% of our customers on the platform effectively now bring in additional assets equivalent to around 50% of their current assets.

Q - William H. Elderkin {BIO 3349136 <GO>}

Okay. I'll follow-up afterwards, but thank you.

Operator

Thank you. We can now take our next question from William Hawkins from KBW. Please go ahead.

Q - William Hawkins {BIO 1822411 <GO>}

Hello. Thank you very much. All in the Americas, Darryl, can you just explain a little bit more clearly with the assumption change in variable annuities, and the loss recognition charge in fixed annuities? I just don't understand why you've done there. And can you just repeat and explain why you think the long-term care charge in the fourth quarter is so clearly a one-off? You said something in your passing remarks, but I didn't quite follow that.

I think some - no news is good news, very little reference to mortality in the U.S. this quarter. To what extent do you think, post your assumption changes we're generally

seeing some good news on the mortality front or is it too early to call that at the moment just given that the fourth quarter seasonally is normally quite a good one anyway? Thanks.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah, (44:15). Yeah. So, let me see. I'll take them in order. Variable annuities, fixed annuities. On the fixed annuities, the charge we had was really just related to some spread compression that we saw as - really as the assets that are there. It is starting to run-off a little bit slower than what we have been projecting combined with the low yields we took a look at the overall spread projections going forward, and we felt like we needed to do a true up on the intangible calculations. And that was the charge and it was very much a one-off.

On the variable annuity, it was really, we had a little bit of leftover work from the Q3 assumption update where we had to make some estimates related to some of the policyholder behaviors and some of the smaller blocks, and this was really just the timing issue that we didn't get it all into the third quarter. And it turned out to be a positive for the last piece that was left for the fourth quarter. So, that was something we'll strive to make sure we get all in the third quarter in the future. But that was some carryover that came into the fourth quarter.

On the long-term care side, really, was the overall health book that had the negative experience, but it was predominantly coming from long-term care. We saw a lot of lower claim terminations than what our - sort of our normal trajectory was, and so we took some provisions for that, and were obviously, something that we'll continue to watch very closely going forward, but I very much expect that to come back into more normal, long-term rates as we head into the first quarter.

On the mortality side, yeah, the mortality was in line with expectations in the fourth quarter. So, there was really nothing to report on the life mortality side.

Q - William Hawkins {BIO 1822411 <GO>}

Thanks.

Operator

Thank you. We can now take our next question from Benoît Pétrarque from Kepler. Please go ahead.

Q - Benoît Pétrarque

Yes. Good morning. It's Benoît Pétrarque from Kepler Cheuvreux. First question will be on the operating free cash flow. Yeah. I was wondering if you could give us the figure on the Solvency II framework, whether that's basically - whether that was consistent with the €1.3 billion you've mentioned in Jan?

And then to come back on the slide 20, I was wondering if you could give us an update on this oil exposure. What is the amount of unrealized loss at the end of, let's say, in February? Just give us an update there. And will you expect downgrades during the year or have you seen already downgrades on this sector? And I was wondering - or you think it could translate into potential drag on cash flows in 2016. Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. On the Solvency II, operating free cash flow for the fourth, no, I don't have that number, and we're not in a position to put that out. We'll be - with first quarter results, we'll start to flip over and start reporting the - not only the Solvency II positions for the quarter, but also the capital generation on the framework in Q1. So, as of now, the only thing we're putting in Solvency II is still our estimate for the end of the year, which is our day one reporting. So, unfortunately, there's nothing I can give you on that.

On page 20, and I think on your last few questions, do we have an update on how this is moved going forward from December 31 to as we stand here today? That's not something that we have available or that we're putting out. Obviously, the spreads have widened a little further in the energy sector. That was something that we continue to watch as I mentioned before. But they still continue to move up and down in really fairly volatile way although they've come back here. Just in the last couple of days, they've gotten a little better.

I'm not sure, in terms of downgrades. We did see in the fourth quarter there was some ratings migration activity that actually did impact. That was included in sort of the market impacts on the operating free cash flow in the fourth quarter. Some of that was in fact related to ratings downgrades in this sector.

Q - Benoît Pétrarque

Okay. Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah.

Operator

Thank you. We can now take our next question from Steven Haywood from HSBC. Thank you. Please go ahead.

Q - Steven A. Haywood {BIO 15743259 <GO>}

Good morning, gentlemen. It was just on - following on from - you were saying that in UK, you really need to build scale here, and that's what's going to driving earnings going forward. I was wondering how open you are to acquiring scale in the UK whether from bolt-on acquisitions or acquiring further assets under management or platforms, et cetera, and how do you feel about any of this?

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

It is a scale game and a cost game. Obviously, you cannot take your cost down below a certain level, but I indicated clearly we want to take our cost down and drive scale. Now, we are driving scale organically by a number of elements. As I said, we're driving scale by moving customers from the old world to the new world. We're driving scale by helping them to consolidate assets. I shared it just before. We're driving scale by getting new customers. And obviously, if there's an opportunity to accelerate the process of achieving scale, we certainly should be looking at it.

Q - Steven A. Haywood {BIO 15743259 <GO>}

Excellent. Thank you very much.

Operator

Thank you. We have no further questions in the queue. I'd like to turn the call back over to you for any additional comments.

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Many thanks for listening in, and I wish you a good Friday and a good weekend, also. Thank you.

Operator

Thank you. That will conclude today's conference call. Thank you for your participation, ladies and gentlemen. You may now disconnect.

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