# Q2 2018 Earnings Call

## Company Participants

- David Louis Richardson, Group Deputy Chief Executive Officer, Managing Director-UK Corporate Business & Director
- Rodney Malcolm Cook, Group Chief Executive Office & Director
- Simon George Thomas, Group Chief Financial Officer & Director

## Other Participants

- Alan Devlin, Analyst
- Andrew J. Crean, Analyst
- Gordon Aitken, Analyst
- Greig Paterson, Analyst
- Marcus Barnard, Analyst
- Oliver Steel, Analyst

## MANAGEMENT DISCUSSION SECTION

### Rodney Malcolm Cook {BIO 14008420 <GO>}

Good morning, everyone. I'm Rodney Cook, CEO of Just Group. I'm joined, as usual, today by our CFO, Simon Thomas; and our Deputy CEO, David Richardson. I'd like to thank Nomura for the use of their conference facilities and welcome all of you joining us today, including those on the webcast. We really do appreciate your continued interest.

I'll start by giving you a brief update on how we see our business. Simon will then go through the numbers in more detail as usual, and David will talk about our capital position, which I know you are very interested in.

We do appreciate that these results, which are the absolute record in the corporate history of our company, are overshadowed, to a certain extent, by the uncertainties surrounding the regulatory treatment of lifetime mortgages and our consequent capital position. Each of us will address this matter. Do not fear. So, to the results highlights. The two big operating highlights today are the 64% growth in Retirement Income sales and the 10.2% new business margin attached.

The sales growth is a record for our group, and what's more pleasing is, of course, the 10.2% new business margin which is more than double the margin before the merger in the first half of 2016, and that reflects our continued pricing discipline. The combination of an excellent sales performance and our continued focus on margin has helped us to deliver an 88% increase in new business profit and a 85% increase in adjusted operating profit. The markets we are participating in are attractive. They provide growth that enables Just to price selectively and achieve mid-teens rates of return on the new business capital being deployed.

So, moving to the fourth bullet point there. As we said at the full-year results, now that the merger is complete and the cost saves have been achieved, we are able to give our attention to how we can disrupt markets further and diversify our model by focusing our investment on innovation. And since that time, we've continued to develop our capabilities in the HUB Group which is our professional services and distribution business.

We've launched recently HUB Pension Solutions which is a new fintech business. And to complement this, we recently acquired a small pension consulting business called Corinthian. This week, HUB Financial Solutions launched a major partnership with M&G Prudential to provide shopping around services to Prudential's retirement customers who are looking to purchase a guaranteed income for life. By the way, this is the largest deal of its kind that we have signed. Now, these initiatives extend the group's capabilities and help us to grow our addressable markets. And we'll start seeing the benefits of that deal in our 2019 results.

Moving then on to embedded value which has increased to £2.30 and our tangible IFRS net asset value was £1.69 at the end of June. Given the uncertainties surrounding the potential outcomes from CP13/18, the board has made the decision to defer any interim dividend declaration until the position with respect to the PRA's ongoing consultation has been concluded.

I'll talk more about our attractive growth markets in which we operate shortly. But first, let me address what I know most of you are waiting for, and that is the PRA consultation and the potential consequences for the capital position of Just.

So, most importantly, the consultation is open, and it is ongoing. So, of course, we do not have the answers yet. Nobody does. There are three messages, however, I'd like you to take away today, and Simon and David will expand on these explicitly.

So, first, we have already made changes to our pricing of annuities and DB contracts and made changes to the product features of our lifetime mortgages. And we are writing new business on terms we believe that continue to be attractive to shareholders in the new world.

Second, having addressed new business, CP13/18 for us is substantially a back book issue. Now with respect to the back push (00:05:23), we are going to show you the strength of our mortgage portfolio and how conservative our current position is with respect to mortgages.

Finally, we'll explain that we continue to plan actively for a wide range of possible outcomes so the board will be equipped to make decisions that deliver the best possible outcome for our shareholders. That is our focus. I think it's important to say on the record to all shareholders that obviously we will comply with the regulations when they're finally concluded and announced. I should also state that we're in active dialogue with the PRA over a number of aspects of the proposals contained within the consultation paper. We are assessing the consultation paper and we intend to put forward constructive challenge and also alternative solutions directly to the PRA and via our trade bodies which are the Equity Release Council and the Association of British Insurers.

As you know, and we will demonstrate to you again today, lifetime mortgages remain a very good asset to match GIfL and DB liabilities. And they are becoming an increasingly important tool for UK retirees to manage their later lives. We believe policy makers at the highest levels in the UK see the value of those lifetime mortgages and what they can provide to UK citizens.

We have concerns that the proposals as they are currently drafted are overly cautious and could have unintended consequences for some groups of consumers who may no longer be able to access lifetime mortgages or at the level they currently do.

So, I'd like to make a comment now on prudence. We at Just are committed to maintaining prudent levels of capital. We are after all a customer-centric business and we're focused on helping people achieve a better later life. We owe it to our customers to have sufficient levels of capital and flexibility to take action in the event of more difficult economic times. We already have that. We judge that the proposals in the consultation paper will go well beyond this.

When viewed from our portfolio perspective, they appear to require capitalization for an extremely adverse housing market scenario. A scenario, in fact, which goes well further than the Bank of England's extreme stress test for property in the banking industry.

Now, this could result in an adverse impact on the Retirement Incomes paid to new retirees across the UK. The proposal also assumes that we would have no flexibility in the actions that we could take over the next 20 years or so to mitigate the consequences of such an extreme economic scenario.

So, the consultation process is, I said, ongoing. It finishes at the end of this month of September, and we currently expect the final supervisory statement to be published before the end of the year. And when that statement is issued, we will be able to determine the effect it has on our capital position.

As you would expect, we are preparing for a broad range of potential outcomes. If we do need to enhance our capital position, we have scope to do so by using a range of financial instruments. Simon will discuss those options in detail in a moment.

So, just to reinforce my opening comments, this for us is substantially now a back book issue. Our new business pricing has been adapted already to comply with the Supervisory Statement 3/17 and we expect to earn attractive internal rates of return on new business shareholder capital deployed under this new world.

So, back to the stuff that we actually find quite exciting, for a moment, the markets in which we operate. So, despite very strong sales growth in the first half of 2018, can I remind everyone that our strategy has been about growing profit, not about growing headline sales. And we have, again, used the expanding markets in which we participate in to select more attractive risks.

So, starting with the chart on the top left, the defined benefit derisking market is experiencing a step change in activity. Industry volumes in the first half of this year was £7.8 billion, well above last year's first half and are likely to be even bigger in the second half.

Back in July, Hymans Robertson estimated the market could well be worth £18 billion for the year, and the total together with insurer-to-insurer business of £35 billion. You may know that the research identified there is a potential £700 billion of de-risking opportunities to come through the period to 2031. To remind everyone, we target the up to £250 million transaction size sub-segment, and we are increasing our risk selection focus for the second half of the year.

Turning then to the Guaranteed Income for Life or GIfL market, the top right, the outlook continues to be positive. The chart shows that the open market that's our addressable market (00:11:55) continues to increase as a proportion of the total market. And we expect that to continue into the future. The open market is now actually bigger than the internal market. And we are pleased to see that the Financial Conduct Authority's recent proposal to strengthen their rules that require pension companies to show the best quote available from the open market, including enhanced rates, in order to stimulate shopping around in the open market and where we are a leading provider.

And then finally turning to the chart on the bottom left, growth in the lifetime mortgage market continues to be very strong. It increased by 32% in the first half of this year and that was following up on growth in 2017 of 42%. You'll see that the first half of 2018 was actually bigger than the whole of 2015. So, quite a significant move in this market. Customers are now increasingly disposed to using the equity in their homes to help with their later lives.

So, now I'll pass to Simon to take you through the numbers.

## **Simon George Thomas** {BIO 15219564 <GO>}

Thanks, Rodney. I'm Simon Thomas group's CFO and I'd like to add my welcome to all of you today. We've made a good start to the year in terms of operating profit and are proud of the progress that we've made.

This slide shows the summary IFRS result and let me go into little more detail. Our adjusted operating profit grew by 85% mainly driven by the 88% increase in new business profit. I'll talk about the new business profit and margins in a later slide. The in-force profit was a little down on H1 2017 but the same as H2 2017. The impact of a higher opening actuarial reserve was more than offset by reduced earnings on surplus and by the small effect of corporate bonds spread tightening.

Operating variances and assumption changes produced a small positive. The increased development expenditure was flagged at last year end and this is mainly our investment in the GIfL plug-in and the HUB Pension Solutions business. The increase in our reinsurance and finance costs is of course due to the issue of the £230 million Tier 3 bond in February this year.

So, looking at the sales in a little more detail, Retirement Income sales growth for the first half of the year was an exceptional 64%, driven by a step change to the (00:15:00) level DB sales. The DB market has very exciting long-term growth characteristics and has had a very good first half. The good news is that employee benefit consultants have changed the way that they do business, and that so are able to unlock many more of these pension de-risking opportunities than they could in the past. This, together with the improved funding of schemes, means that the market is likely to be bigger and probably less seasonal going forward.

DB sales were almost 2.5 times higher than in the same period last year. We've maintained our pricing discipline and are ahead of plan, and the focus as before is on relatively smaller transactions, where our asset liability management works best and where our medical underwriting can add the most value.

Product innovation is also important here. And the launch of DB Choice proposition in November has been positively received by EBCs. The DB pipeline remains very well stocked and market pricing discipline is robust, with multiple potential transactions of various sizes in our target segment.

The GIfL open market continues to gain traction and the FCA is helping in this regard supporting our 9% sales growth. Our own distribution company, HUB Financial Solutions, is at the forefront of innovation in the industry, linking up with more and more pension companies and channels to help bring retirees a panel of insurers to choose from, rather than just defaulting to the company that helped them to save their retirements in the first place. Lifetime mortgages advances are up 36%, a touch ahead of the market. However, our lifetime mortgage growth has been below our DB and GIfL volume growth.

Now turning to the new business margins. Our disciplined growth strategy has led to further new business margin expansion from 5% in H1 2016 to 8.9% in H1 2017, and now 10.2% in H1 2018. Combined with Retirement Income sales growth of 64%, this has led to a net doubling of the new business profits compared to H1 2017.

This highlights the strength of our new business franchise and its high return characteristics. The strength in the new business margin was driven by many of the same things we've discussed before, including firstly and most importantly, pricing. The strong growth in DB demand has meant the pricing has been reasonably attractive.

In the GIfL market, we've also maintained pricing discipline and made some further improvements in risk selection. In both the GIfL and DB margins were helped by continued attractive mortgage yields. The growth in supply has been exceeded by the growth in demand, and mortgage spreads have remained healthy. This has supported (00:18:14) new business margins. Finally, in relation to expenses in the first half, we've benefited from operating leverage on the cost base due to the strong sales growth.

Looking ahead, the strength of the first half means that we're in a position to price even more selectively over the second half, and we've already taken action to improve our prices in the light of the CP, as have others, to make sure that we obtain an appropriate return on capital. We remain comfortable with full year expectations albeit with moderated volume growth in the second half and higher margins than previously expected.

However, the outlook is undoubtedly made uncertain by the wide range of possible outcomes of CP13/18, and the board is focused on attaining clarity as soon as possible. This strong new business performance provides clear evidence that our new business story represents a strong investment opportunity, especially considering the structural growth opportunities our markets offer.

Now just turning to the in-force, our first-half in-force profit is flat on the second half of 2017, although it's slipped a little from the first half of last year. Whilst opening reserves to the period grew the flat in-force profit is reflective of a couple of other factors, both themes that we saw in 2017. Firstly, returns on surplus assets have reduced as we've continued to use up surplus mortgages and longer term bonds which have been replaced with a greater proportion of shorter term bonds and cash.

In 2017, we've been warehousing mortgages in the surplus assets which had benefited that return. Secondly, credit spread narrowing in 2017 creates an unflattering comparative in 2018 as we assume slightly lower margins. Looking ahead, for the remainder of the year and subject to spread developments, I'd expect the second half in-force profit to be similar to the first half.

Next, I wanted to look at our statutory results, specifically the non-operating items. First of all, nonrecurring and project expenditure of £8 million was up from £3 million. The main costs here are the IFRS 17 expenses, some IT migration activity, and the completion of our GDPR project. The investment in economic profit line has made a net negative contribution of £59 million. Here, by far the dominant factor was the impact of interest rate changes where risk-free rates have increased by about 25 basis points at the 10 year duration compared to December 2017.

Our IFRS balance sheet is negatively affected by increases of interest rates, and this accounted for about £35 million of the £59 million investment variance. Other factors included the fact that house prices were broadly flat over the half year, together with a slight widening of credit spreads, offset by the fact we have no corporate bond defaults and some changes to the gilt/swap spreads. Finally, the cost of amortization of intangible assets is flat over the year.

Now, I'll examine the significant flexibility that we have to adapt our capital position. We've already talked a little a bit about CP13/18 and how there's significant uncertainty over exactly what it will look like in final form and its potential effect on our capital position. I'm going to give you an idea of the various capital levers that we have at our disposal.

Before we would turn to capital issuance, the board will ensure that we make the absolute best use of the capital we already have, and this would include carefully considering the volume of new business that we write. The first source of external capital we have listed on this slide is reinsurance. If UK insurers need more capital to back lifetime mortgage assets, then we could look to pass the rest to reinsurers and reduce our capital requirements commensurately.

We're looking at a number of options in this area and have been very pleased with the level of interest out there. Whilst there is interest, these solutions do not, of course, come for free. There would be a cost to them, and we would need to balance how much future profit we give up compared with the improved level of capitalization that they bring.

Another possibility is hybrid debt. Earlier this year, we successfully issued £230 million of seven-year, Tier 3 capital with a 3.5% coupon. There is some room in the Tier 2 bucket, and there will more if the PLACL £100 million 9.5% debt is called in Q1 2020. But there's most room in the restricted Tier 1 or RT1 bucket. The Solvency II regulations limit RT1 to 25% of unrestricted Tier 1, implying significant capacity.

Also, remember 12 months ago, we announced a five-year revolving credit facility. This gives us flexible access to liquidity at interest rates broadly 100 basis points less than the previous senior term facility. This facility remains undrawn and gives us up to £200 million of liquidity if need be.

And finally, equity. It is, of course, our most costly source of capital. The board will consider the optimal capital mix and would only issue equity to the extent it is considered necessary. So, we have a number of levers to pull once we know the outcome of the consultation paper.

So, I'll now hand over to David who'll take you through our capital position and our thoughts on the CP in more detail.

## David Louis Richardson {BIO 18045016 <GO>}

Great. Thank you, Simon. And again, I'd like to add my welcome to you all today. I'm going to focus on the capital position before handing back to Rodney for his concluding remarks.

So, let's jump straight to it and talk about lifetime mortgages. There's been a lot of comment on lifetime mortgages in recent weeks and particular focus on their treatment in the regulatory balance sheet. In the coming slides, there's five key areas that I would like to cover briefly.

The first of those, just to remind ourselves, that LTMs are a good match for our long-term liabilities and are an appropriate asset for annuity providers to invest in. Complex changes to regulatory rules should not distract us from that fundamental point.

Secondly, Just has always managed our exposure to NNEG risk carefully with the results that the likelihood of significant shortfalls is low. Third point is that Just, in common with our industry peers, already makes very significant allowance for NNEG risk in our Solvency II balance sheet. The fourth area is the matching adjustment itself. Let's not lose sight that it is an integral part of the rules, one which the PRA and industry joined forces to secure. The matching adjustment dampens volatility and encourages investment in long-term matching assets.

And the final point relates to CP13/18. This is an ongoing consultation and we will constructively challenge it in a number of key areas. Of course, we will plan for a full range of outcomes, but we will also make all reasonable efforts to get to a more appropriate outcome than the current draft. So let's turn to each of these points in more detail. And a lot of emphasis is placed on the high and attractive risk-adjusted yield offered by LTMs. This helps us after all to offer higher Retirement Income to our customers. But it's also worth reminding ourselves that from a risk management perspective, LTMs also offer very attractive cash flow matching characteristics.

Now, we show this in the top right hand chart. First, we split out a representative GIfL liability profile in the top blue line, and a representative DB profile which starts off as the lower red line. You can see that the DB liabilities have a much longer tail, typically due to a higher level of indexation compared to GIfLs. Adding these together gives you an aggregate liability profile. We then show representative asset profile from a mix of corporate bonds which is the pink area and LTMs which is the blue area. Now, what you can see from that is that the longer duration cash flows from LTM assets are a good match for later liability cash flows and particularly for DB business.

Now, going a step further, in the bottom left chart, we've split the cash flow profiles of different types of LTMs. There is not a single LTM product. There is a range of product that meets different customer needs. Now, as of January this year, there were 86 different types of LTM products in the market, and these can have quite different cash flow profiles, ranging from lump sum products, which is there at the gray line which have the most back-end loaded cash flows, through to drawdown products, which are in the middle of the range, and then finally, a niche for growing segment of interest serviced mortgages which have the shortest duration as the pink line.

Now, the ability to originate different types of LTMs and then dynamically allocate those LTMs to the underlying annuity liabilities is a key capability of Just. We vary our LTM allocation depending on the GIfL and DB scheme liabilities on one side and the mix of LTMs available to match on the other side.

To further illustrate the value LTMs offer for ALM purposes, the graph on the lower right-hand side shows you how the number of sterling (00:28:42) past a term of about 20 years. With the corporate bond getting thinner at those tenors, LTMs provide a very useful solution for long-term inventors.

Add into the mix, the LTMs provide a partial longevity hedge for our Retirement Income liabilities with both lengthening, if customers live longer, and this gives you a flavor of why we think LTMs are a good matching asset and a very sensible part of the business model. This is an important point which can sometimes get lost in the midst of complex discussions around esoteric concepts, such as deferment rates.

So, moving on to the next slide, of course, there are risks around LTMs with most time focused on the No Negative Equity Guarantee. We manage these risks actively at the point of underwriting the mortgages, such that exposure to actual NNEG shortfalls is low. Now, these controls include: low loan-to-value ratios, which we vary by age; geographic diversification; and also valuation and risk controls on the underlying properties.

It's worth pointing out that the average LTV across the entire portfolio currently stands at 31%. The graph on the top right shows that there is a negligible amount of loans with LTVs in excess of 50%. And this, in turn, has translated into very low levels of NNEG shortfalls in the past and, critically, low levels of expected shortfalls in the future.

In the bottom right-hand graph, we analyze the JRL portfolio in detail, which accounts for over 75% of our LTMs. Since we started writing these products 13 years ago, there have been only 13 NNEG shortfalls out of 9,500 redemptions during that time. That has amounted to a total shortfall of £250,000, out of total redemptions of £765 million.

Now, that's the past. If we look at the future, on a central estimate, the number of NNEG claims is expected to remain very low over the next 10 years, as the graph in the bottom right shows. In pound terms, the cumulative amount of NNEG shortfalls is only expected to reach £1 million by 2028, out of £2.5 billion of redemptions expected over that period, a tiny proportion. This emphasizes that NNEG risk is something we have managed very carefully since inception and is well out of the money on the vast majority of cases.

Of course, there are long-term risks of adverse deviations. And for this reason, just along with our peers regulated by the PRA, already made significant allowance for the risk on LTMs in our Solvency II balance sheet. One way to measure this is to solve for the level of house price falls we would need to experience on the Just portfolio in order to give rise to NNEG shortfalls that are equivalent to the allowance we make for LTM risks in Solvency II.

So, looking just at our current Solvency II base balance sheet, so as we stand today, future house prices on the properties underlying our LTMs would need to fall by 0.3% in nominal terms each and every year over the next 50 years. Now, why is that figure so much lower than our headline HPI assumption of 4.25%. Well, the graph on the top right aims to show that.

The first thing to emphasize is that we use option pricing techniques to allow for volatility around our best estimate assumption. Together with an allowance for dilapidation risk, this is equivalent to assuming a uniform reduction in HPI growth of 3% per annum in all future years.

A further buffer is then provided by the Solvency II requirements for LTMs to be securitized in order to create notes that qualify for the matching adjustment. The assumed yield on the securitized notes is significantly below that expected on the underlying LTMs, in particular, following the changes we have made to comply with the requirements of SS3/17.

Now, this buffer is equivalent to assuming a further uniform reduction in HPI growth of just over 1.5% in all future years. Adding that together and you get to the minus 0.3% per annum equivalent growth rate. That's the base balance sheet.

Moving past the base balance sheet, we also, of course, hold solvency capital requirements for property risk. We would need to see a further 1.4% per annum reduction in HPI to fully erode our stand-alone property risk capital, and that's at 100% SCR level. Adding it all up, we would need to see a nominal house price falls of minus 1.7% per annum in each future year to give rise to actual NNEG shortfalls equivalent to the allowance we make for LTM risk in our Solvency II balance sheet. So, it's expressing its annual falls.

Another way of expressing that is that to produce that level of NNEG shortfalls, we would need to see house prices fall by 28% immediately and never grow from that level. The graph on the bottom left-hand side shows how this extreme scenario would play out in practice. You can see here that there would not be an immediate spike in NNEG shortfalls following the 28% fall.

You can see the number of shortfalls remains negligible for the first few years, and cumulative NNEG shortfalls only first exceed £10 million by 2025. Even when you get to the end of 10 years, the cumulative NNEG shortfalls are £69 million. And, again, that's relative to redemptions of about £2.5 billion. This emphasizes that even in a very extreme scenario such as this, NNEG shortfalls are a very long-term exposure. It's the combination of the sharp fall and no subsequent recovery over a very long period which causes the issue, not just the initial sharp fall.

Now, how does this level of prudence compare to other benchmarks? Well, the chart at the bottom right attempts to show this. The Bank of England base and stress test for banks are in shades of green in that graph and you can see that over the long term, both assumes significant house prices appreciation in nominal terms.

Over long term, which as I've just demonstrated, is what matters for actual NNEG shortfalls. Our base balance sheet produces a more prudent outcome than the Bank of England stress scenario. In relation to property stresses only, it is broadly in line with Moody's AA. And then, when you allow for the SCR we hold for stand-alone property risk, we start approaching Moody's AAA property stress.

So, we appear to be managing the NNEG risk well and have set aside significant allowance for LTM risks on our Solvency II balance sheet. This then brings us to the matching adjustment and the potential of (00:36:23) changes in its treatment announced in the PRA's consultation paper on the 2nd of July.

First of all, it's worth restating that the MA is a key part of the Solvency II rules. The PRA support it and have been vocal advocates of it. In July, Sam Woods, the Chief Executive of the PRA, was emphasizing its virtues to Treasury Select Committee. He highlighted that it dampens volatility and encourages long-term investment. Although the PRA support the MA, they have expressed some concerns around the amount of MA benefit at certain asset classes deliver, with LTMs being the most prominent case, and this is what led to the publication of CP13/18 in July, which consults on how SS3/17, which was issued last year, should be applied in practice.

Now, as Rodney has already stated, there are a broad range of potential outcomes under CP13/18, in particular, how it applies to the back book. In terms of the substance of the CP, it is fair to say that we see challenges relating to a number of its key aspects. And these include applying the CP to LTMs, which were written in the past and complied with the prevailing regulations at that time, does not seem appropriate to us.

This is particularly the case for business written prior to Solvency II. As I've shown in the earlier slides, the risk of NNEG shortfalls is not an imminent one, and therefore, even if these new standards are to be applied to the back book, then a lengthy glide path from the current level of provisions would seem more appropriate.

Applying the CP as currently drafted would introduce significant interest rate volatility into the Solvency II balance sheet in our current ultra-low interest rate environment. It would actually introduce a degree of pro-cyclicality with the matching adjustment falling when risk-free rates fall. This volatility in pro-cyclicality does not seem aligned with the objectives of the matching adjustment. It is also inconsistent with how the MA operates for other asset classes such as corporate bonds and infrastructure.

Further, there is a lack of clarity over how it should apply in SCR calculations and this could introduce counter-intuitive outcomes if not applied carefully. And finally, the matching adjustment is not derived from market consistent principles, yet the key valuation principles of the consultation are driven by market consistent principles. It's, therefore, not surprising that it gives rise to unusual outcomes such as the volatility and pro-cyclicality.

Of course, it is worth repeating that the CP is a consultation and there is the opportunity for all stakeholders to feed their points into the PRA before it issues definitive guidance by the end of the year. We will be making a full submission, which will include suggested improvements, as well as providing input to the Equity Release Council and ABI. And notwithstanding the points I've just made, the board is, of course, preparing for a full range of outcomes.

Okay. So, moving on to our actual Solvency II position at the end of June, on a regulatory basis, it was 150%. This benefited from favorable market movements over the first six months of the year, predominantly rising risk-free rates. Now, if you allow for a notional TMTP recalculation at 30th of June, our underlying Solvency II capital coverage ratio was 142% compared to 139% at the year end. This increase in coverage ratio was driven by the Tier 3 bond that we issued earlier in the year, and I'll take you through the moving parts in more detail in the next slide.

The economic capital ratio at the end of the year – by the end of the half year was 256%. It's worth remembering that this is also calibrated to a 1 in 200-year risk event. It is much higher than our Solvency II capital ratio as it reflects our true economic view and does not contain the more onerous elements of Solvency II, such as the risk margin, SS3/17 or other inefficiencies introduced by the structuring required to make lifetime mortgages eligible for matching adjustment treatment. You'll see that the gap between economic and Solvency II capital ratios widened during the first half of 2018, and don't be surprised if the gap continues to increase as we layer on more business under the Solvency II regime.

Now, moving to the next slide, let's go through the change in the Solvency II surplus during the first half. Note that all figures here are net of tax, by the way.

First, our year-end surplus in 2017, as disclosed in our Solvency Financial Condition Report in June, was £596 million, a Solvency II coverage ratio of 139%. This position reflected a 2% reduction compared to the preliminary estimate we included in the report and accounts in March, and this change arose due to a reduction in our internal LTM note ratings and spreads in the Solvency II balance sheet. These changes reflected our interpretation at that time of Supervisory Statement SS3/17.

Second, as you're aware, we successfully raised £230 million of Tier 3 debt in February, and that improved our capital coverage ratio by 15%. In-force surplus over the period was £61 million, and this represents the gradual release of all the margins Solvency II requires you to hold, including risk margin and SCR, and allowing for half-year's amortization of transitionals.

The level of surplus generation in the first half of 2018 is slightly lower relative to 2017, and this is primarily due to a delay in moving PLACL onto an internal model, something which is not currently feasible in light of the uncertainty created by CP13/18. Please note this is a timing issue and is not a reduction in the total level of margins that are expected to emerge.

We expect underlying in-force surplus to resume its growth from this revised level, subject to the important caveat that it depends on the outcome of CP13/18. New business strain over the period, loaded for post-synergy cost levels, was £95 million. On £1.2 billion of new business premiums, that represents a strain of 8% of premium. This is higher than our previous mid-single-digit percentage of premium guidance.

And the reason for that increase in strain is due to the stronger reserving required by SS3/17. Despite this additional strain, we still expect a mid-teen IRR on shareholder capital deployed on that new business written during the first half of the year. In light of SS3/17, since June, we have reviewed our pricing of GIfL and DB business, as well as making changes to terms on our lifetime mortgages. These are reducing new business strain and improving returns on capital.

At this stage, it's not possible to predict with accuracy how new business returns will be impacted by CP13/18. However, based on our current understanding of the consultation, we expect new business to deliver attractive returns on shareholder capital. As we previously explained, ultimately, the amount of new business strain and that IRR is dependent on variables such as business mix, customer rates, the level of spreads on LTMs, and economic variables.

During 2018, there was £19 million of experience variances, which include the costs incurred in investing in our business and other non-recurring expenditure that Simon touched on earlier. The dividend and interest cost captures the final dividend paid in May, and also reflects the coupons that have been paid on our Tier 2 debt in that period. The full year of interest costs on all Tier 2 and Tier 3 debts are expected to be £40 million pre-tax.

Finally, there was a negative variance of £61 million from other items during the period. The largest single component of this was a negative economic variance of £49 million arising from our property exposure. This was driven by property prices being largely flat in the period and, hence, resulted in property prices at the 30th of June being around 2.5% lower than expected.

Now, £49 million may appear quite a lot of money to put aside for a relatively small variance such as this, in particular, when you bear in mind the low risk of actual NNEG shortfalls that I discussed earlier. Probably the best way to think about it is that the property price fluctuations in the first half have increased the time value of future NNEG shortfalls as opposed to any significant increase in the intrinsic value of future NNEG shortfalls.

Other (00:45:43-00:45:47) of £150 million of TMTP spread over the next three years. This acceleration is due to a revision to (00:45:55) may have picked up in our SFCR. It's been partly offset by net positive contribution from other variances.

Now, this chart shows the sensitivity of our capital position to the key risks that the balance sheet is exposed to. These sensitivities are all calculated using our current Solvency II approach. We've not attempted to second guess the impact of CP13/18. Also, of course, they make no allowance for any potential management actions to mitigate the impacts of the scenarios modeled.

(00:46:27) absorb falls in interest rates. A 50-basis-point fall from 30 June levels would have left (00:46:35-00:46:46) dampened to changes in risk-free rates after recalculation of TMTP. As before, to be clear, a 50-basis-point fall does not automatically trigger a recalculation of the transitionals, although it is a reference point, and the TMTP was last recalculated at the end of December.

On the other sensitivities, credit spread expansion is manageable in a Solvency II world and a 10% increase in LTM early redemptions would have a negligible effect on the ratio.

Our principal balance sheet risks otherwise remain property and longevity. Our exposure to property is, of course, related to our NNEG on lifetime mortgages. The stress we show here represents a 10% permanent fall below the assumed long-term trend for property prices, and assumes no subsequent recovery from that fall. This stress would've reduced the coverage ratio by 15 percentage points.

And as for longevity, the trends are still favorable. The latest CMI analysis shows that the rate of improvement has continued to fall. The 5% uniform increase in longevity shown here would represent a material surprise to the business given the credibility of our accumulated mortality IP. But again, this is a risk we could absorb should current trends dramatically reverse.

And with that, I'll hand back to Rodney for his concluding remarks.

## Rodney Malcolm Cook {BIO 14008420 <GO>}

Thank you, David. You might rest your voice for a minute because I suspect there'll be plenty of questions on capital. Right.

So, before turning to questions, let me conclude today's session. The board is very pleased with the results for the first half of 2018 as a record; sales up 64%, new business profit up 88%, and adjusted operating profit up 85%. Critically, the new business margin at 10.2%, and a range of new innovative solutions developed and launched through our HUB businesses in the first half.

Simon and David have walked you through in some detail our position and preparedness for CP13/18 outcomes. And before I close, I'd like to illustrate why we feel it would be appropriate to introduce any changes arising from the consultation over an extended period of time. We have resources set aside that provide for an immediate 28% fall in house prices with no recovery. And as David said, that is at 100% SCR. And in addition to that, we have further £671 million of surplus, obviously, to get to 142% of SCR.

Under these extreme stress scenarios, the cumulative realized shortfalls from our Just Retirement life company portfolio, over the future 10 years from now, are expected to be less than £70 million, suggesting that the levels of additional capital talked about in the CP may be disproportionate to the economic potential outcomes.

So, let me close with three key points. We have a highly attractive new business franchise and have already made changes to our pricing and product features that we believe will continue to deliver attractive returns to shareholders in the new world. Having already addressed new business, the consultation is primarily, for us, a back book issue.

We have a carefully underwritten mortgage portfolio, which, as you can plainly see, has performed exceptionally well and we are using prudent assumptions with respect to the future. Finally, we're taking a pragmatic approach and are preparing for a wide range of outcomes so that the board will be equipped towards the end of the year to make decisions that deliver the best outcome for our shareholders.

Our colleagues across the group remain committed to our purpose, which I should remind you, is to help people achieve a better later life. And we remain steadfast in delivering outstanding services to a wide range of both individual customers and, of course, our corporate clients.

So, now, I'll move to questions and I'll start here in the room and later turn to the webcast, which Steve is monitoring. So, first question back there. Have we got a microphone? If you could say your name for the benefit of the webcast, please.

## Q&A

### Q - Gordon Aitken {BIO 3846728 <GO>}

Yeah. Morning. It's Gordon Aitken, RBC. Three questions, please. First on equity release mortgages, you said you'd basically limited the supply to younger customers and those wanting higher loans to value, and you talked about your active dialogue with the PRA. What's the PRA say to that? And also, you very much implied at the start that the government is very keen on lifetime mortgages. So, what's the government saying about you limiting supply and I gather your peers are also doing the same?

Second on the No NEG risk, you've said the historic risk is about 1 – has been 1 in 1,000. The next 10 years, it sounds like 1 in 4,000. Solvency II obviously treats the risk already well inside 1 in 200. What is that, when and what? And what are that PRA's most prudent proposals? What does that equate to, 1 in what?

And finally, on annuity reserve releases, now Legal & General said that they would expect to release more in 2018 than they had done in 2017. Can you say the same? And in the 2017 numbers, you made a reserve addition on the lifetime mortgage book by bringing life expectancy forward, reduced it by a year. Do you need to do the same again this year? Thank you.

### A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Okay. Just to be clear, you said two questions, and that was three. But – so I will tackle the first one in terms of the PRA and the government. David, if you can handle the NNEG and I think we do have a view what the CP means in terms of what sort of economic stress, and if you wouldn't mind also doing the one about mortality experience and reserves.

So, just to be clear, the PRA has been seeking through an RFI from the industry and from us the impacts on our specific portfolios. So, obviously, up until the announcement of the CP, they didn't have all of the infinite detail of individual portfolios. How could they? So, we are providing that. So, we have provided them recently the expected NNEG experience on our own portfolio. Every company's portfolio, Gordon, by definition, will be different. So, I hope that they will take a careful regard for our own portfolio, which we've presented to you today.

As you can gather, we are not working in a non-existent theoretical world. We know exactly the 50,000 customers that we have mortgages with in Just Retirement. We are experts at longevity, so we have a very clear and fairly accurate view of what's going to happen over each of the next 10 years in terms of those redemptions.

And as David said, we have calculated that we expect £2.5 billion of redemptions and that – in that extreme scenario, a stress of 28% fall tomorrow and no inflation for the next 10 years, we would experience around £69 million of shortfalls. Can I just make clear, though, for everyone listening that a shortfall is not a loss to us. It is just not as achieving as higher yield on that asset as shareholders might have wished. And just to be clear, we will still achieve after the £69 million of shortfalls a return of just over 5%.

So, when David says that these are very attractive assets, I presented an extraordinarily extreme scenario, we, and I think on behalf of our shareholders, will not be disappointed to have achieved 5% return even under that scenario.

So, the House of Lords and the government are well-briefed on the challenges in later life, and up until now, they have been fully supportive of people accessing the value of their homes. So, we don't see why they would have changed their view on that. And the government, of course, is very closely concerned about the cost of care and the cost to the taxpayer of the increasing burden of the retired population.

So, we see the product is a critical one. I believe everyone in this room knows that life insurers and people who are matching long-term annuity liabilities are the obvious and the most appropriate provider of these mortgages because of the asset match.

So, David, can you speak about the NNEG and the mortality, please?

## A - David Louis Richardson {BIO 18045016 <GO>}

Yes. So, it is tricky to translate some of these scenarios into one-in-X-year-type events. Because, as I'm sure you know, Solvency II is meant to be calibrated to 1-in-200-year risk over a one-year time period. And as we've kind of demonstrated here, NNEG risk isn't a one-year time risk. It takes 20, 30 years for it to really fully materialize.

So, we need to be a little bit careful on that, which is why we showed those long-term graphs on slide 18, which kind of allows you to get the feel versus other benchmarks. And what you can see there is if you include our stand-alone property SCR, the equivalent stand-alone property stress in Moody's is – it's slightly stronger, but it's in the same ballpark and it's about AAA. Now, you can look at Moody's AAA risk of default as much as I can, it varies by term. And as I understand, it's kind of 20 years, well over 1 in 1,000. So, you're talking about very, very extreme events here.

With respect to annuity reserve releases and longevity reviews, we absolutely will be doing a full review of our longevity basis on all major product lines at the end of the year, lifetime mortgages and our GIfL and DB business. The underlying general trends continue to be very favorable, as you see with the CMI and you've commented on yourself. We just need to be a little bit careful translating that into our portfolio. And so at this stage, we haven't concluded that work, it'll be too early to kind of give you a definitive steer one way or the other on that.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Greig was next.

## Q - Greig Paterson

Hello. It's Greig Paterson, KBW. I've got about 10 questions, but let me ask three.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

I can't...

## Q - Greig Paterson

I've been sitting here trying to...

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

(00:59:00) couple down, Greig.

## Q - Greig Paterson

Yeah. So, the first one is you know there's a statement over some debate about going concern with the directors, et cetera. Would you just enlighten us what was going on there? And if, for some reason, the auditors decided to classify as an ongoing concern, what the implications would be of that?

Second thing is you mentioned Restricted Tier 1 debt, your capacity there now. Fitch's debt (00:59:26) obviously doesn't contribute to Fitch's ratings treated as (00:59:29) equities as positively. But if you issue any significant amount of debt, that (00:59:33) your fixed charge covers a drop into (00:59:35) BBB range and then you'll be put on a negative rating watch. So, my question is, we want to talk about around that whether you do actually have capacity to issue Restricted Tier 1 and maintain your credit rating.

And then the third question is this 10.3% (sic) [10.2%] (00:59:51) surprise on your upside versus consensus and my numbers on the margin. Am I correct in one of the reasons underlying that is that you've re-priced for SS03/17 (sic) [SS3/17] (01:00:04) but you haven't changed either the IFRS and in [ph] EG (01:00:11) assumptions or how that translates into the liability discount rate [ph] moving (01:00:16) factors. In other words, there's an accounting boost going through that?

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Well, can we pause there because that's three questions now? Unusually, Simon, they're all for you. So, just...

## A - Simon George Thomas {BIO 15219564 <GO>}

Thank you very much.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

So, firstly, be absolutely clear, there's no question about whether the company is on a going concern or not and Simon will clarify...

## A - Simon George Thomas {BIO 15219564 <GO>}

Yeah, Greig.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

...the statement. And RT1 issuance, Simon, and the margin of 10.2%, what does it include with respect to SS3/17?

## A - Simon George Thomas {BIO 15219564 <GO>}

Okay, Greig. Starting with the going concern, the first point to make is that the accounts are unqualified in relation to both the audits (01:00:52) and the going concern by SS (01:00:53). But clearly, as part of a going concern assessment, the directors have to make a consideration of any material uncertainties, and that's what you'll see in the back. And unsurprisingly, one of the material uncertainties we've got at the moment is around the CP and where it's going, and taking account of all of the projections that we can think of. The directors have concluded we're certainly a going concern and there's absolutely no question about us being able to pay our debts in the normal course of business, so that's that point.

The second point I'll go through is the margin point and it's interesting one on this. I think when I was trying to allude in the speech to the fact that the benefit this year that we've seen coming through has been particularly around the pricing side, and I think I've highlighted the DB in particular. And if you think about it, we're in a position whereby this market has really taken off, it really has. It's had a step change.

Ordinarily, Greig, if we've been sat here (01:01:50), the first half of any year was normally the sort of quietest part of the year. That's completely changed. And because of that, we've been able to selectively price looking for better IFRS returns but also better capital margin benefits coming through. And so, that's allowed us to pick and select a better range of DB schemes coming through. And we've been able to pick up some pricing there.

## Q - Greig Paterson

So, you haven't changed your IFRS expenses (01:02:15)?

## A - Simon George Thomas {BIO 15219564 <GO>}

No. No.

## Q - Greig Paterson

But yet, you've changed your pricing...

## A - Simon George Thomas {BIO 15219564 <GO>}

Yeah. We've gone in – we've been able to price, as we say, a little more positively towards that. Let's put it that way. Similarly, on the GIfL side, and I think we talked about this last year. On the GIfL side, we have a whole matrix of conditions on a matrix of sort of ages. And we've been able to target more selectively there, we've become more sophisticated and that certainly gave us a benefit as well.

On the mortgages, I think last year, I tried to guide you down a bit to sort of say, look, it could be an 8% margin coming through, starting with an 8% I think I said. And that was because we were concerned about competition coming into the mortgage space.

Frankly, the mortgage market, as you've seen in the chart, grew by another 32%. And that has, therefore, meant that the mortgage yields we'll be getting have come off a little but nowhere near as much as we first expected. And then finally, Greig, the other thing I'd flag is obviously putting through an extra sort of 60% more business, you get a bit of operational gearing as well in the expenses, but that's relatively small. And if...

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

RT1, please.

## A - Simon George Thomas {BIO 15219564 <GO>}

RT1. Now, Greig, on your question on that, that was to do with ratings, just repeat the question again. Sorry.

## Q - Greig Paterson

So, the fixed charge cover. So, Fitch's fixed charge cover, if you issue substantial amounts of RT1, it will drop into the double – the BBB (01:03:37) and my understanding from speaking to the (01:03:39) that would possibly trigger a negative outlook.

## A - Simon George Thomas {BIO 15219564 <GO>}

I'm not sure that's quite right. I think they actually don't classify it as standard debt in that respect. It's classified as equity.

## Q - Greig Paterson

Yeah. On the leverage ratio. But on the fixed charge cover, they do classify...

## A - Simon George Thomas {BIO 15219564 <GO>}

Well, clearly, Greig, in terms of sort of the overall characterizations of the capital measures we will take, we will consider exactly what each one of them will do. And I think as I went through the various things we've got in terms of the actions we could take, reinsurance will change things in terms of sort of the limits, of course, in terms of how you deal with that, particularly if you lose SCR by doing that.

Similarly, RT1 will have impacts, as you say, and we'll have to consider exactly what that does, perhaps to a credit rating. And, obviously, the Tier 2 will have an impact in itself, which is classified as pure debt. But that will be considered in the round, Greig, but at the moment, we don't know what figure we're targeting because the CP isn't there, yet.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

This lady here.

Thank you. Just follow-up on this Tier 2, page 20. (01:04:55), by the way, Goldman Sachs. Page 20, you mentioned that your Tier 2 and Tier 3 capacity is 39% or the SCR is 39%, so the capacity is actually 11%. And if we go back to the previous slide, you're mentioning £100 million Tier 2. So, what exactly your Tier 2 capacity especially if you are planning to have reinsurance?

## A - Simon George Thomas {BIO 15219564 <GO>}

As I said – sorry, (01:05:28).

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Yeah. Sure.

## A - Simon George Thomas {BIO 15219564 <GO>}

As I said, it will really depend on exactly how the CP lands and exactly how much reinsurance we decide to go for. I think in the discussion that we had earlier, I was flagging that from the perspective of reinsurance, we have been pleasantly surprised – let's put it that way – with the interest that we've seen. And whilst I can't go into any details, but there are a number of reinsurers who are interested here.

And I would say to you that clearly, the pricing of that will dictate exactly how the reinsurer looks at this particular aspect. And the pricing of that will also dictate exactly the impact on R Tier 1 effectively because unfortunately, as I said before, that doesn't come for free. So, you'll have to give away some value. And it's thinking about the balance between the capital strain that you're taking for that and the cost that you're taking, the capital benefit insurers (01:06:28) that you're getting against the cost itself in the first place.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

But just to be clear, when you do reinsurance like this, you will release into available equity a sum, which can be deployed against the remainder of your business if that makes sense. So, the reason why we can't be specific on what amount of Tier 2 you can have is what will be the remaining solvency capital requirement. So, your Tier 2 and Tier 3 capital is limited to 50% of your solvency capital requirement. But as Simon said, if at the same time you were to recall the PLACL debt, which is £100 million, then there's potential to have a market-sized issuance.

And then, this one and then Andrew.

## Q - Marcus Barnard {BIO 2103471 <GO>}

Marcus Barnard from Numis. Could you share with us any insights you've got about the deferment rate? Because this is something I certainly haven't heard of more than six months ago, and it seems a rather arbitrary rate that's come out of this consultation paper, and it seems to be something that is having a material impact on your capital. I think any help in explaining this in this forum would probably help all of us. Sorry to put you on the spot.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

So, just a couple of opening comments. Obviously, the option pricing theory is more focused on equity markets, and it's usually focused on deep and liquid markets. There are not deep and liquid markets for lifetime mortgages. And as far as I know, there's no market for deferred purchase of people's homes.

Just to be clear in option pricing, the dividends that are paid are an important aspect. And as you know, if you pay a dividend from a company, it has an impact on its value when the dividend leaves the company. Our observation is that in properties, whether you pay rent or not pay rent, has no impact on the value of the property at sale.

So, there are quite a number of concepts, all being (01:08:59) on top of one another as we're trying to – someone is trying to apply a theoretical approach from, one, a set of financial instruments to the mortgage market.

So, David, any further comment, where does 1% or 2% come from?

## A - David Louis Richardson {BIO 18045016 <GO>}

I'm not going to comment on the derivation of those. But the concept that underlies them is that somebody would pay less than current market value for a property which they can't take ownership for a period of time. So, if you've got a one-year waiting period before you get a property and the deferment rate is 1%, it means you're paying 99% of the current market value today for that right, which is, as you just can hear as we start to describe that, is a tricky concept to get your head around when it comes to residential properties.

So, look, it's one of the areas that we will feed into for the consultation. I think there are a number ways of (01:10:08) skinning the cat, I think, to try and get to the types of outcomes that maybe the PRA are trying to achieve. But we just need to be very careful how they're applied so you don't get the counterintuitive and procyclical outcomes that I described earlier.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Andrew?

## Q - Andrew J. Crean {BIO 16513202 <GO>}

Good morning. It's Andrew Crean from Autonomous. Three questions, if I can. I think you got £1.8 billion of TMTPs. Could you tell us how much of those are related to actually release mortgages and therefore at risk for being amortized over 3 years as opposed to 13.5 years?

Secondly, your evaluation of the impact of the now NNEG was done – you chose 10 years out; whereas, I think being much more interesting and instructive if you told us over a lifetime of the mortgage, because obviously, the NNEG rolls up each year. And taking an arbitrary 10-year point, it doesn't really give you a flavor of the reality.

And then thirdly, I wanted to talk to you a little bit about your sales outlook because at the one hand, you're talking about very exciting industry outlook. On the other, you're talking about limiting the amount of sales you're doing because of the balance sheet and the capital. And notwithstanding the auditor's report saying there's a significant doubt about the group's ability to continue is a going concern, whether that will have an impact on some of the employee benefit consultants in terms of giving you BPA (01:11:40) business.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

So, let me just cover off the word doubt. That is an auditing and accounting statutory set of words. And that is why it is in there. I'll ask David to do any comment on £1.8 billion of TMTP. The critical one though, Andrew, is you immediately turned to a three year glide path. And the reason we don't have any specific guidance to give you is we don't know whether three years is the final answer.

In terms – can I just pick up the NNEG and why did we choose 10 years? Well, 10 years is a nice round number. Let's be absolutely clear. I said that whatever the new rules are, our business will comply with those. The transitional will disappear in 13 years. So, if you had asked me why didn't I produce 13 years' worth of NNEG figures, I think that, that would be a valid pushback. We picked 10 because it was – it sounded less arbitrary. But to be clear, the 20 years that you asked for, forgive me, is not relevant because we will be committed one way or another to be fully compliant with whatever the regulator requires. So, at the end of the glide path period, be it three years 10 years, 13 years, it wouldn't go past 13 years because as you know that's the remaining period of the transitional.

So, going back to what I said, we've adopted and adapted for our new business. We are focused on the business we wrote between 2005 and 2015. And as you know, we wrote all of that business under the rules and compliant with our regulators' requirements in each and every one of those years. So, that is why the reason for presenting the 10 years is to share – and we've shared the numbers with the PRA, is to say is there something special about three years because very clearly to us 10 years wouldn't pose any risk to customers over that period. So, that is why we chose 10.

David, any comment on the £1.8 billion?

## A - David Louis Richardson {BIO 18045016 <GO>}

So, we don't have that split at hand, Andrew, how much of it just relates to LTMs. But it will be a misleading number anyway because CP13/18 is not about wiping out all the TMTP. It is about moderating the amount of matching adjustment. And if you roll it back into Solvency I, it would also moderate the amount of liquidity premium there, and there would be some reduction in TMTP. But it's not talking about eradication of TMTP. There would still be some liquidity premium in the old (01:14:52) Solvency II world that you would glide path from.

So, we don't have that figure here. Rodney has made a point about 10 years. It was a round number. It was shown that a reasonable glide path, longer than three years, is entirely sustainable and would seem appropriate. But I just looked it up here, if you were to take the central projection and extend it from 10 years to 15 years, the £1 million of expected shortfall becomes £2 million. So, it doesn't suddenly leap up.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Simon, will you cover the important point Andrew is making about the impact on our business if we slowed sales significantly?

## A - Simon George Thomas {BIO 15219564 <GO>}

Yeah, Andrew, I mean, I think, frankly the direction where we're giving you there was the fact that I didn't want people to double what we did in the first half putting it, bluntly unless expectations are obviously quite a bit lower than that in terms of doubling it. And what we're indicating here is that we're well ahead of our plan. And the second half of the year, clearly the pricing changes that we've put through which we've talked about, and indeed the pricing changes that we're putting through at the moment will likely lead to a slowing up of the new business volumes coming through, but obviously we'll have a pick-up in the margin as well.

Just to flag though, we put pricing changes through just after the start of July on the individual business, and also we've done it again in August. Directionally, what I'll say to you is that the market has reacted what I would describe as economically in terms of they have responded as well. And I think people are starting to recognize that CP direction is going this way and therefore we need to take on great amounts of an allowance for the fact we've got extra capital behind it.

Similarly on the DB side, we have also looked on individual schemes to price, and price a little bit more aggressively in terms of beneficial to our side, and that, again, has meant that we've also taken on new business slightly with better margins. However, just to pull you back on one thing, the mortgage side, we have reshaped the mortgages, and have taken away what I would describe some of the longer duration mortgages.

So, we're changing the shape. So, we are removing some of the younger ages in terms of our competitive position on younger ages, our competitive position on joint lines which is basically shortening the duration of the mortgages. And in doing so, we've got less of an IFRS pickup on those compared to the ones we may have written in the first half. So, net-net, I think those two broadly net off in terms of the GIfL changes, the DB changes, and the mortgage changes. So, that's where we're going.



## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Oliver?

## Q - Oliver Steel {BIO 6068696 <GO>}

Good morning. Oliver Steel, Deutsche Bank. So, three questions. First is, if UK residential property prices remain unchanged in the second half, is that another £50 million off the Solvency (01:17:54) and so on?

Secondly, in relation to reinsurance, I mean, the calculation I've done is still if you manage to reduce your SCR by 20% from reinsurance, which sounds a pretty tall order, then actually you have no Tier 2 or Tier 3 debt capacity. So, is that approximately the right sort of calculation, or is there some wrinkle there which we should be aware of?

And then the third question is so you've restated your calculation of strain to take into account SS3/17, which to my understanding is that that was the forerunner of CP13/18. I think I read somewhere that you have not taken into account any CP13/18 numbers into your solvency calculation. But I'm just wondering if you can sort of clarify exactly what's happening there. Are you using exactly the same numbers and assumptions in both your strain and your solvency numbers?



## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Right. So, David, if you do what happens with flat UK property every half year and the view thereafter. Just to explain the reinsurance, we are thinking here not of more longevity swaps. This is about reinsuring the whole portfolio and releasing the surplus capital that's held against that portfolio. So reinsuring a whole portfolio and that, that will create equity that then is available for the rest of the group and that – from itself. And then that would also assist with any capital actions at all when they have built on top of the lower SCR.

Just to be clear, in any three-year, five-year forward period, your SCR is growing. So we didn't say to you that the Tier 2 availability is tomorrow. So, as the SCR grows over the next so many years, there are points during that forward projection when there is Tier 2 capacity. So that's the critical one on that. And importantly, Greig asked me the same question earlier, CP stands obviously for consultation paper. The CP13/18 is to clarify the Supervisory Statement 3/17. So, it's on the same topic. It's been extended, clearly, because on the 2nd of July, it started talking about back book more explicitly than if you look back to July of 2017.

So, Simon, can you do the strain on that, but David first, what happens in the next six months, the flat property?

## A - David Louis Richardson {BIO 18045016 <GO>}

Yes. So, the sensitivities kind of allow you to scale adjustments as you see. So, if we had 0% growth over the second half of the year, that'd be a variance of about 2.1%. So, you can just apply that to the sensitivity provided there.

On the strain number that we show in the Solvency II waterfall, the new business has been strained, has been measured using the principles of SS3/17, which are the same as CP13/18, with the volatility of 12% and a deferment rate of 0.5% and that is the basis that we are currently applying in our balance sheet. So it is consistent with our current balance sheet, 12%, 0.5%.

## Q - Oliver Steel {BIO 6068696 <GO>}

(01:21:58)

## A - David Louis Richardson {BIO 18045016 <GO>}

Solvency II balance sheet, it's all Solvency II, the whole - SS3/17 is only impacting that.

## A - Simon George Thomas {BIO 15219564 <GO>}

Let's be clear, Oliver, as well. The pricing changes that we put through in, obviously, July and August and the changing to the shape of the mortgages...

## Q - Oliver Steel {BIO 6068696 <GO>}

(01:22:16).

## A - Simon George Thomas {BIO 15219564 <GO>}

...will obviously change that strain figure going forward, be beneficial to us, strain figure going forward.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Alan?

## Q - Alan Devlin {BIO 5936254 <GO>}

Thanks. Alan Devlin of Barclays. A couple of questions. Just as a follow up on your last comment on the new business (01:22:35) going forward, given the change in annuity pricing and the shape of the LTMs, where should we expect that minus, I think, 8% strain to go to in H2 given the minus 0.5% deferment rate?

And then just secondly on the - you've talked a lot about the reinsurance options. That was the first capital lever you've talked about. How material could that be? You've already reinsured 75% of your longevity, but how material could the total reinsure in the back book be and how much benefit could that potentially give to you, and could that answer a lot of your capital problems? Thanks.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

So, David, do you want to take the second one? What's the first (01:23:15) question for - I was just checking on the webcast because there is a question Steve (01:23:19) wants to ask in one second. So, if we just address these two.

## A - David Louis Richardson {BIO 18045016 <GO>}

So, yeah, in terms of new business strain looking forward, we're not giving specific guidance today because clearly we've just been pushing through this pricing change in the last few weeks. There is a lead time to see how that's going to play out, and ultimately it's going to depend on CP13/18 and where that lands. But what we are doing is focusing on reducing the new business capital strain and increasing the return on shareholder capital.

So, I would maybe manage down expectations for the second half of the year because if you make a change to pricing in July or August, that's really going to start impacting sales in September or October. So, it's going to be a gradual change. We'll be able to see how the market reacts as well.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Because there's a good flow of applications in (01:24:11) the last two weeks which are all on the new pricing basis. So, it hasn't stopped (01:24:17).

## A - David Louis Richardson {BIO 18045016 <GO>}

No.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Was there a second part to that for Simon?

## A - Simon George Thomas {BIO 15219564 <GO>}

I think, Alan, you're asking about sort of the materiality potential of the reinsurance contracts, that's right. I can't give you any figures, Alan, but the sort of organizations we're dealing with are serious organizations and there are a number of them. And they will only be interested in something that's reasonably material. Let's put it that way.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

So, just to be clear, they will remove the solvency capital requirement attached to all of the assets, and the remainder 25% of any unreinsured (01:24:55) life proportion. So, effectively, apart from some collateral capital that we might held against the reinsurer risk which I think you would understand, then the SCR would disappear. Status, (01:25:10), because we're getting close to conclusion, is there a webcast question?

(01:25:14) Thank you to all those on the webcast that have asked questions. I think a number of them have been answered but there's a couple on pricing which may be worth answering. So, from Abid at Credit Suisse. He's asked there, wouldn't the (01:25:27) the new business margin remain unchanged once you implement the final CP13/18 rules, i.e., can you increase pricing to offset the high cost of capital?

And then a related one which is when did you reprice the LTM offerings in response to CP13/18 and how much impact will this make in H2 margins, and how about the providers also re-priced?

Okay. So, Simon, I think you have answered the question. We didn't alter the prices for lifetime mortgages. We have altered the LTVs and the length of the portfolio. So, on one hand, that has a reduction in the IFRS margin. However, that is offset by the fact that we're potentially moderating the volumes we're seeking in the second half which allows us to get higher margin per case.

His other question about pricing, we have already put through more than one pricing increase. Just to be absolutely clear, we are not happy that we're increasing prices for annuity customers and DB schemes in the UK. But when you are required to hold greater amounts of capital against that risk, we need to deliver an appropriate return on that capital for shareholders and that the customers were, therefore, in the future will pay for that.

The real benefit of the risk selection and the higher margin is that, that reduces the commensurate amount of capital as well. So, higher margin, lower capital requirement gives a higher return on that capital.

David, is there any clarifying point you want to make on that?

## A - David Louis Richardson {BIO 18045016 <GO>}

I think that captures the key drivers.

## A - Rodney Malcolm Cook {BIO 14008420 <GO>}

Well, ladies and gentlemen, it's 11:00, we've passed our time for our next set of media interviews which I'm very much looking forward to. Thank you again for your time today. And if I can just remind everyone, these were the best sets of financial results in the entire corporate history of our company.