Y 2018 Earnings Call

FINAL

Bloomberg Transcript

Company Participants

- David Richardson, Group Deputy Chief Executive Officer & Interim Chief Financial Officer
- Rodney Cook, Group Chief Executive Officer

Other Participants

- Andrew Crean, Analyst
- Ashik Musaddi, Analyst
- Barrie Cornes, Analyst
- Gordon Aitken, Analyst
- Greig Paterson, Analyst
- Oliver Steel, Analyst
- Unidentified Participant

Presentation

Rodney Cook {BIO 14008420 <GO>}

Good morning, everyone. I'm Rodney Cook, CEO of Just Group PLC. I'm joined this morning by David Richardson, our Deputy CEO and the Interim CFO. 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 do appreciate your interest.

I'll start as usual by giving you a brief update on how we see the business and then talk about the capital actions that we've announced this morning. As well of course thinking on our dividends. David will then go through the numbers in more detail and talk about our capital position post these capital actions and before I come back with some concluding remarks.

So moving to the highlights. 15% growth in retirement income sales and 11.2% new business margin, incredible results. Sales growth is an excellent outcome for our group, given some of the external factors you know only too well in the second half of the last year. It is the strength of our new business franchise that you see. What's even more pleasing, of course, is the 11.2% new business margin, which is over three times the pro forma margin before the merger in 2015, reflecting our continued pricing discipline and cost control. Combination of an excellent sales performance and continued focus on margin has helped us to deliver 44% increase in new business profit and underlying operating profit up 31%. The markets we have chosen to compete in remain highly attractive and importantly, they're providing the growth that enables us to price more selectively and to achieve attractive mid-teens returns on new business shareholder capital deployed.

Following the completion of the merger, we have now in 2018 aligned all of the differing demographic assumptions between the two legacy companies. We've also updated our mortality assumptions. However, in response to clear economic uncertainty largely driven by Brexit, we have also made changes to some of our property assumptions, and that has increased our provisions and therefore, negatively impacted on our IFRS results.

David will take you through these shortly in detail, but the assumptions and, of course, the impact that, that will have flowing through to the new business margin that we recognized in 2019 and onwards. I'll outline our capital raising plans announced today in a bit more detail, but can I pause and say we are absolutely delighted to be able to take such a decisive step to improve our capital strength. We have thought long and hard on how to do this in the most shareholder-friendly way. Given the extensive feedback we have received from our major shareholders, we judge strengthening the group's balance sheet is a very important step in supporting the value creation for them, our owners.

And finally, our embedded value per share did drop a little, but is still GBP2.06 per share and our tangible IFRS net asset value at GBP1.60 before the dilution from the additional share placement. Okay. So just quickly on the markets, I think you know them only too well the three major markets we operate in continue to offer excellent growth potential. I want to reinforce our strategy is about growing profit, not growing headline sales, and David will give you an indication on how to see sales progressing from 2019 onwards. Those markets had clear strong growth, as you can see. And as I mentioned that enable us to be even more selective and pick the most attractive risks, utilizing our intellectual property.

Starting with DB, enjoying a period of very rapid growth. We haven't seen the final results published for 2018, but estimate it'd be a record year of GBP21 billion, up by quite some margin. Expectations for this year even higher. Towers Watson indicating perhaps GBP30 billion. And of course, these numbers are still lower than the Hymans Robertson's potential of GBP50 billion per annum over time, given that they see there would be GBP700 billion of derisking opportunities to come in the medium term.

Typically, we focus on the market at GBP200 million, GBP250 million or less. During the first half of 2018, which is the most recent figures available to us, we were actually the leader in that segment of the DB market. Lifetime mortgages, the next chart, clearly, very strong growth, 28%. We grew at a lower rate than that, somewhere around 18% as we sought to track more closely to our growth in retirement income sales. However, this is a category that we still remain very positive about. We recently launched a complete new suite of lifetime mortgage products, which enable customers to also make interest payments.

And going forward, they are much more capital less intensive, which as you would understand is a critical point. Third chart, guaranteed income for life or GIfL. This is still a core offering for us. Growth in our available market is supported by increased shopping around and recently announced FCA rules, which will come into effect later in the year should further bolster that shopping around. The last few weeks, we've launched an exciting new fintech solution for financial advisers in this space provided on investment platforms, it's called Secure Lifetime Income. It will enable GIfL products to be used within a self-invested personal pension or SIP. This is a market-first in the UK and it should help further grow our addressable market for retail guaranteed income.

So I put it to you and I put it to current and prospective shareholders that these favorable prospects for our markets warrant investor support, which we are clearly seeking today.

Now to the capital actions. We have announced alongside our results an underwritten debt offering of GBP300 million and an underwritten placing of no more than 9.99% of existing share capital, so the proceeds will be dependent on the clearing price. You'll see in the formal announcement that I intend to support the equity placement up to my allowable percentage, indicating my strong confidence in the business going forward. As I mentioned earlier, the Board thought long and hard about the appropriate level and mix of actions since the announcement of the PRA's policy statement on the 10th of December with respect to equity release mortgages.

In doing so, it is absolutely sought to minimize the amount of equity sought, but also, importantly, to balance the interest of all stakeholders, that's shareholders, bondholders, customers and regulators, in deciding upon this set of actions, which will enable the group to maintain its clear focus. As you know, that focus is to grow sustainable profits. And I stress the word sustainable, sustainable profits by using our successful new business franchise to capture opportunities in the attractive growth markets that we participate in. At the same time us maintaining a stronger solvency capital position. So we have selected these actions in order to optimize our cost of capital, maintain what we believe to be an appropriate leverage for a growing business and also to support the group's A+ Insurer Financial Strength rating from Fitch.

As you can see from the chart on the right-hand side of this slide, the package today takes our pro forma ratio at the end of 2018 from 136% to around 160%, depending on the final results this afternoon.

Going forward, we will still have further capital flexibility, an important question. It is true that today's debt offering uses up a fair proportion of our restricted Tier 1 capacity, not all of it, but a fair proportion. But of course, as we grow, that capacity will also grow as a source of funds in future. We also have further Tier 2 capacity available to us at the moment. And in 2020, we do have a whole period for our partnership insurance GBP100 million bond. It is clearly an important priority for our Board that we set an appropriate dividend policy going forward. And as you all will have seen from the announcement, we have decided -- sorry, we did decide to defer the 2018 interim dividend due to the uncertainty last year around the potential outcomes of the PRA consultation.

The Board has taken into consideration feedback from our shareholders, which we've received extensive feedback on this matter. And importantly, given the capital actions that we announced today, the Board does not consider it appropriate to pay a final dividend for 2018. The Board's current expectation is to recommence dividend payments during this 2019 financial year, but at a lower rebased level. The dividend is expected to be approximately one-third of the total dividend paid in the 2017 financial year, subject naturally to economic and capital conditions applying.

So I'd like to now pass over to David, so that he can take you through all of the numbers in detail before I come back to conclude.

David Richardson {BIO 18045016 <GO>}

Great. Thanks. Okay. Good. First of all, thank you, Rodney, and good morning, everybody. And I'll now take you through the IFRS results and then onto a discussion on policy statement 31/18, before going through the Solvency II balance sheet. So let's start with the summary IFRS results. The underlying operating profit grew by 31%, driven by the 44% increase in new business profit. This is an excellent operating performance for the business as Rodney mentioned.

I'll go into more detail on the new business profit margins in a moment, so first let's look at the other numbers on the slide. The in-force operating profit of GBP72 million was a shade higher than in 2017. This was in line with the run rate that we saw in the first half of this year and represents a 44 basis point margin on the opening reserves. Operating variances and assumption changes show a negative result of GBP34 million. In contrast, there was a positive number in this line last year, so this is the main reason for the 5% decline in adjusted operating profit.

Now you'll remember that we talked in the past about how we would expect these movements to even out in the long run. Indeed, the 2017 number was equal in size, but opposite in size to what we've seen this year. Embedded in this line is the impact of a comprehensive review of our longevity assumptions, including completion of the exercise of integrating the intellectual property from the legacy Just Retirement and Partnership businesses. Following this comprehensive review, a number of changes were made, which included our industry-leading tool for pricing and reserving new business, PrognoSys, has been recalibrated using the combined post-merger mortality dataset.

Mortality initial improvement rate has been updated to CMI 2017, which reduces them in the short term, although our longer-term rates of improvement for males and females have been marginally increased. Improvement rates have also been harmonized across all retirement income lines and lifetime mortgage. And finally, the structure of our other legacy GIfL bases as of predating PrognoSys have been developed to align better with experience. And that includes the modification on the runoff of excess mortality for medically underwritten lives.

Overall, the net effect of mortality assumption changes has been broadly neutral. The key message is that our aggregate valuation of the business has remained relatively stable in respect to mortality assumptions. And critically, customers continue to benefit from our cutting edge IP. After mortality, the principal other demographic assumption for Just is in respective voluntary redemption rates for lifetime mortgage business.

The JRL LTM book has shown higher rates of voluntary redemption than expected albeit from very low base actual numbers. We have increased our assumptions regarding these future voluntary redemption rates slightly, leading to a shorter projected long durations and therefore, a charge of just over GBP30 million. Next, the increased development costs were flagged last year and mainly relate to our investment in our innovative secure lifetime income solution for investment platforms that Rodney just mentioned as well as a new range of interservice mortgages, which was launched in the market in January of this year.

The increase in our reinsurance of finance costs is due to our Tier 3 bond, which was issued in February of 2018. And so with that, let's look at our sales in a little bit more detail. Retirement income sales growth for 2018 was a very healthy 15%, driven by an excellent performance from our defined benefit derisking business. And as you know, I have a personal stake in the DB story, and I'm really proud of the team's success, including just two weeks ago being recognized at the Pensions Age Awards as the Risk Management Provider of the Year in the DB derisking market, a really great recognition for the brand and reputation we're building up in the DB market.

Now this market has some very exciting long-term growth characteristics and 2018 was a record year. The prospects look very bright as scheme funding improves and employee benefit consultants work harder -- to take trustees and sponsors along the derisking journey. Our DB sales were up 32% for the year and was noticeable that the spike in sales in the fourth quarter, which has been a feature in the market in the past did not occur this year. Indeed, the final quarter saw a slight slowdown in transactions as we and many others in the market were increasingly selective in the business we transacted.

Now the market will always be lumpy, given the relatively small number of high-value transactions compared to our retail business, but our focus as before is on relatively smaller transactions up to around GBP250 million or so, where our ALM works best. It also means that our flows should be somewhat less lumpy than firms targeting large-value transactions. In terms of current trading, although we expect relatively few quarter one completions in our target segment, the pipeline remains very well stocked with multiple potential transactions of various sizes in our target segments.

With respect to GIfL, the market as a whole fell a little, but importantly for us, the open market continues to gain traction with overall open market sales up by just over 2%. Now as you mentioned back in September, we put through a number of price increases in response to CP13/18. Whilst the market follows to some extent, we chose to give up market share in the last four months of the year. In 2019, we expect the GIfL sales will contract further as we put our capital to work selectively.

Our lifetime mortgages advantages -- excuse me, our lifetime mortgage advances grew by 18%, in line with the growth in retirement to income sales. This was supported by an excellent growth in the overall LTM market, which was up 29% in 2018. Going forward, we should continue to see sales volumes of LTMs move broadly in line with retirement income sales. And in addition, we continue to change the shape of our new LTMs with slightly lower LTVs, so loan-to-value ratios, and slightly shorter durations, which both help to reduce the capital consumption under the new capital rules.

Next, let's turn to new business margins. First of all, given all that's going on in the background over the second half of 2018, we're proud of how new business profit has progressed. Retirement income sales growth of 15% combined with margin expansion generated that 44% growth in new business profits to GBP244 million. This disciplined growth strategy has produced a margin of 11.2%, a 2.2 percentage increase for the second year in a row.

We already discussed a number of the reasons behind this increase. Just to recap on those, first of all, pricing for DB was attractive and it continue that way. Secondly, mortgage spreads have remained healthy; and thirdly, we benefited from operating leverage on the cost base due to the strong sales growth. These trends continued in the second half and they were supplemented by the measures we put in place to offset the increased capital requirements that came about as a result of the Consultation Paper.

The most important of these price increases was in the GIfL business, although there were some in the DB market as well. The level of capital that we needed for new business went up as a result of the CP, and I'll explore that in more detail in the capital slides. The good news is that the pricing increases we pushed through meant that we continued to deliver mid-teen IRRs on shareholder capital invested in new business.

Now Rodney has already signposted that we made some important changes to our IFRS assumptions as at year-end 2018. These will have an impact on new business profit next year in 2019. The figures you see here use the opening 2018 assumptions. Like-for-like margins will be lower in 2019 because of the assumption changes. I'll talk more about it later. But in a nutshell, given the macroeconomic outlook, we judge it was appropriate to make changes to the IFRS property assumptions.

We've reduced our house price inflation assumption from 4.25% to 3.8% and increased the assumed volatility around this trend from 12% to 13%. These moves together will reduce new business margins by about 1% in 2019. Furthermore, and as I discussed in the previous slide, we are taking measures to reduce the capital strain that new business generates in light of the new capital requirements for LTMs. So first of all, we expect the LTM backing ratio for new business to drop by a couple of percentage points. And also, we are reducing the duration of our LTMs too. Taken together, this will reduce the new business margin by at least another percentage point.

So if you're thinking about how 2019 may develop, using actually the 9% margin we reported in 2017 feels about right. And in terms of volumes, the pattern of sales that we had in the second half of 2018 after the CP was published is more likely to be representative of 2019 than what you thought in the first half of 2018. And finally, as you think about how our profit develops in the future, don't forget to allow for the extra interest cost from the RT1 debt that we launched today.

So next, I'll move to non-operational items. There is a little bit more than usual this year, particularly on the investment and economic line. But first of all, nonrecurring project expenditure of GBP20 million was up from GBP12 million last year. The largest part of this is costs relating to the Tier 3 issued debt in February and the cost of exploring a range of capital options that we looked at when the CP was published in July. Additionally though, there have been the completion of our GDPR implementation, preparation ongoing for IFRS 17, development work on new markets and IT migration activity.

However, the main feature below the operational line is investment and economic losses, which made a negative contribution of GBP252 million. I've drawn this out in more detail in the mini-table on the right. The two big moves are related and both are as the results of us changing our long-term property assumptions, which are the key inputs into the valuation of no negative equity guarantee risk. Every year, we carefully review all the key assumptions, which underpin our IFRS balance sheet. And this year, in light of the macroeconomic and financial uncertainty caused by Brexit, we paid particular attention to our property assumptions.

We felt it prudent to strengthen these assumptions at this point in time. So as I said before, we've reduced our long-term house price growth assumption for our portfolio from 4.25% per annum to 3.8% per annum and increased the assumed rate of volatility around this trajectory from 12% to 13%. Taken together, these had an impact of GBP211 million. Now we want to be clear that no money is leaving the business as a result of these changes. What we are doing is setting aside more money for potential net costs should they arise in the future.

And also, for the avoidance of that, these assumption changes are not linked to the Solvency II Consultation Paper. A final line, the cost of the amortization of intangible assets is flat over the year. So we've already referenced it several times. Let's take a little time to talk about CP13/18, which eventually became PS 31/18 on December 10th last year. So the most important outcome for Just was on the treatment of the pre-Solvency II business. By keeping full TMTP allowances for pre-Solvency II business, the PRA decided that it was not appropriate to change the treatment of LTMs written under full compliance with the Solvency I rates that applied at that time.

Now as I'm sure most of you are fully aware, the PS stipulated that in relation to the treatment of lifetime mortgages, firms must meet an effective value test for EVT, as I'll refer to, using a 13% volatility rate and 0% deferment rate by the end of 2019. And that the deferment rate should increase to 1% by year-end 2021. So what are we doing? Well, we've complied with the test using the parameters that are stipulated for end 2019, a year early in 2018 and we've gone a little bit further than the minimum.

We are already meeting a test equivalent to a 13% volatility rate and a 0.3% deferment rate. Now this has the same overall outcome on the balance sheet as using 12% volume and 0.5% deferment rate, which is what we used at the end of last year, but it complies fully with the 29 stipulation on volatility. And, as I said, is more conservative than the minimum requirement on the deferment rate. We will complete the move to 1% deferment rate in stages over the next three years.

So what the policy statement has done has removed the big uncertainty, but there is some ongoing consultation, which will cover how the parameters of this new test are reset and how that test, the EVT test, will apply in stress scenarios. We are supportive of resolving both of these issues as quickly as possible. So with that introduction, I'll look at our Solvency II balance sheet. So our Solvency II capital coverage ratio on a regulatory basis was 144% as at year-end '18. This benefited from favorable market movements over calendar year '18. So if you allow for a notional TMTP recalculation, our underlying Solvency II capital coverage ratio was down slightly compared to 2017 year-end at 136%.

Now if you take into account the capital actions, which we're announcing today, then this rises to 160% as Rodney mentioned earlier. I'll take you through the moving parts of that in the next slide. But I'd like to draw your attention to the economic capital ratio at the end of the year, which was 256%. It's worth remembering that this is calibrated to a one in 200-year risk events. It is much higher than our Solvency II capital ratio as it reflects our true economic view. It does not contain the more onerous elements of Solvency II such as the risk margin. This new effective value test or inefficiencies introduced by the structuring required to make LTMs eligible for matching adjustment treatment under Solvency II.

And again, with capital actions announced today, that would rise on a pro forma basis to 290%. The gap between economic and Solvency II capital ratios widened once again during the second half of 2018 and don't be surprised if the gap continues to increase as we layer on more business under the Solvency II rules. On the right-hand slide, we show how the own funds is made up of different buckets. So after today's capital actions, we have used up the majority of our GBP400 million of RT1 headroom, but we still have around GBP200 million of Tier 2 capacity.

So let's move onto the next slide, where I can take you through the change in the Solvency II surplus during the year. A lot of detail here, but hopefully it will be helpful for you in projecting this forward as well. First thing to say, by the way, is all these numbers are net of tax that are after-tax figures. So first of all, our year-end surplus at 2017 was GBP596 million, a coverage ratio of 139%. Second, as you will recall, we successfully raised GBP230 million of Tier 3 debt in February. And that improved our capital coverage ratio by around 15%. This year, we decided to split out the TMTP amortization from the in-force surplus, so it helps you get a better idea of the underlying capital generation and the growth in our in-force book. The in-force surplus of GBP256 million represents the gradual release of all the prudent margins Solvency II requires you to hold, including risk margin and the release of SCR. The amortization of transitionals comprises two numbers. The normal TMTP amortization over 16 years from the beginning of 2016, which is GBP131 million; and then a voluntary accelerated amortization of GBP150 million, that's a pretax number, of TMTP over the next three years.

Note that at the half year, we have this in the other block, but we've now split it out to help you build your capital forecast. The accelerated amortization was GBP58 million post-tax in 2018 and will fall to around GBP40 million this year and GBP25 million next year, so 2020 before disappearing. New business strain over the period was GBP160 million, on GBP2.2 billion of new business premiums, that represents a strain of 7.4% premium. This is at the upper end of our previous mid-single-digit percentage of premium guidance. To help understand this, we have again split it out between half-one and half-two new business strain to show that it was lower in the second half at around 6.5% than the elevated level of 8% that we saw in the first half of the year.

Remember that the increase in strain that we saw in the first half was due to the stronger reserving required by SS3/17, which came into force before our subsequent pricing increases had come through and taken effect. Now as those price increases came through in the second half of 2018, the strain has come down. Going forward, as the pricing changes take full effect and some of the product design characteristics change, we expect that the strain will be back to mid-single-digit levels for 2019 and beyond.

During 2018, there were GBP45 million of expense variances, which includes costs incurred investing in our business and other non-recurring expenditure that I touched on earlier in the IFRS slides. The dividend and interest costs capture the final dividend paid in May and also reflects the coupons that have been made on our Tier 2 debt in the period. And then finally, there was a negative variance of GBP53 million from other items during the period. This includes a number of items, including the negative property variance of GBP49 million that we saw in the first half and highlighted then. There has been negligible property variance in the second half of the year.

And finally, as Rodney will actually talk about in a bit more detail shortly, we now expect excess own funds to increase organically following the full implementation of the policy statement at the end of 2021. So the key expected changes over the times that would lead to that outcome are the ongoing growth in the in-force surplus, which Rodney will touch on, completion of the voluntary TMTP acceleration and reducing new business strain. In fact, if it wasn't for having to implement the policy statement, then we should have achieved a growth in excess funds during 2020 as we previously indicated.

Finally from me, this chart shows the sensitivity of our capital position to key risks the balance sheet is exposed to. Unlike the previous chart, we thought we would show you these after the capital actions that we've announced today, although it still allows for the notional TMTP recalculation at year-end 2018. And for consistency, all figures in this slide allow for a notional TMTP recalculation. Also remember that these sensitivities make no allowance for any potential management actions to mitigate the impact of the scenarios modeled.

So first of all, just calling out the key features, we can absorb falls in interest rates. In fact, we have positioned the balance sheet on a PVR 1 [ph] basis, so that the effect on the coverage ratio is relatively insensitive to changes in risk-free rates after recalculation of TMTP. So you can see here that the 50 basis points fall as at 31st December, 2018, would have left the Solvency II pro forma coverage ratio around 4 percentage points lower. Excess own funds do not move because own funds in the SCR rise by similar amount. Credit spread expansion is manageable in the Solvency II world and a 10% increase in LTM early redemptions will have a negligible effect on the Solvency II coverage ratio.

So our principal balance sheet risks remain property and longevity. Our exposure to property risks, primarily rates, of course, are no negative equity guarantee on lifetime mortgages. The property stress, just to recap, represents a 10% permanent fall below the assumed long-term trend for property prices and assumes no subsequent recovery of that fall. The stress would have reduced Solvency II coverage ratio by 17 percentage points. If you compare it, that's an increase from last year and that's due to the additional sensitivity introduced to the regulatory balance sheet by PS 31/18.

And as for longevity, well, we've already talked about that. Suffice to say that given the work we've done here, a 5% uniform change in longevity would represent a material surprise to the business, given the credibility of our accumulated 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 Cook {BIO 14008420 <GO>}

Thanks, David. Let's look to the future outlook of the business. Let me say just for the avoidance of doubt that we are committed to achieving capital self-sufficiency, and discussions with shareholders indicate that, that is an important element. As a management team, we've identified the steps we plan to take to achieve that. These are shown on the left-hand of Slide 17. And on the right-hand side, you'll see the outcomes that we're targeting. Our aim is to reach this goal from 2022, which follows this full execution of our management actions in order to meet the expectations from the PRA's policy statement 31/18.

So quickly through the management actions. Firstly, to new business, we've been evolving the shape of the business we target in response to the PRA's announced changes. As David indicated, lifetime mortgages, we're seeking to lower capital strain by selecting slightly older customers. They, of course, have a shorter loan duration, and we are also targeting borrowers who would like a smaller loan relative to the value of their properties. We've also developed new products such as interest service mortgages, which clearly attract a different style of borrower, and capital utilization is lower.

Then on to expenses, we've implemented a number of business process optimization projects during last year. And we will continue on that cause in 2019, and those activities will deliver material efficiencies which will enable us to capture cost savings but also importantly, improve the efficiency in other parts of the business. So that when we grow, the costs will not be proportionate. We have actually proven our capabilities at good cost management through the GBP55 million in savings achieved from our merger integration.

Third item, management of no-negative equity guarantees, we are currently working with third parties to develop innovative solutions to hedge NNEG risks. And we will update you when we have a Solvency II effective solution. Investments, as David mentioned, we are reducing our LTM backing ratio for new retirement income business slightly. And also, as an alternative, sourcing different long-duration assets such as infrastructure. And we have increased our exposure to these new assets quite significantly over the last year.

We do importantly still view lifetime mortgages as an excellent asset to back annuity liabilities. Here, we're not alone. David rule from the PRA in his letter that a company -- the policy statement last December said, we continue to believe that restructured equity release mortgages are a suitable asset to back annuity as part of an appropriately diversified portfolio. So if we're investing slightly less than 30% in these mortgages, I would say investing more than 70% in other assets clearly satisfies the definition of diversified portfolio.

Onto the right-hand side, new business. We expect, as David said, mid-single-digit new business strain as a good guide. We'd like to do better than that as our new products mature and we secure more of our targeted mortgage customers. But look, for now, that's a reasonable estimate. In-force surplus, it's important to stress that David is talking about the in-force surplus after normal TMTP amortization. This element should grow at 15% per annum. So you can do the sums for the next four years to capital self-sufficiency.

David mentioned that the voluntary accelerated amortization in addition to the normal amortization that was shown as GBP58 million post-tax and that will be GBP70 million post-tax over the next -- spread over the two years as he said. And then that will cease. On the solvency bridge page, we show the in-force and normal amortization split out separately, so that you can model that. The dividend and interest, I've outlined the proposals with respect to the dividend and interest. They'll obviously be influenced by the final capital raising today, and that's an item you'll need to therefore update in your models.

Onto PS 31/18, we have the impact of fully complying with the 1% deferment rate. We've started that transition, as David indicated, at 0.3%. So we expect two further steps in '20 and '21. And we've indicated that you should think around GBP100 million over the three-year period, and that gives some allowance for the growth in our total book over that period.

Before I conclude, I'd like to just highlight a few important points on our lifetime mortgages. Our average LTV for new business last year was 28.6%. This has hedged up slightly over the last year because we're now targeting older borrowers, but importantly, while the loans-to-values at individual ages have actually come down over the previous years. So we have lowered the loans-to-value across all of the age groups. But because we're focusing on older customers, they're the ones with the higher LTVs but of course, shorter duration and much lower NNEG risk and therefore, lower capital utilization. We now have the entire portfolio at 32.5% and less than the portfolio being above 75%.

At the interim presentation, David told you that since we started writing these products in the Just Retirement Limited portfolio 13 years ago, there have been 13 NNEG shortfalls to the 30th of June. There was one additional shortfall since June. So we're talking GBP11,250 redemptions or maturities, a total shortfall of less than GBP300,000 in 13 years of GBP925 million over that whole period. So in last year alone, 200 million of redemptions and just under 100,000 of shortfall. To put that into context in terms of yield, those shortfalls have had an effect of reducing the effective yield by less than 1 basis point.

We're extremely happy with how this portfolio is performing. The assumption changes are all about looking into the long-term future in the macroeconomic outlook. Also (inaudible) important, we do not judge that there are material incentives for customers to voluntarily redeem. And where customers do indeed make decisions to redeem early -- and remember these are lifetime mortgages -- but if they choose to redeem early, the contract terms allow us to recover losses that the lender receives by applying an early redemption charge payment. This has had the impact of more than mitigating the impact on the yield that I just spoke about. However, I should add, no early repayment charges made if the impact of redeeming the mortgage each is neutral to the lender.

So we still judge lifetime mortgages as an excellent investment to back our retirement income portfolio. And as I said, we're delighted with the portfolio's performance today. To questions in one moment, a few conclusions. Clearly, 2018 was a year of significant contrast. We faced serious headwinds that we had to navigate and respond to the PRA's consultation into equity release mortgages. As you can imagine, that consumed an enormous amount of the board and saved the allegiance time from across our group. It also created quite some concern for many of my colleagues in the company. I'd like to pay tribute to all of them for the resilience they've shown and the focus they've clearly demonstrated to provide outstanding service to our customers and results for the business.

I do want to say that I recognize the challenge many of our shareholders also face during this challenging period. We are committed as a leadership team to rebuild value for them. The contrast of course is that we have delivered an excellent new business trading performance, margins over 11% profit for new business up over 44% as well as winning new mandates, building and launching new products and innovative solutions and winning a few awards to boot along the way. So the four blocks on the screen sum up our performance. We've continued to apply pricing discipline to grow our new business profits.

We further developed our new business franchise. We have now helped over 600,000 customers achieve a better life, which is our fundamental purpose. And we've started executing a plan to deliver capital sales sufficiency by 2022, a tough but rewarding year.

So I'll start with questions in the room. And if you could say your name and company for the benefit of those in the webcast, and then we'll move to the phones.

Questions And Answers

Q - Greig Paterson

Thank you. Greig Paterson, KBW. Three questions. One is Aviva said the interaction with effective early test in the SCR resulted in increasing the SCR by GBP200 million. I was wondering -- you have a similar amount of equity leases. If that was the case here, that would be a very problematic issue. I wonder if you can give us some insight into what's happening there?

The second point is could you give us -- you alluded to it, but I was a little confused. Your Solvency II ratio, as previous guidance, will reduce and then trough and then start climbing. That's the expectation. I want to know when it will trough and at what level will it trough post the capital actions. And the third thing, I met with some EBCs the other day, and they said something very interesting to me. They've said most pension funds don't like top slicing. Because if they provide that data, they only get two people quoted. And they'd rather not provide top-slicing data and get 11 or 12 people quoting. So I mean, to me, that sounds like a major material headwind for you guys in the long-run. So I was wondering if you want to talk about that as well.

A - Rodney Cook {BIO 14008420 <GO>}

Well, you're obviously going to make David work hard. David, do you want to take top slicing? Just to be clear, we have given you a great deal of insight into how to run your models. So we're not going to do your models for you. So you can work out how the ratio will go down over the next three years, but David should answer top slicing.

A - David Richardson {BIO 18045016 <GO>}

Yeah.

A - Rodney Cook {BIO 14008420 <GO>}

And also comment on EBT. Because clearly, the PRA's consultation isn't even out. Other companies haven't included an allowance. And of course, I think the most important thing is we do hope that the regulator will take note of the input from the Institute of Actuaries in terms of the overall conservatism in the NNEG calculation in the next part of their consultation. But can you pick up on that one and top slicing?

A - David Richardson {BIO 18045016 <GO>}

Yeah. So I'll do top slicing, and that's quite straightforward. It's been a very small part of new business sales, Greig, for a while now. And we still do some reasonable volumes as medically underwritten business in the DB space. But increasingly, it's our DB Choice proposition which we actually kind of set out in the appendix to the slides today. And effectively, that's where we offer and improve price, go down the medically underwritten route. But we only actually conduct the medical underwriting after the pension scheme has chosen to transact with Just. So it kind of avoids that -- the risks you've just described.

And in fact, the launch and the success of that DB Choice was one of the two reasons we were cited as the winner of the risk solutions provider of the year, such type of innovation. That really goes out well into the DB market. And with the SCR and the EBT and stress tests, obviously, I'm not going to comment on what competitors have done up no insights into their models. And we await with interest what the PRA are going to come out with. We're actually very, we really would like it clarified.

And as Rodney has mentioned there is a wrath of conflicting views out there and comments on this topic, some of which are arguing for much lower capital requirements. There are some outliers out there saying there should be higher capital requirements. So we'll engage very constructively with the regulator once that consultation comes out. But from our perspective, that's -- you just can't call it at this stage, it would be speculative.

Q - Oliver Steel {BIO 6068696 <GO>}

Oliver Steel, Deutsche Bank. First, can you give us some guidance on the cost overruns in the roll forward of your Solvency II figure? And secondly, I actually think Greig's question on the Solvency II outlook is quite a reasonable question. You're raising almost half your market cap in new debt or equity. It seems quite a reasonable, I think, to find out what level you see as the minimum level over the next three years. I'd quite like to know what sort of target range or solvency you're targeting? And secondly, in order to keep within that range, how do you see the outlook for new business volumes, not just in 2019, but also in 2020 and 2021?

A - Rodney Cook {BIO 14008420 <GO>}

Right, will you -- I'll do the second part, if you'd like. So just to repeat, so we're saying in terms of your models, think of the business level from the second half of last year, so maybe GBP2 billion and growing from there. We will base our -- we intend to husband [ph] with fresh capital very carefully. We will utilize it. So for example, if we get breakthroughs in NNEG reinsurance and other such matters, if we can price at less than the 5%, then that would give us potential further growth. But we want to husband that capital very carefully.

We've indicated that you should think of GBP100 million cost over the three years alongside that capital growth. You've got the one-off amortization element that will be gone in the two years. We've spelt out the amount of that, and you can factor in a high single-digit cost on our tier -- RT1 instrument. And David can talk to you about the costs. So to be clear, the Board is comfortable with 136%.

And the important things we also take into account from the market view is the Fitch. So Fitch in their rating for us say three things, we'd like you to see you keep your Solvency II ratio above 130%. We'd like you to keep your coupon coverage above three times, and we'd like you to keep your leverage below 30%.

Now going beyond any of them at any one point is not a trigger for a downgrade, but obviously they would wish to talk to us about what actions we'd take into the future to rectify that. So 160% isn't a new board appetite. They're comfortable with 136%, but very clearly, the board would be looking and saying -- I've just indicated the things that we'll be moving in the next three years, it's timely. And one of the critical things here, Oliver, is we want -- what you guys have been saying to us is, look, the profits look great. But are they sustainable? We always are asking questions about your capital position.

We're saying that we're taking a fundamental and significant strength to -- step to strengthen our capital position to put some of the very concerns that you've raised with us behind us. So no, we're not targeting 160% or any particular number, I've given you the range. The good thing is Fitch consider the RT1 as equity. So in the first step, we have lowered our leverage.

As David indicated, we could head look to the Tier 2 market, and you fully understand how companies normally use business-as-usual finance when they're coming up to refi bonds. You can see that in our accounts, and we're well above the coverage. So I think that's as good as I can give you in terms of how that will trend down, it clearly will. And David, importantly, costs.

A - David Richardson {BIO 18045016 <GO>}

Yeah. So 2018 I'd say was an unusually high year for that because we did incur a lot of non-recurring costs associated with our response to the Consultation Paper. So as you'll recall back at the time of the interims, we talked about how we were preparing a range of potential capital actions depending on how severe the outcome might be. The preparation for all those significant capital [ph] actions tends to cost a lot of money whether you're looking at -- remember we mentioned a large in-force reinsurance transaction -- that runs up a lot of costs. And also preparing for some of the potential capital raises also costs money.

So the non-recurring elements, look, any business will always have some degree of non-recurring. But I think what you in 2018 is highly unusual. In terms of the expense overrun, because we're guiding that we are going to slightly rebase sales in 2019 and grow from that revised base, I think you should assume there will be a degree of expense overrun for the next, say, couple of years, 1 to 2 years. But it should not be a significant component of your roll forward really, really beyond that.

Q - Ashik Musaddi {BIO 15847584 <GO>}

Hi, thank you and good morning. This is Ashik Musaddi from J.P. Morgan, just a few questions. First of all, it seems like your SCR went down in this year. I mean, I was a bit surprised because you have done the new business strain, which should have increased your SCR. But if I look at Slide 14, it looks like SCR actually went down. So where is that benefit coming from? That would be great to know. And in which bucket is that? That's the first question.

The second one is can you just give a bit more math on this breakeven in 2022? Because if I think about your in-force release, say, 125 million without extra amortization times, say, 15% growth, it would be around say 180 million, 190 million. If I look about your SCR for second half, 65 million times two, 130 million, that number should grow as well. So we are kind of breaking even on this one. But you still have interest cost of 70 million negative. So how should we think about this break even over a three, four-year review?

And lastly, is dividend. I mean, you're still generating negative capital. What's the rationale of paying a dividend at the moment, given that it feels like in three years' time, you will be kind of close to 130%, 140% solvency ratio. So I know it's a token dividend, I mean, 1% -- 1.5% be -- dividend yield would be 1%. That's not material, but what's the rationale behind doing that? Thank you.

A - Rodney Cook {BIO 14008420 <GO>}

So I'll do the dividend one first because obviously spoken to a large number of investors this week prior to the launch of the placement. So the sum -- all investors want us to husband this capital very carefully, and the breakeven self-sufficiency is important to them. So yes, we -- a large number of investors had paid no dividend. Some said, and this is in the minority, can you keep the dividend? But overall, the consensus was that the discipline of paying some dividend was important. But to put it into clear perspective, with the increased share count and our previous dividend policy, you would be thinking around 40 million per annum over the next three years. That's 120 million now. If we reduce it by a third, that's 40 million. So the shareholders were very clear with us, do not give us back

120 million when you've asked for 180 [ph] million. Something much more modest is understandable.

When we talk to the debt market, to be clear, they saw the participation from our owners and shareholders alongside themselves. And you see 300 million versus an 80 million contribution. The debt market saw that as very supportive that the owners of the company were also participating. So that's why I call it a package. So look, it's a very difficult call for the board. But that current expectation is that we would pay a dividend for that discipline but at a much lower rate.

I'll let David explain the SCR, but the easiest one is at the 2nd of July when we read the Consultation Paper -- and it came as a surprise to us as much as to all of you in the room, our DB promise has already made. Of course, we couldn't back away from those in the pipeline. Every annuity customer has at least 30 days guaranteed price. So the makeup is the full flow of business promised in the second -- in the first half into the second half. And then the pricing changes. And we didn't hit the market on one day with the final price. We made two or three changes between July and September. So that is the reason for the 6.5%. We're pretty comfortable with the sort of 5% guidance. Can you help with the other part? And then if we can go to Gordon after.

A - David Richardson {BIO 18045016 <GO>}

Yes. So just to round out what Rodney was saying there. So absolutely, you're thinking about it in the right terms, in terms of the in-force surplus, you take the net 125 million and grow it at about 15%. But then in terms of working out the new business strain might look like, it's more a ratio of about -- a 5% strain on new business, give or take, and then apply that to the volumes. And if you do that, you should hopefully get into the right ballpark.

With respect to SCR, they actually increased by about 4% this year. So when you get a chance to go through our financials, you see the increase by about 4% from the year-end '17 to year-end '18. And that's achieved on a post -- a notional TMTP, retail. So there is no kind of interest rate sensitivity going on there, so that reflects the growth of the balance sheet.

A - Rodney Cook {BIO 14008420 <GO>}

Hi, Gordon?

Q - Gordon Aitken {BIO 3846728 <GO>}

Thanks. Gordon Aitken from RBC. Three questions please. First, reinsurance was an option. David, you mentioned it. What happened there? Why wasn't it chosen? And economic capital ratio of 256%, it just begs the question why you didn't use a reinsurer which -- outside of the Solvency II regime.

Second question on the assumption changes in -- I see the GBP34 million charge as a difference between two items that you said basically you got a zero on annuities. But you have a negative on lifetime mortgages. You moved to CMI '17. So what was the life expectancy reduction in months on the annuity book? And what was it on the mortgage book and if you allow for the voluntary redemptions? I mean, you've got CMI '18, which is coming, it shows a much bigger six-month reduction in life expectancy. I see your sensitivity analysis. It makes me think I should have or should keep the very large reserve release I've got in my numbers. But after this year, I'm not so sure. So if you can explain that one?

And then just finally on equity lease mortgages, I mean, Rodney, you alluded to the Institute of Actuaries' recent research. And they said historically, volatility on average has been about 5%. Actually only in Northern Ireland in one recent 10-year period has it been anywhere close to double digits and that was 10%. Why are you increasing to 13% one year early and one year before you're required to do so? And this sounds like being overly prudent. And prudence in an insurance company is great, but prudence when it causes you to issue equity is not so great. Thanks.

A - Rodney Cook {BIO 14008420 <GO>}

So I want to be clear, the capital steps that we're taking are with respect to the Solvency II balance sheet, not the IFRS balance sheet. I accept in hindsight having a 13% IFRS volatility makes it coincidentally look like it's connected to the PRA's assumption, and that was not its purpose and it is not connected. My comments with respect to the Institute of Actuaries, they have raised some questions about the PRA's model and also the calibrations.

You've said they've talked about 5% volatility. Of course, there is idiosyncratic risk that you need to load on top of that, but I appreciate their comment was that something over 10% looks like a stress scenario rather than a best estimate. I think we are responding to questions that people in this room may have asked us about our level of prudence. So we do want to make clear that when we make these prudent changes, that should give in your mind and those of investors that our declared profits are more sustainable, because we've been asked those questions. David, can you tackle the 256% and the CMI very quickly? Because I'd like to give Barry a chance and maybe Andrew if we have time.

A - David Richardson {BIO 18045016 <GO>}

Okay. So on the longevity, we did a comprehensive review across frankly all our retirement income business and all our LTMs. So it wasn't a simple X month change. And a really important thing to bear in mind in our business is that whilst overall mortality improvement slowing down across population is helpful for us in the round. And it's a complicated picture for us because of the impact of medical underwriting. And for medically underwritten business, that interaction between the assumptions you make about impact of the medical or lifestyle conditions is something that we tailor to each individual that we underwrite.

And as you know, select periods, we've got a relatively young book of business that's still in its select period. And so that interaction of how the mortality excess runs-off over time is almost as important as the underlying change in trends on broader mortality improvements. The impact of CMI 2018, we need to go and look at that carefully. We do anticipate some of these trends. So as you'll know, within the CMI model, there is an assumption about the smoothing parameter, which is how much credit do you give to recent information versus smoothing it out over time.

You'll pick up from our slides over more than two or three years now, we saw this trend coming for quite some time. And so we've actually anticipated some of that CMI 2018 change a couple of years ago. So again, managing expectations down on what the impact CMI 2018 will have, we need to have a good close look at now that it's come out and how it interacts with our business.

On reinsurance, yes, we absolutely did look at a large in-force reinsurance transaction on back book of business, so kind of pre-Solvency II business. And that transaction might well have made sense if the Consultation Paper had been implemented as originally drafted. So if the rules had been applied to the old back book without the full TMTP offset, that might have made economic sense to do so. But once that was avoided or averted, from a shareholder value perspective, it just didn't stack up.

Why the reinsurers, as you say, don't reflect the economic capital, and that's fully in their pricing. You'll have to ask them. I've seen at least one in the room here today, so you can catch him later. But -- just the pricing, just from a shareholder value perspective didn't make sense. The one thing I will say though is a consequence of the new capital requirements on LTMs being so onerous is that risk transfer solutions around the NNEG risk itself may now look more attractive. And so that's an area that we will -- we are looking and will continue to look at.

A - Rodney Cook {BIO 14008420 <GO>}

Just an important comment on models. There are many models as the Institute talked about. We can operate, given time, on any model that is put to us. We have a real portfolio of real customers. What we announced at the interims was if we applied the PRA's effective value test at 13.1%, it produced a NEGG for our portfolio and then we can back-solve and work out that for our portfolio, nobody else's, for our portfolio, we would need property prices to fall 35% across-the-board and never recover in order for our property portfolio in the real world to deliver that NEGG calculation.

So we've been clear that we think that, that calibration is very conservative indeed. But you've all written that the regulator sets the rules. The consultation hasn't come out. Obviously, we know that they will read carefully the Institute's input, and we have to wait for that.

Barry, a quick question rather than three and then to Andrew please.

Q - Barrie Cornes {BIO 2389115 <GO>}

How about two then?

A - Rodney Cook {BIO 14008420 <GO>}

Okay.

Q - Barrie Cornes {BIO 2389115 <GO>}

First one. I think, Rodney, you mentioned about possible hedging of the -- NNEG. I just wonder if you -- I was obvious whether there was a market for that. I think you indicated there wasn't couple of years ago? Could you just give an update on that? So what it might be (multiple speakers)? And second one, just wondered -- going into all this process, I just wondered if the Board maybe took a view on strategic options ahead of going into the capital raising again. So any comments on that please?

A - Rodney Cook {BIO 14008420 <GO>}

Well, let me do the strategic options. Of course, I met with 50 investors after the interims. And a number of them said, is your company for sale? We are listed on the stock market. Of course, our company is for sale. The important thing that we undertook from that point on and we still do is if our company is for sale, that we maximize the price and the value for our shareholders. The capital actions that we are taking today and the discussions with our major shareholders say this stabilizes our position, gives us the capital strength to show to anyone in the market that we are an ongoing, strong new business franchise that would actually -- its attractiveness has been increased by these capital steps, not diminished. But no, we're not asking for strategic options. This capital gives us a strong -- a foundation to remain as an independent business. And the market will be the market, the negative hedging...

A - David Richardson {BIO 18045016 <GO>}

Yeah, just very quickly. So what we've seen out there, Barrie, is there is a demand -- an ability, a desire to provide long-term economic risk transfer on NNEG risk. Long term -- and I'm not talking about over a couple of years but over 20, 30 years plus. And what we're working through at the moment is can we find the right type of solution which gets -- that's Solvency II compliant, higher yield -- or not just get the economic risk transfer. But you'll also get the benefit in your Solvency II calculations and make sure, for example, that it all works in the context of this new effective value test. So that works in an ongoing (multiple speakers)

A - Rodney Cook {BIO 14008420 <GO>}

Because, Barry, as you know you have to convert the mortgages in a group into notes before it flows through into your Solvency II balance sheets. So we're delighted that there is parties interested in, we were at the forefront, we believe, in this sort of innovation. Andrew, I think this will have to be our last question. (inaudible), sorry about that.

Q - Andrew Crean {BIO 16513202 <GO>}

Okay. It's Andrew Crean with Autonomous. Could you just say based on IFRS and on Solvency II if we get flat property markets this year, what would be the impact on those two things? And secondly, you talked about the growth in the BPA market. From what I understand, quite a lot of that growth was on big-ticket stuff, above the GBP250 million. What is this -- what is the growth prospects of your part of the BPA market?

A - Rodney Cook {BIO 14008420 <GO>}

Right.

A - David Richardson {BIO 18045016 <GO>}

Yeah. So we are still -- on the latter question, we are still seeing a strong growth in our target segment.

Q - Andrew Crean {BIO 16513202 <GO>}

Is it the same as in the bigger market?

A - David Richardson {BIO 18045016 <GO>}

We don't have full visibility on the big market because we don't play there. But the big market's clearly lumpier, yeah? So if a GBP4 billion transaction comes along, that could make the difference to the growth rate in that market quite significantly. But we're seeing very strong growth drivers, very healthy flow of transactions because pension schemes are improving their funding levels all the time. They're going further along that derisking journey, yeah.

A - Rodney Cook {BIO 14008420 <GO>}

Right. And movements in property prices.

A - David Richardson {BIO 18045016 <GO>}

So...

A - Rodney Cook {BIO 14008420 <GO>}

And could you cover our experience in the last half of last year?

A - David Richardson {BIO 18045016 <GO>}

Yes. So within the GBP256 million of in-force surplus that we show in the Solvency II waterfall, that bakes in our assumed rate of property growth, okay, which will now be 3.8%. So you get a positive surplus by achieving that. If you have flat growth, then you don't get that positive surplus emerging. So it's less that it's a hit of a significant quantity but more that you don't get that surplus emerging. You saw in the first half of this year that we had a GBP49 million variance from what was, from memory, just shy of a 2.5% variance. So it was a pretty -- it was a slight negative, so just below flat. So it would be -- broadly speaking, that 256% will be reduced by, I don't know, high double digits, maybe around 100 million.

Q - Andrew Crean {BIO 16513202 <GO>}

But in the second half of last year...

A - David Richardson {BIO 18045016 <GO>}

Second half of last year was in line with our assumptions, those negligible property variance on both on IFRS and the Solvency II (multiple speakers)

Q - Andrew Crean {BIO 16513202 <GO>}

And the next question was the difference between the IFRS and the Solvency II. Is there difference for that flat property market versus 3.8%?

A - Rodney Cook {BIO 14008420 <GO>}

So absolutely, yeah, because there is just less -- you're holding a lot more margin. We've also published our IFRS sensitivities today, so you'll be able to contrast those versus the Solvency II -- to see the relative sensitivity.

Steve, do we have to close?

Q - Unidentified Participant

Just one very quick. Am I correct, were you saying you could -- sorry about that (inaudible). Were you saying that on the lifetime mortgages that customers will now be able to pay interest rather than it ratcheting up on the LTV?

A - Rodney Cook {BIO 14008420 <GO>}

So we've launched this suite of intraservice, and we've expanded our portfolio, so that people can pay interest. David, it -- I mean, it applies to business written from now?

A - David Richardson {BIO 18045016 <GO>}

Yes.

Q - Unidentified Participant

Yes. And what I can go out on all products?

A - David Richardson {BIO 18045016 <GO>}

Yes...

A - Rodney Cook {BIO 14008420 <GO>}

For all in new option -- on owned new, new sales...

Q - Unidentified Participant

And will that -- does that materially change the dial in terms of how much capital you have to hold against the product?

A - Rodney Cook {BIO 14008420 <GO>}

Absolutely. Because if you service the interest, it might be 5%.

Q - Unidentified Participant

Yeah.

A - Rodney Cook {BIO 14008420 <GO>}

And we give preferential. If you're servicing the interest, the interest rate is slightly lower. And if you're not servicing, so there is all sorts of incentives. Then the loan doesn't increase at all, and you've lent someone 30% on a GBP30,000 or a GBP100,000. So of course, that the risk is much lower...

Q - Unidentified Participant

Would those -- does that mean, you'd be prepared to lend higher LTV against that product by virtue of the fact that paying annually?

A - Rodney Cook {BIO 14008420 <GO>}

Slightly. Then to be absolutely clear, the customers in this market are ones that have got income. So for example, government employees, DB pensioners, they can't borrow money. But they've got income, and they can definitely service. And we can regard a DB pension as better than employment income in terms of certainty.

Ladies and gentlemen, thank you very much. I'm sorry, I've been told that we've overrun. But I do appreciate your time, and I hope that you'll see that these are very positive steps that we've taken today, will be a strengthening for the organization going forward. Thank you.