Y 2019 Earnings Call

Company Participants

- Andy Parsons, Group Chief Financial Officer
- David Richardson, Group Chief Executive Officer & Managing Director UK Corporate Business
- Guy Horton, Group Actuarial Executive
- Stephen Lowe, Investor Relations

Other Participants

- Analyst
- Andrew Crean
- Barrie Cornes
- Charlie Beeching
- Nicholas Johnson
- Oliver Steel

Presentation

David Richardson {BIO 18045016 <GO>}

Good morning, everybody. And I'm David Richardson, Chief Executive of Just Group. And I want to welcome you to our Full-Year Results today. Understandably, we have more people than usual on the webcast due to travel restrictions. So a warm welcome to you too. And I'd like to thank Deutsche Bank for the use of their facilities today.

I'll introduce everyone to our new CFO, Andy Parsons. Andy joined us just over 10 weeks ago, it is only 10 weeks Andy. And I'm truly delighted to have him by my side, he has got up to speed rapidly, which is probably not surprised given both the depth and the breadth of experience that he brings in to role from previous roles in the sector. I'm also joined by Guy Horton, who leads our Actuarial and Capital teams. And you hopefully remember from our interim results, Guy is going to help out with the Q&A today. So I'm sure, you'll keep him busy.

I'm going to open today with some overarching remarks. We have a clear strategy focused on improving the group's capital position. And today I think, we can announce that we're making really good progress on that. Despite operating in a tough environment, we took big spread -- the big strides in improving our organic capital generation and reducing balance sheet risk during 2019.

We've halved new business capital strain. We've reduced our property sensitivity. We signed our first DB partnering deal, and we've released capital through longevity reinsurance. We achieved organic capital generation in the second-half of the year and at the same time accelerated our adoption of the new regulatory requirements. However, we've no plans to ease up, there's much to do and still a way to go before we're truly capital self-sufficient. And I mean that in the sense of having a level of capital surplus being generated that it's giving us real choices in how to deploy it.

We are confident, we've a robust planned to deliver sustainable capital model, and achieving this will allow us to refocus on a real purpose of helping our customers achieve a better later life, while creating value for shareholders.

So, let's step into the results. As you all know, capital was my number one priority, when I assume to CEO role last night. We've already made some big strides in the right direction. We've held a discipline our new business pricing, costs and product design. And our award has been a halving of new business capital strain, despite only having to trim volumes by 12%. This means that in the second-half of the year, the margins and capital release from the back book actually exceeded capital consumption by new business strain, finance costs and other expenses. And for the years a hold -- as a whole, we were organically capital generative, when you take management actions such as the DB longevity reinsurance into account.

I'm also really excited our first DB parting deal has been done. It's the kind of deal that will help us deliver sustainable organic capital generation of the future, and we'll come back to that later. We've also decided that the sooner we recognize the full cost of reg change to better. So, we've decided to take GBP219 million of regulatory cost today, not just the GBP70 million that we flied at the time of the interims.

We now estimate the remaining regulatory cost of fully implementing SS3/17 and PS19/19 at around GBP80 million, which together with the GBP219 million we've always hit would be well within the guidance of an aggregate GBP350 million that we provided at the interim results.

Now getting to this point, has required us to restructure the internal LTM resecuritisation, which is the mechanism by which we recognize the matching adjustment on these assets. The old notes structure was designed before the recent regulatory changes, in particular the advent of the effective value test or the EVT for short. The restructuring facilitates our compliance with the new rules.

The decision to accelerate our regulatory costs has obviously effected our headline capital coverage ratio. If we hadn't decided to recognize these regulatory cost upfront, our capital coverage ratio would have been a 156%. Haven taken more of the regulatory charges upfront, we believe that our underlying solvency ratio trajectory, absent significant unhedged market movements should be positive from this point forward. This will be driven by our expectation that we will be organically capital generative, and also given that we have a range of capital management actions still available to us.

Now in ordinary circumstances, market movements would cause some fluctuations around that underlying trend. Right now, we are experiencing truly extraordinary short-term market fluctuations, but our increased level of interest rate hedging, means that our capital coverage ratio is unchanged since the year-end and remains at a 141%. Andy will cover this in more detail later on.

And finally, although, our primary focus is on capital, we've still managed to post healthy IFRS operating profits. And our IFRS intangible book value of 181 pence per share obviously remains significantly higher in our share price.

So moving on Slide 5, you'll recognize this from the interims, it shows the capital actions toolkit available to us to offset the regulatory costs we have faced. I'm pleased that since the interims we've made good progress on all six of the boxes on the right, but with more to come on each. I'll talk to most of them over the coming slides.

So, let's start with no negative equity guarantee or NNEG risk transfer. As a reminder, we're hedging our property no NEG risk for two reasons: The first is just to improve our regulatory capital position. And the second is to reduce the level of property sensitivity on our regulatory balance sheet. Since year-end, we've concluded a second transaction, this time in respect of a rather more substantial GBP670 million of lifetime mortgages, roughly 3 times the size of the first transaction.

The counterparty is very well-regarded AA rated insurance company. It is a partial hedge with a 30-year duration, providing loss absorbency of up to GBP220 million, and has delivered a useful capital benefit since year-end. We also expect to get some matching adjustment benefit from this in the future, but we'll update you when that work is complete.

The no NEG hedging has also contributed to the reduction in property sensitivity, which you'll see later on when Andy covers it. Now with this transaction and the pilot one, we've hedged almost GBP900 million of LTMs, but there are still GBP5.5 billion unhedged. So there's plenty of potential to derisk further in the future.

We've also made significant further progress in creating a capital our DB solution to tackle transactions of more than GBP250 million. We have excellent pricing and distribution skills for larger DB transactions, but we don't have the capital base to retain a significant number of them on our own balance sheet. So, writing these larger transaction using mainly external capital provided by reinsurers enables us to play a part in this huge market by deploying our award winning new business franchise at the front-end, but using somebody else's balance sheet at the back-end. The good news today, is that we're up and running with our first reinsurance partner, and we're working hard to sign others and to do further partnering transactions.

Now, I think it's fair to say that we've transformed our organic capital generation dynamics in 2019. This has been achieved primarily through the reduction in new business capital strain by more than half. It's fell from GBP160 million in 2018 to just GBP74 million in 2019. Premiums were 12% lower, but strain as a percentage of premiums fell from 7.4% to 3.9%.

And is now well within our mid-single digit guidance. And we think this broad level of strain is sustainable in the future.

We made multiple price increases to compensate for the additional capital we now required to hold under the new EVT test and to mitigate the impact of lower risk-free rates. As well as our prices, we have changed our business mix, and are rising shorter liability duration business, which is less capital intensive.

The DB longevity reinsurance, we announced the half year has already had a beneficial effect in these numbers. What this means, is that even in the new capital regime we are achieving our targeted mid-teen return on shareholder capital deployed in new business, with an average five-year payback period. We've shown further details on full cash flow emergence profile of new business in the release at this morning, if you want to look into further detail.

And a recurring team, we're not finished here yet either, further management actions such as DB partnering and potentially additional reinsurance should enable us to reduce strain further in the future.

Cost control is another important focus across the business, and has been a key contributor in our journey to organic capital generation. We dully the GBP16 million of cost savings in 2019 that we estimated the time of the interims and that's broadly equivalent to a 10% reduction in our core management expenses compared to 2018. We have further initiatives plan for 2020, and we are focused on the need to eliminate the GBP18 million of expense over on which you'll see later.

Now, back to organic capital generation. When you add all these factors up, you can see in the top graph that perform management actions we came very close to being organically capital generative in 2019. And that once you add the management actions which are shown in the bottom graph, we were organically capital generative in 2019. We think there's a reasonable chance, we will get there before management actions in 2020, and fully expect to make take it over the line when those are included.

The leadership team are now all strongly incentivized to deliver organic capital generation, not just IFRS profits, and that certainly helps to focus minds. This means, we are more confident than ever that we will achieve our goal of capital self-sufficiency.

Now, in the context of significantly improved organic capital dynamics, we thought it was time to grasp the nettle on regulatory change. As I said at beginning, we've restructured our LTM securitisation notes in an EVT effective value test compliant way. We take less matching adjustment credit in our solvency II balance sheet, and we've increased our SCR. This reduced our excess own funds at year-end by GBP219 million in total, and the reduction in MA also reduces our property sensitivity.

As I mentioned earlier, there were still some unfinished business, which we estimate will cost approximately GBP80 million. Although, it isn't exactly comparing like, as I mentioned before, the revised total cost of complying with the new regulatory rules we now estimate at GBP299 million and that compares to the GBP350 million, which we'd indicated at the time of the interims.

So again, the process is not yet complete, but we feel we have significantly greater clarity. Now that the note restructuring has been completed, and given that we've already faced up to a greater proportion of the ultimate cost.

And maybe just a quick reminder, lifetime mortgages remain an economically attractive asset class, as well as acting as a partial hedge for longevity risk in our retirement income book. And what this slide shows is the amount of credit you get for different assets on the solvency II or regulatory balance sheet. What it shows is the amount of credit we now take for LTMs in the regulatory balance sheet, has fallen significantly since the introduction of solvency II, mainly as a result of SS3/17.

So following our construction of the LTM securitization, the MA allowance on lifetime mortgages, which is the pink bar where you could include the green bar with TMTP relief. But either way, it's broadly in line with infrastructure loans now, and only slightly hard in our corporate bonds. Although, it should add that typically the MA benefit in pound terms is still greater on lifetime mortgages, and that's a function of their longer duration, you earn that credit that yield pickup for longer, right?

So with that, I'll hand over to Andy.

Andy Parsons {BIO 20726474 <GO>}

Thank you, David. And good morning, everybody. I'm very pleased to be able to stand here today as the CFO of Just Group. I joined shortly after new year, and it's been quite a long wait since I was announced in June, so I'm pleased to be finally on board. But before I move on to the numbers, I just wanted to say a few words on why I decided to join the group and what I've found since coming on board.

I've always recognized and being impressed by Just's ability to compete in the retirement marketplace. The regulatory challenges impacting on the business have been well documented. But from the outside, I could see that the fundamentals of the business were robust. And the growing in-force surpluses would lead to positive capital generation, provided that new business capital strain was kept under control and the costs were contained.

I strongly believe that the market and in particular customers, benefit from the presence of Just in a retirement marketplace that can lack innovation and to an extent competition. I'm observing since last summer and more recently since joining, I've been hugely impressed by the progress the group has made during 2019. The energy and determination they've shown in overcoming its challenges and succeeding.

I've really appreciated the warm welcome I've had from the whole team, and hope to be able to get up to speed quickly and add my contribution going forwards.

So turning then to the 2019 financial results. I want to focus first on the capital journey, and I've come from a place where capital was key and completely share David's focus on this, as his number one priority. This quarter fall shows the development of our solvency II surplus over 2019. I'll go into more detail in the following slides, but first let's pick out a few of the more important numbers.

So, our opening surplus was GBP577 million, and a capital coverage ratio of a 136%. And as you can see, we would have finished the year with a surplus GBP390 million higher on a 156% ratio, before making the regulatory changes that David has described. Those changes have taken our ratio back to a 141%, but that's still 5 points higher than at the start of the year. But not yet at the level where I would feel satisfied.

I'm very pleased to be able to point to the positive contribution from organic capital generation in 2019, with this contributing two percentage points to the ratio in the year. And this is included the accelerated release of DB longevity capital via reinsurance. The economic movements for the full-year similar to those at the half year, with the housing market performing largely in line with our long-term assumptions in the second-half.

And you should already have been aware of the capital issuance, which includes GBP125 million of new Tier 2 debt issued in the autumn, net of the GBP37 million repaid following the October tender offer. But this bar doesn't include the GBP63 million redemption of Tier 2 debt, where we announced our intention to call a couple of weeks ago, and that will happen at the end of this month.

But now let's go into further detail on the organic capital generation and how we see this developing?

This slide shows it's key components that make up the organic capital generation. We see this as a measure of capital generation achieved by the business, before the impacts of regulatory change, market movements and any capital raising. It includes the ability of the business to generate capital surplus from management actions. The GBP36 million of organic capital generate in 2019, is obviously a significant improvement on the GBP165 million consumed in 2018, with a huge benefit coming from the reduction in strain.

Our in-force surplus grew strongly, reflecting growth in the book and higher investment margin unwind with further growth expected as we move forwards. Although, it's slightly lower rates, I would expect high-single digits in future.

The increase in finance cost you can see here mainly reflects the RT1 coupons. Although, note these are on a paid basis and will be around GBP14 million higher in 2020 after tax creating a small headwind.

Expenses outside of acquisition and maintenance allowances are similar to last year, and there's more still to do here. But good progress has made -- has been made in 2019. And the acquisition cost overall was fallen by GBP2 million to GBP18 million, which included the GBP16 million of acquisition cost savings David outlined earlier, offset obviously by the reduction in volumes.

We have further savings to come on a targeting the elimination of this GBP18 million expense overrun by the end of 2021. I would expect development and non-recurring costs to be at similar levels in 2020, as we continue to reshape the business and finalize the impacts from regulatory change.

The other management actions section includes a number of items, but most importantly, the GBP89 million gain from the DB reinsurance deal that we discussed at the interims. This number is a little lower than we previously indicated, in part because GBP12 million of the benefit has been included in the new business trend line relating to the first-half of the year. The GBP38 million other cost in this line includes a number of modeling and bases changes.

And note that in 2020, this line will include the benefit of management actions such as the no NEG hedging we've announced today, and potentially further management actions such as increased longevity reinsurance.

As you can see from this slide, this highlights the dynamic has driven the improved organic capital generation picture, which is impressive both in terms of the quantum and the speed of the changes delivered to reshape the business in 2019. So, as you can see from the intersect of the two lines in the second-half of 2019, the margins and capital being released from the back book now exceed new business strain and other costs including interest.

And note within this, we're already pricing and computing the new business strain based on 13% volatility and 1% deferment rate for lifetime mortgages, even though, we don't get reserve fully on this basis.

So as you can see, we're already living within our means in half to 2019, but it wasn't by very much, and we've got further to go particularly on the cost agenda. We're committed to drive -- to continue to drive further progress, to extend the positive yields on this chart, with the aim of this will then start to give us real choices on how to deploy surplus capital in future.

Now, let's have a look at the non-operating items. Firstly, the property variance of GBP101 million. This represents the solvency impact of flat house prices seen through the portfolio, largely during the first-half of last year, compared to our long-term 3.8% per annum house price inflation assumption. In the second-half of the year, prices broadly tracked our long-term expectations. A GBP96 million out of the GBP101 million cost for the year arose in the first-half.

Other economic variances for the year totaled GBP45 million. Also little change from half-year, comprising small positives from corporate bond default experience and a small negative on interest rates. Remember half-year we told you, we've been proactive in hedging our sensitivity to interest rates. 2020, will be the final year of the accelerated TMTP amortization with GBP25 million expected this year after the GBP42 million in 2019.

And then on to regulatory change. So the interims as David mentioned we've flagged GBP70 million of regulatory change. But through the restructuring of the LTM securitisation notes at year-end, we've chosen to take more of the impact of this change upfront. The cost here of GBP219 million includes meeting an EVT test, parameterized at 13% volatility and 0.67% deferment rate within the matching adjustment. And with a level of SCR that we believe will cover the allowance for EVT in stress, required under PS19/19 by the end of 2021.

A key benefit is, obviously that we believe now we only have GBP80 million of expected further regulatory headwind ahead of us, in order to achieve the full requirements of the new regulations for LTMs by the end of 2021.

So there's still much work to do, including with the PRA to flow the new regulatory requirements into our capital model. Overall, we've achieved improved clarity on the impact of regulatory change and a lower expected cost.

Moving on then to the sensitivities. We're focusing first on interest rates, given the significant movements we've seen in the market year-to-date. Our interest rate sensitivity on the chart is shown here at year-end, and demonstrates the impact -- the effect of hedges that we had in place at the time. As a general principle, we looked hedged the impact of long-term interest rates on our solvency II excess own funds position. But since year-end, we actually increased our interest rate hedging to continue to minimize our solvency II capital exposure to interest rates, particularly given the extent of the market movements, which are reduced tenure rates by over 50 basis points.

Credit spreads have also helped marginally as you can see from the slight positive sensitivity. And early redemptions are only a minor factor. And as you know, we don't disclose an equity sensitivity, as we don't hold any equities.

But as we disclosed a half-year '19, our largest exposure is to UK housing. And you'll notice here that our hit to the capital ratio from a 10% fall in property prices is now estimated at 15 percentage points, compared to the 20 points at interims. This is a very encouraging reduction resulting mainly from the regulatory changes to our balance sheet, less matching adjustment benefit now included. And there's also some benefit from no NEG hedging tariffs, including the trade we've completed recently. Further hedging trades will reduce the sensitivity more.

Now to-date, the housing markets performed well post-election, but we should recognize in the current environment the outlook for house prices must be uncertain. On policyholder mortality, we can see that reduction of 5% would affect us by ten percentage points. This is also come down since the interims due impart through our increased use of reinsurance.

On this next slide, we bring our solvency coverage ratio up-to-date by combining the three key non-economic developments since the year-end, with our estimate of movement from the business and due to the financial markets.

Firstly, the key non-economic developments. As many of you expected, we've called the remaining Tier 2 notes, with that -- with this action, not in our reported solvency position at year-end, but very much included in the way that we look at solvency. But since year-end, we've obviously completed two significant deals, which David outlined earlier. Specifically the no NEG hedge and the DB partner reinsurance, and that obviously has a full-point benefit.

Along this slide, we then brought the picture fully up-to-date by including the first couple of months of normal business, as well as all of the market moves up to the 10 of March. The combinations of two have reduced our coverage ratio by only 1%. As a result of our active hedging on interest rates impact on our solvency position from the significant rate falls we've seen to-date, and from other economic and market moves is actually a very minimal change to our capital coverage ratio, delivering an even better result than the year-end sensitivity we would suggest. So, factoring all of these changes against the reported year-end position, we'll produce a coverage ratio of 141% today.

As I mentioned earlier, we'd -- I'd really like to improve this ratio further. On absolute significant unhedged market movements, we'd expect to see this growth further over 2020 and beyond, as we continue to grow our organic capital generation.

Moving now to IFRS. Our adjusted operating profit before tax rose by 4% to GBP219 million, as a decline in underlying operating profit and a higher finance charge were more than offset by positive assumption changes.

Our underlying operating profit fell by 16% to GBP266 million, with the 18% increase in-force operating profit not enough to offset the 25% decline in new business profit. The new business profit decline reflects the 12% from the retirement income volumes and lower margins as flagged in the results last year.

The operating variances and assumption changes were GBP42 million positive this year, and this included the GBP10 million pre-tax cost of the DB reinsurance we flagged at the interims. We're also positive at elements from maintenance cost reductions and from LTM redemption charges, where our positive basis change as offset negative experience variance. There were minimal longevity variances or changes.

Our other group company losses are now declining, and the pace of this decline should increase given management's focus.

Finance costs on this slide have increased as a result of the RT1, which will add another GBP11 million in 2020, as we recognize the full annual coupon cost.

Looking on this slide then, our new business and in-force profit in more detail. As we previously guided, our new house price inflation volatility assumptions could -- together with a change in LTM duration and backing ratio, result in a roughly two percentage point drag on IFRS new business margin compared to the full-year 2018. In the second-half, combination of pricing improvements and expense control has resulted in a slight uplifting margins compared to half one.

Going forward, we would expect a similar margin level. And we'll maintain our pricing discipline and would hope for some growth in new business in 2020, absent any significant impacts from coronavirus.

Our in-force operating profit increased by 17%, similar to the increase in half-year. This was driven by the growth in the in-force book and better returns on our surplus assets, which increase following the March capital rates. So overall, are pleasing in-force result. Although, I would expect future growth to be a lower double-digits going forwards.

Moving then to the below the line items. So, although, operating profit rose only slightly although there was quite a dramatic swing in total profit, as a result of investment variances. So much shows that this record year for Just IFRS profit before tax. GBP369 million 2019 compared to the loss of GBP86 million in 2018.

David Richardson {BIO 18045016 <GO>}

Great. Thank you very much, Andy. And again, really good to have you on Board today. And I'd like to start my conclusions by just spending a moment to recap on, why we do, what we do at JUST?

And our purpose statement that we show here on the slide is a really good reminder of why JUST exists. We help people achieve a better later life. Every colleague across the group contributes to this purpose, whether they're directly serving customers or providing support someone else who is doing that. We're helping retail savers, homeowners, pension trustees and clients of our corporate customers, we'd advice a solution that help them to achieve peace of mind in later life; and at times like this, it truly appreciates you to just how important that is. The value of locking into certainties never been greater.

Our group businesses have leadership positions in attractive segments of the retirement market. We achieved this leadership by investing to innovate and by deploying our great customer insights. This ensures, we are able to fulfill our purpose by providing great value and outstanding service to customers. And it's recognized in the awards we have won across all sections of the later life market in 2019, and just a few of those are provided on the slide.

We continue to invest in new disrupted solutions albeit selectively given our focus on managing costs. Two examples of that we're pausing two new developments this year. One, is to help close the financial advice gap for people in middle Britain with much more modest pension savings. And the second is a highly innovative solution to deliver guaranteed income to retail investors, who've manage their portfolios on modern investment platforms. So, we continue to invest in the future to ensure we can fulfill our purpose, a purpose which motivates me and over a thousand of our colleagues every day.

Now, you'll know Investors are increasingly interested in how Boards are addressing environmental, social and governance issues. At JUST, we have a very active ESG agenda. So, first of all on sustainable investing, we consider key ESG factors in our investment, analysis and filtering. And for some time, we have excluded new investments into tobacco, and we have seized making investments in upstream oil and gas companies.

Our ESG credentials are evidence in the significant investments we've already made in renewables, such as the Volni [ph] and Hornsea offshore wind farms, as well as investments in solar and social housing. We were also the first UK ensure to signup to the UN principles for responsible investments.

Secondly, I'm pleased to report, we've reduce our carbon footprint by 41% in 2019. We've been building a modern workplace, which has enabled us to provide increased flexibility for our colleagues, and also reduce our property square footage by roughly 30%.

We've been taking our social purpose to new levels this year by investing in our communities too. We've been helping older adults get active for a happier, healthier life through our new walking sports program JUST get active. JUST are raising awareness of walking sports is an alternative way to introduce exercise into people's lives as they get older, and guide them to opportunities to get involved.

And finally, we've making good progress on diversity as part of our governance agenda, which you can see on the slide.

So, before we end the formal part of the presentation, I just want to underline a few key points. First, we have made really significant progress on improving the organic capital efficiency of the business, and I want to ensure that positive capital generation is sustainable.

Second, this progress on organic capital generation, means we are confident in achieving capital self-sufficiency earlier and previously expected.

And thirdly, we've accelerated the recognition of the regulatory costs of the change to the new EVT requirements.

We take all these things together, this means that the absence of any significant unhedged market movements, we expect the capital coverage ratio to gradually grow from this point.

We've taken decisive action over the last nine-months. I hope you'll agree, we've been doing whatever it takes to get us onto a sustainable capital trajectory. So, our message is the transformation is underway, but there's still more to do.

Now, before we go to questions, I just want to say a few words about our Chair, Chris Gibson-Smith, who's at the front there, who has informed us obvious intention to retire as Chair of the Board, as soon as we have identified a suitable successor.

On behalf of the Board, I'd like to thank, Chris for his leadership, he's provided to JUST since we were formed in 2016. He has brought great insights to the role gained over his rich and varied career. And personally, I've thoroughly enjoyed working closely with Chris over the past seven years. He has steered the group through some very challenging times, and he genuinely takes our best wishes into the future. Thank you, Chris.

So, with that, who'd like to ask the first question?

Questions And Answers

A - David Richardson {BIO 18045016 <GO>}

Question And Answer

Q - Charlie Beeching {BIO 21296314 <GO>}

Hi, it's Charlie Beeching, KBW. Three questions, please. Firstly, what would be the expected benefit paid to the solvency position on the no NEG transactions that have already taken place assuming regulatory approval of the MA adjustment? And as a follow-up of to that, on the other items line within organic surplus generation, why is the trend flat there? Assuming you would assume a benefit from the no NEG equity you're hedging alongside further longevity reinsurance. Is this implying a further drag from methodology and modeling changes going forward?

Secondly, would you expect to receive the dividend in full year '20, assuming given the improved capital outlook and at what level? And thirdly, what are the drop to embedded value disclosure? And can you give us a figure for -- can you give us a figure for the year-end? Thank you.

A - David Richardson {BIO 18045016 <GO>}

Great, okay. So I'll actually split that into four questions. We've got the question on further potential benefit from no NEG on the MA, which I'll ask Guy to pick up. Andy, I'm further thinking you get the next three, which is the other line in OCG, any statements we want to make about the dividend and EV disclosure. Guy, do you want to go first?

A - Guy Horton

Sure. So the two negative hedges we have done quite sensitive, they're quite commercially sensitive. So you'll see that we don't disclose this one by itself. So we think we've taken a prudent approach on both. We do think there's more to come, but we don't disclose where it is, I'm afraid.

A - Andy Parsons {BIO 20726474 <GO>}

So, picking up your other three questions. I think in terms of the other line or management actions line within the capital generation, we haven't particularly given guidance on what that will be going forwards. We're obviously looking at further management actions as we go forwards. The impact of the no NEG equity hedge will go into that line in 2020. So we are expecting that to be positive from a management action perspective. In terms of basis changes et cetera, then I would assume there will always be some noise from that, but I would assume that going forward that would be a net neutral.

Moving on to your second question, so the dividend, in terms of how we're thinking about the dividend. I think in terms of where we are in the capital journey, we are taking out sort of first steps really in terms of the capital ratio, started to move in the right direction. We've moved into positive territory from an organic capital generation perspective, but we very much want to see ourselves move further along that journey, and see that capital ratio moving in the right direction, as we move forwards before we would contemplate a conversation around the dividend.

And in terms of embedded value disclosures, we have dropped those in line with pretty much all of our peers. I think now have dropped embedded value as a measure. Primarily because you have a certain number of metrics that you want to try and calculate and run the business by. So we don't run the business on embedded value, we run the business very much on -- our lead metric is very much the subject to one, but with the sort of more or less commercial value flowing through the IFRS numbers.

Q - Charlie Beeching {BIO 21296314 <GO>}

(Inaudible Question)

A - Andy Parsons {BIO 20726474 <GO>}

We don't have one that we are disclosing, no.

Q - Charlie Beeching {BIO 21296314 <GO>}

(Question Inaudible)

A - Andy Parsons {BIO 20726474 <GO>}

Yes.

Q - Charlie Beeching {BIO 21296314 <GO>}

(Question Inaudible)

A - Andy Parsons {BIO 20726474 <GO>}

So, sorry, yeah, I saw you looking slightly confused. So there are different elements in there. Within that line you have management actions, but then you also have any sort of modeling and basis change. So it's a modeling and basis change element, I would see being net neutral within that line. We expect positives from management actions.

A - David Richardson {BIO 18045016 <GO>}

(inaudible) slightly even more simple than what you're asking which is the number was 50 in 2019, and we're indicating that it may be broadly of that similar magnitude going forward allowing for as there's always some uncertainty on the assumption changes. So we're saying we don't expect the management actions to below 50 in the future or materially higher, but somewhere in that ballpark, that you will have some noise from assumption changes in any given year.

Q - Analyst

Hi, Tom Hamilton [ph], Barclays. Three questions for me. So, on the DB partnering. I was just wondering, if you can kind of talk to us about how the economics work, and kind of how the strain works, and kind of particular interest in the (inaudible) says fees and success base?

And then kind of on the NNEG reinsurance and the remaining capital drags. I just wonder if you could explain to us how we should think about the HPI insensitivity trajectory in the next few years? And then lastly, just any kind of update on thinking around your debt stack. Thank you.

A - David Richardson {BIO 18045016 <GO>}

I missed the third question. Say that again.

Q - Analyst

So just questions on anything here on your debt stack going forward.

A - David Richardson {BIO 18045016 <GO>}

Debt stack, thank you, right. Okay. So I'll take the DB partnering question, and I'll let Andy pick up the other two. So as we talked about it in the past on DB partnering, fundamental thing is that we just are the party that's transacting with the pension scheme. So the pension scheme has the peace of mind of transacting with a PRA regulated company.

And then typically, we've talked in the region of, excuse me, 90% of the risks being seeded to reinsurance partner, and we retain 10%. So let me talk about the 90%. The 10% will be just as it is normally. The 90% will get seeded and we effectively get a paid fee upfront. The fee reflects the value of our franchise that's allowing us to be active in the market, origination fee, et cetera. We also get paid in administration fees, it's with administered business going forward. And we pass on all the investment, all the longevity risk to our reinsurance partner, and we don't need to hold capital for those risks on our balance sheet.

So in terms of the dynamics, what's left is we get on that 90%, a fee income upfront, which we're not going to disclose the ratio, the percentage, because as Guy said, that's commercially sensitive, but it's meaningful. We're not doing this for a few basis points. We will get a fee upfront, and that will effectively be capital generative. You need to set aside a small amount of capital for counterparty risk, the risk that the reinsurer defaults, but that would be a small proportion of the fee that we earn, and it is a capital generative source of fee going forward. And that's it, day one and IFRS profit, until IFRS 17.

A - Andy Parsons {BIO 20726474 <GO>}

In terms of your other two questions, I think, Guy will probably take the second one. In terms of answering your third in terms of how we're thinking about the debt stack. You'll see in the pack, in the appendix. I think it's Slide 31, that indicates our current stack. It also shows that we have got up to GBP250 million of headroom within the Tier 2 element of that stack. But at the moment, the way I'm thinking about where we are is, we clearly want to be on a positive capital journey going forward.

We need to look at the extent to which we should be using management actions versus debt, in order to do that, we need to look at whether the economic impacts hits us as we go through the next couple of years. So it's useful to have that in the kit bag. We don't -- we are not planning to use it imminently, and I'm very keen to understand our ability to generate capitals through management actions which quite often come with a better cost of capital than the debt would.

A - Guy Horton

To your second question, I'm going to ask you to perhaps give me more clarity on what part of it you want. But let me use, perhaps what was part of your question to follow up on a very brief answer I gave before. It might be helpful to note that, I think we have obtained the majority of the benefit that we expect. So it's not that there's multiples of it still to emerge in terms of the benefit of the NEG hedges we have done, does that perhaps give a better sense of scale of some sort. To your question about the remaining capital drag, can I understand more, so I can answer it well?

Q - Analyst

(Question Inaudible)

A - Guy Horton

So there's two elements that come from these NNEG hedges. One is by releasing capital on the balance sheet to allow for risks that could emerge in the future. And the second piece is how they improve the resilience of the balance sheet as HPI does change. So that's why we in particular, like some of these management actions, that they free up capital as well as reducing your sensitivity. So as -- I think, that therefore relates to the first part that talks about the majority of the benefit being there. So it's not a multiple still to come.

So these things do play and it does. It is important to remember that we've done GBP900 million out of GBP6.5 billion. So this is not going to change the balance sheet overnight. You need to do more of these if you really want to get that sensitivity way down. So we've done well so far. So then that talks a bit to the sensitivity, it is reducing it, but it's reducing it in sort of scale of the fact that we've done about 15% of our LTMs.

A - David Richardson {BIO 18045016 <GO>}

Go ahead, Barrie, yeah.

Q - Barrie Cornes {BIO 2389115 <GO>}

Thank you. It's Barrie Cornes, Panmure Gordon. I got three questions as well, please. First of all, I think you're giving guidance on new business margin going forward. But can you just tell me what the impact of low interest rates would be on the new business margin?

And secondly, the impact, is there any impact of possible benefit of a changes to risk margin going forward that have been talked about. And thirdly, the credit default reserve, which I think at the half year was about GBP359 million. Could you tell me where that is at year-end, please?

A - David Richardson {BIO 18045016 <GO>}

Okay. So I'll speak to the risk margin point, and Andy, I'll let you pick up the new business margin and credit default. So, on risk margin, like I said for some time the PRA have been indicating that they might like that revisited and reduced, and kind of I'd say, the sounds coming out seem to be getting slightly louder on that. But in reality, we're not holding our breath for that. We've not factored that into our planning in the future whatsoever. So for us it would be very much -- it'd be very much a kind of a cherry on top, because these things can take time, and there's no guarantee that they'll happen.

So, we think it will be a helpful development, not just for our own personal balance sheet, but I think in terms of getting better value to customers, because it's a very expensive drag at the moment. But as I said, it's not a core part of our planning for the future. Andy?

A - Andy Parsons {BIO 20726474 <GO>}

So in terms of, I guess, sort of the impact of the low interest rates we're seeing at the moment, we're not seeing a massive impact in terms of certainly having an impact on our margins, in terms of how we're pricing the new business. We still need to see whether there's any impact on actual new business volumes from customer activity changing through the coronavirus.

In terms of your third question, on the credit reserve, I don't have the figure to hand right now, but from memory the number at year-end is very similar to that half year number. I think it's around 370, but we can get back to you with the exact number.

Q - Nicholas Johnson {BIO 1774629 <GO>}

Good morning. It's Nick Johnson from Numis. I have three questions, please. First, on the guidance to be organic capital generative in 2020 and beyond, how that differ to the objective to be capital self-sufficient by '22? Is it one the same thing or is it slightly different?

A question to Andy, you said, 141% not yet at level that you're satisfied with. Could you possibly give some sort of indications of what sorts of level you will be satisfied at? I appreciate it's difficult in terms of sort of way need to be to have other choices for use of capital. And then on COVID-19, so new business volumes, just wonder if you could comment to be seeing any impact yet, and if it worsens, what we do to mitigate? Thank you.

A - David Richardson {BIO 18045016 <GO>}

Okay. And obviously, Andy, I'll let you speak about your levels of satisfaction. I'll pick up the other two, and yet -- and because I was the one who spoke about it in the past. And when we talk about capital self-sufficiency in the past, we've always talked in terms of, are we generating capital surplus, and is the ratio improving. And you could argue that by the kind of narrow definition where at that point, that we've reached the turning point and are capital self-sufficient.

As I said in my comments, in reality, we're not there, and I would say a further layer to add on top of that is you're really capital self-sufficient, when the level of that surplus being generated is giving you real choices on how you should deploy it, making real choices between, for example the question on dividend versus future new business growth trajectory. We're not at that point yet. But what I have said is we're more confident that we're going to get there sooner than we were last time we spoke. I hope that's clear.

And on coronavirus, we could obviously talk about that for quite some time, but I'll try and keep it fairly short. And first of all, your question, Nick, was around commercially have it impact us. And at the moment, the story [ph] to tell, what we're not seeing clear indications that this changes in our markets, but I think it's safe to assume that the retail market will slow down. So both guaranteed income for Life and LTMs will slow down, if we get into more extreme social distancing measures.

People just aren't going to have appointments with financial advisors. To make these big decisions, you need to meet a financial advisor. Some people might do it over the phone, but not many, and not many in that demographic. So we expect it to be slow down. I'd highlight that the need for these solutions doesn't go away. So it's more of a deferral rather than I think a complete lost opportunity, but that's why, Andy had some words of caution in guidance for this year, it's too early to tell.

I think it's a slightly different story in the DB de-risking market. The trustees of pension schemes are required to continue to oversee the pension schemes effectively, and they're all on de-risking journeys, they're all on funding plans and they just need to continue to run the pension scheme much like a Board needs to run a company. And therefore, I would expect that we will continue to see good levels of activity in the DB market. There will be some schemes that may slow down. There may be some schemes whose deficits get impacted by equity market falls, and have to slow down some of their de-risking decisions. But the vast majority of those who are looking at buy-in or buy-out have already de-risked their investment strategies with respect to pensioners they're going in to buy-in, and we'll have hedged largely or completely against interest rates and inflation. So I expect maybe a bit of slowdown in DB, but not as much.

A - Andy Parsons {BIO 20726474 <GO>}

Sorry, I need to answer that.

A - David Richardson {BIO 18045016 <GO>}

Yes.

A - Andy Parsons {BIO 20726474 <GO>}

I think the one other thing which was -- your question is really about the 1.41%, and why we -- why am I saying I'm not satisfied with that. And I guess the -- for me the answer on this is, I don't think that we should focus too much purely on a ratio, and we can't get overly carried away with that. For me, what I would look at is very much the ability of the business to generate capital as it goes forward, so being able to do that confidently over time is important, but also looking at the sensitivity on the balance sheet. So what risks are we running and what shocks could impact on us? And it's almost a combination of those that then almost generates your confidence in terms of the capital level that you're at. So it's very much building that in and I think we need -- we've made good progress in 2019, but we need to see that continue into the future, and we need --

Q - Nicholas Johnson {BIO 1774629 <GO>}

(Questions Inaudible)

A - Andy Parsons {BIO 20726474 <GO>}

No. And we'll take two more in the room, because we've got online, we'll go Andrew there and then Oliver, and then we'll go on to online

Q - Andrew Crean {BIO 16513202 <GO>}

Good morning. It's Andrew Crean for Autonomous. Can I ask three questions? The first one is a break in record -- credit migration. Could you give us the sensitivity on credit migrations by the fix [ph] I may lost this. Secondly, you've talked an awful lot about benefits from de-risking, but I'd like to know a bit more in monetary terms about the costs of doing it. So cutting the strain on new business, you've shorten duration. What is the fall in the future cash generation, undiscounted from reducing the strain? Secondly, what is the cost of longevity reinsurance, as you pass away the potential profits on that?

Thirdly, I'd suppose the DB partnering, you're not going to answer, but also then, finally the cost of no NEG hedging, in terms of how that hits you. And then the third question related to that is, how much more no NEG hedging do you want to do on your LTMs? You've got GBP5.5 billion still there, and how much DB partnering would you like to do?

A - David Richardson {BIO 18045016 <GO>}

That's quite a collection. So I'll take the credit migration question, since I'm the one you keep asking, and I'll talk a little bit about how much more no NEG or DB partnering, we might think about. And in terms of the cost of de-risking, Guy, I think you can have a first go those ones.

So you'll be pleased to know, we actually have run to credit migration scenario, Andrew. We didn't publish it. No offense, but I don't think it's a particularly meaningful one, but we're happy to share it.

The reason I think it is particularly meaningful is the scenario we run is that, you wake up one morning and 20% of your credit portfolio has downgraded by a big letter, so, AA to A, A to BBB. And the reason I'm mentioning is particularly realistic is because we're entering that type of tariff, we're entering a kind of a real shock now, and we along with all our peers are I'm sure looking at our portfolios, and working out where we think soft spots are. But therefore, for transparency and comparison, the impact on our group ratio would be about 13%, 1-3, of a single letter downgrade on 20% of portfolio instantaneously.

Q - Andrew Crean {BIO 16513202 <GO>}

(Question Inaudible)

A - David Richardson {BIO 18045016 <GO>}

Yes. And then how much more no NEG and how much DB partnering do we plan to do? So a no NEG, we absolutely would like to do more. We've done GBP900 million so far, it's about GBP5.5 billion, and we would like to move on to further transactions. We're not going to kind of put a number on that at this stage. It is very much a pioneering at the edge of developments here.

We believe these are not just -- these are the first two transactions of their type to be done, because they're real long-term risk transfer, 30 years plus. And there are a couple of parties out there, who seem interested in providing that cover, but it's not a whole raft at this stage. So I wouldn't want to create a misleading level of certainty over how much that might be in the future, but we certainly want to go after more, Andrew, and we will be going after more, and the parties that we've talked to have expressed further appetite, so hopefully more.

DB partnering is something we would like to become -- it'll still be a minority of a source of our profits, but it's one which will become meaningful over times where we'd like to get it to. There's a huge opportunity, in excess of GBP250 million transactions, we are very, very -- we write very, very few transactions there at the moment. So we really would like to tap into that market.

Guy, would you like to go to cost of de-risking?

A - Guy Horton

Yeah. So on Page165, in the financial statements, we give the profile of what we think the Solvency II profits look like versus the strain. So I think with Page 165 of the financial statements. I know it's quite towards the back, it just means it's fairly I think transparent there, but I would note that I don't think there's a big economic cost coming from it. The duration piece is not a big piece, it's just part of an overall part of positioning in the market, where what's the price elasticity of the market, and where can you price, how do you combine your ingredients like reinsurance and asset mix with that. So I don't think there's a huge strain that comes from what we're doing. But you -- I'm not sure how comparable, it's the past, but Page 165 has a lot of detail.

The cost of longevity reinsurance and the cost of NNEG hedging, as I alluded to before, two benefits, one is what's the implied cost of capital, and the second one is the three resilience it gives you as well on top, the fact that you are now less exposed to risk. So putting aside the second part and assuming that their collateral benefit that has no value that we take credit for, then we still find the implied cost of capital attractive relative to all the other costs of capital from other sources that we have. So that's one of our key metrics. When we do any of these transactions is we make sure that it washes its own face on the surface in terms of the implied cost of capital.

What do we pay for the capital that it reduces from our balance sheet or removed from our balance sheet. How much more do we want to do? It depends on -- for longevity reinsurance, which is more of a commodity. It depends what kind of pricing we can find. So we're always looking at where is the next most attractive piece to do. And we've looked at all of our management actions, not just from what's most financially attractive, but what is easiest to digest from a regulatory point of view. And what is most available in the market, and what is easiest to do with our systems.

So the idea is, we're trying to be very pragmatic in terms of choosing the next series of actions. That's why, hopefully, you will see that we are delivering actions in an order. It doesn't mean we do one thing then move on to the next. There are various actions at various stages of incubation, so that you can produce a steady stream of these things, and it gives you flexibility in your negotiations with people that you are not reliant on that action, at this point in time, in order to achieve something.

So, the longevity reinsurance is what you might call more a pragmatic kind of approach, where you see what you can find. In the case of NNEG hedging, that's a little more unique and bespoke. And therefore, we would like to do more and we'll see what capacity we can find. I think everyone question whether we can do a second one. Hopefully, the proof is now there, but it is a front Tier market. So therefore you can never assume that it's around to rely on, but we would certainly have hopes in that regard.

I do want to remind what we don't -- when we hedge GBP900 million of LTMs, it's not every pound of risk of on them is hedged. It's a partial hedge. Just as reinsurance is also a partial hedge of longevity. So in terms of that, it doesn't mean that we have fully hedged 15% of our LTMs.So it does mean we'd like to do more, because it certainly seems that there's more could be done 15% hardly it seems like the place to stop. Have I answered all your questions?

Q - Analyst

(Question Inaudible)

A - David Richardson {BIO 18045016 <GO>}

Yes. Right. Thank you.

Q - Oliver Steel {BIO 6068696 <GO>}

Oliver Steel, Deutsche Bank. And as ever, following Andrew, he sort of mix all the best questions. But you didn't answer it very full. So I'm going to ask it again in a different way. So the question was what is the cost of the longevity reinsurance, and the NNEG hedging? You used to say that it was too expensive, relative to an enormously expensive equity issue, and an enormously expensive debt issue. So is it now cheaper than debt, or is it still more expensive? Question one.

And question two. Again, this question has been asked in a couple of ways. But when you say that you expect the solvency ratio to be moving gently ahead, we're trying to work out, what is actually assumed within that number. As far as I can judge, it doesn't assume any payment of the dividend. It does assume positive management actions. Does it include debt issuance, as the balance sheet grows? So can you just give us a little bit more of an idea here as to what we should be thinking about in underlying terms? What I would call genuinely organic sustainable free capital generation including cost overruns and everything else.

Third question, very little one. The fee that you're getting upfront from the -- which one is it, the DB partnering. Is that going into the new business profit margin in IFRS? And is that also netting off the new business strain in your assumptions?

A - David Richardson {BIO 18045016 <GO>}

Okay. So, I'll say Oliver, I'll have a go at the first question rather than Guy repeat himself on the longevity and the no NEG, and I'll let Andy pick up the other two. Well, you can always add to what I say, you can always add to what I say.

So on the -- the cost of longevity reinsurance, I don't think we've ever said that's prohibitively expensive, we've always use longevity reinsurance. And I think it is fair to say that the economics of longevity reinsurance have improved over time though. And as interest rates have fallen, the amount of risk margin you need to hold per unit of longevity risk has gone up significantly, very, very significantly. So the economics of longevity reinsurance have improved, but they've always been a part of our business model and always been a factor. But that is where we're seeing more and more of it taking place, Oliver, because it is actually representing better value for money, as well as our focus on capital.

And on NNEG hedging, the reason that's kind of fallen more into a sweet spot, because it is an area we've looked around at in the past, is a combination of two factors. And when we've looked at in the past with other counterparties, the economics didn't stack up, and so the economics have improved. So terms have improved, but also again from a capital perspective and I'll just highlight that the amount of capital i.e., regulatory both provisions and SER, we need to set aside for this risk has gone up significantly. And therefore with a focus on capital, rather than IFRS, the sense and logic of doing these transactions that whole dynamic has changed significantly.

And (inaudible) some time, I will move on to Andy, with the other two questions, because I do want to give online people a chance.

A - Andy Parsons {BIO 20726474 <GO>}

So I think in terms of the solvency ratio, you probably described it reasonably well in terms of moving gently upwards, going forwards is probably how we would see that at the moment, but obviously, with an objective to actually increase that trajectory if we can. And that if we can, a lot of that depends on what we can do through management actions, to actually boost what we see as a capital contribution from the business, absent management actions, as you saw on David's chart, will has a natural upward trajectory. So that will continue to grow as we go forwards, absent management actions.

The question is, how many management actions can we then add on top of that, that will increase the rate of improvement of the capital ratio. In terms of your question on the DB partnering fee, yes, that does net off new business strain, in the Solvency II and IFRS.

A - David Richardson {BIO 18045016 <GO>}

So Steve, questions from the webcast?

A - Stephen Lowe {BIO 4793133 <GO>}

Thank you. So, Gordon did ask three, from the RBC. We've answered two of them. But unsurprisingly, Gordon's got question on mortality. Why haven't you moved to the 2018 improvement table? What smoothing factors are you using, 7%, 7.5% or 8%? And is there a gain in the base table?

And then one question from Louise Miles at Morgan Stanley. Are you concerned about the potential increase in prepayment risk for lifetime mortgages, given the impact in mortgage rates from the Bank of England's base rate cut yesterday? So we start with those.

A - David Richardson {BIO 18045016 <GO>}

Okay. Sso I'll take the second one. Guy, do you want to go on the longevity first, though?

A - Guy Horton

Sure. This moving factor, we disclose it somewhere in there, it might be 934 or might be another note, sorry, I can't remember, but it's the standard one now that we use when we first introduced it wasn't the standard, but now I think it's either standard or slightly more conservative than it. It seem like 2018, most people haven't gone through , seem like 2019 is now out, and suggested maybe it was a little bit zigging and zagging, if you went to it.

We keep an eye on what's happening in 2020, and obviously, it's a strange time. So we're comfortable with what we have. And we don't we don't particularly like to chase the latest one, and I think most others do the same thing. So that should come as smoothing. If it's not in the disclosures somewhere, then I'm happy to release it. But off the top of my head, I can't quite remember which (inaudible)?

A - David Richardson {BIO 18045016 <GO>}

Okay. So concerns about prepayment risk, with base rates being cut. That's not a particular concern, and the reason being what drives the rates on lifetime mortgages is long-term risk-free rates, and also to extent credit spreads. Because as an asset allocation decision, you're looking at what are the yield you can earn on other assets.

So in the round, obviously we've seen risk-free rates come off a bit, that could itself drive a bit of a prepayment risk. A little bit of re-broking. And I think to be honest, that been in the numbers for a while. We've had rates gradually drifting down over time, over the past couple of years, and actually credit spreads have gone out slightly, which made slightly dampen that down. So it's something we keep a very close eye on, but not a particular concern in terms of short-term change in the dynamics. And certainly, the base rate itself has minimal impact. Whether any on the web?

A - Stephen Lowe {BIO 4793133 <GO>}

Thanks. Maybe there have been a large number of questions. So thank you. I think most of them have been answered. Just one final one, David, from Gul Ahmed at Tideway [ph]. You mentioned incentives to align interests of employees to the right organic capital generation. Can you give some practical examples?

A - David Richardson {BIO 18045016 <GO>}

Yes. So historically, both our short-term incentive plans i.e., annual bonuses and our long-term incentive plans would have been based off in the short-term it would have been very much driven off IFRS metrics, cost metrics, in terms of financials. We've now very much waited at towards capital metrics. So organic capital generation is the dominant factor of our S TIP, and also in our L TIP, it is much more of a balance now between capital and total shareholder return. So that's what's behind those statements.

So, look, thank you very much. I know you're all probably incredibly busy with what's going on in the market. So thank you very much for you interest today. Thank you for those of you who braved it out and came here in person, and we look forward to seeing you at quarter interims. Thank you very much.

The Event has Ended