Q2 2016 Earnings Call

Company Participants

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

Other Participants

- Andrew J. Crean, Analyst
- Gordon Aitken, Analyst
- Greig N. Paterson, Analyst
- Jon M. Hocking, Analyst
- Oliver George Nigel Steel, Analyst
- Vishal Govindram Bhatia, Fund Manager

MANAGEMENT DISCUSSION SECTION

Rodney Malcolm Cook {BIO 14008420 <GO>}

Right. Good morning, everyone. I'm Rodney Cook, CEO of the JRP Group. For those of you listening in on the phone, I'm joined by my CFO, Simon Thomas and our Deputy Chief Executive, David Richardson today. I'd like to thank Numis for the use of these conference facilities this morning and I welcome all of you joining us and we certainly do appreciate your continued interest in JRP.

So, here is the agenda. As usual, I'll start by giving you a brief update on how we see our business. Simon will take you through the numbers in more detail, and David will importantly take you through our capital position. And after that, I'll share with you some perspectives on the future for our company and as usual, we will conclude with your questions.

Before I get into any of the numbers, I should highlight that technically we're reporting on the second six months of an 18-month accounting period which will end on the 31st of December because as you know we're aligning the accounting periods of both Partnership and Just Retirement to a calendar-year period. However, in the presentation, you'll see that we're focused on our performance for the first half of this calendar year and on historic pro forma numbers wherever possible on a calendar-year basis.

So, the highlights. So, you've, no doubt, already seen two important operating highlights are in the results and that is the increased synergy expectations and the improved new business margin, both of which we're very pleased with. The merger has given us impetus and these are some of the fruits of that merger, although there is plenty more to come.

We're now sufficiently confident to be able to increase our synergy estimate from at least £40 million to at least £45 million per annum by the end of 2018. And, indeed, we've already achieved a run rate of almost £15 million, well ahead of expectations, and that's mainly through reductions in head count.

Simon will give you more detail on that later. But what we have seen so far after we got under the bonnet of the two companies means that we are confident to be able to say, we will save more than we previously announced in August of 2015.

I'd like to pose in a note that this integration has not been easy for either of our teams coming together, and I do want to thank all of my colleagues for their understanding and continued focus on supporting so well our customers and partners.

Separately, we did see rapid margin expansion from the start of the year, and we're now back at pre-pension freedoms levels in terms of margin. This was clearly helped by price increases rather than through cost reductions. So, we think there's more to come in the second half and into the future accounting periods once those synergies are recognized.

The growth in new business profit has also been supplemented by a 7% increase in in-force profit growth, driven by higher reserves. I'll talk to you in a moment about our prospects for our core markets. But as you'll see, we remain confident in the medium-term outlook for Defined Benefit De-risking while our addressable market for Guaranteed Income for Life or GIfL, will we expect growth driven by structural growth drivers and also regulatory changes impacting on the internal vesting market, that's the critical driver. We have announced our Solvency ratio for 30th of June at 134%. And the board is comfortable with that ratio and its resilient capital position especially given our low level of gearing.

The last thing I'd like to highlight before we move on to our markets and the results is we've quoted here our tangible net asset value per share of £1.53 and an increased Embedded Value per share at £2.27. So, a really solid first half of 2016 and, from my perspective, a very encouraging start to a new merged entity.

So, to our markets. I'd like to just talk through firstly DB and then moving on to GIfL. DB is firmly established within JRP as a key product for us and, of course, it accounted for the majority of our 2015 sales. As you can see from the top left chart, there has been a clear increase in the number of DB schemes closing to accruals and new members. Corporate sponsors have already worked hard to stop their pension liabilities from continuing to grow. And DB De-Risking helps them get those liabilities off their balance sheets.

Over time, this should mean that the £2 trillion remaining of DB liabilities not yet derisked, may well be looking for a new home, perhaps initially via a (06:03) bulk buying and eventually a buyout. And you can see on the top right-hand chart, how our active members move to pensioners and how deferred members, over time, will move to pensioners which, of course, is the area we concentrate on. So, that process represents a huge opportunity for companies like JRP.

You will appreciate that current average pension scheme funding is well below the level required to provide a full bulk buyout. But of course, each scheme is required to establish a rolling 10-year plan to deal with the accounting deficits that they have. Over time, this will significantly improve the funding situation, and it is then a matter of time before a full buyout becomes a more affordable option for the schemes that we interrelate with.

But just to be clear, our addressable market at the moment is not £2 trillion. It's really, as I pointed out in the top right, it's the buy-in subsection which derisks pensions already in the course of payment. Now, typically, a scheme will already be holding gilts and bonds to match its pensioner liabilities in that particular segment. And therefore, this makes the level of gilt and bond holdings which we're showing in the bottom right-hand side of the chart, which has been growing in the past decade. The gilts and bonds now make up around £600 billion and, as I said, that has been steadily rising.

In other words, our addressable market may be thought more around the £600 billion of the £2 billion mark (08:01). Of course, you well know that the level of de-risking currently is around £10 billion to £15 billion per year. So, hey, that indicates real potential for significant future growth. Okay. So, that's why we're optimistic about our DB De-risking. And I can confirm that our pipeline has never been bigger than in the past and this has actually increased post-Brexit rather than decrease.

But what about the individual market, the GIfL market? The first half of 2016 total GIfL market sales were 7% higher than the prior year for us, suggesting further signs of improvement. And incidentally, our pro forma market share in the total market, not just the underwritten or the open market, grew from 17% to 19%. Of course, our focus is more on profit than market share. You'll see what the reason for that growth is in one minute.

If the individual GIfL market has now found its level, turning to the top right-hand side, demographics should drive further long-term growth. And that chart at the top shows that the numbers of men over state pension age or older (09:34) will increase by 1 million over the next decade. Added to which importantly, the number of people retiring with more substantial defined contribution savings will continue to grow and, of course, those individuals need to convert those savings into some form of retirement income for themselves, where in the past, more retirees would have had DB benefits supporting them, and that won't be a feature of the future.

Of recent times, growth has been driven by the dynamics, however, in the bottom right-hand – sorry, left-hand chart, which is focused on the open market. And just to be clear, JRP only deals in the open market. Importantly, the open market is beginning to reclaim some of the ground that it lost out to pension freedoms, which you can clearly see, the drop from 60% to 41%. And that has helped our market share because that, in pound terms, was a 22% increase in the amount of OMO sales.

It shows on that chart that the open market now represents 45% of sales, up from 41% in calendar 2015, and that has increased our addressable market by a full 10%. You don't have to be Einstein to work out that if the open market returns to 60% levels, then that would be a full 50% increase in the JRP addressable market.

Now, that is the critical part of this chart and the shift from internal vesting to OMO is being driven by the withdrawal of some life companies from internal vestings. We have shared in the past our work with Phoenix, and you'll be well aware that the Prudent (11:48) recently announced their intentions with respect to offering annuities going forward. Now, if that business comes on to the open market, in some cases facilitated by our B2B operation which we have where we run broking panels for companies, this will enable the customer to get the best price and allows us then to compete for that business which was closed to us in the past.

Now, importantly, referring now to guaranteed annuity rates or GARs, we're seeing increased interest in broking GAR flows, which you might find a bit unusual. So, the policy holder benefit doesn't normally change, but the pension company which no longer wishes to keep the guaranteed annuities on their own balance sheet will offload this type of business by paying a premium to another insurance company like us, and then we will pay the lifetime income to the customer. The ABI estimates that GARs represent now 50% of that internal market which hasn't been accessible to us.

So, in future years, if both GAR and non-GAR business begins to flow on to the open market from the captive segment, then certainly there is room for significant increase in our addressable market. And in the highlights, you'll see that we are the market leader in the open market. So, certainly it is early days to call for a strong GIfL growth, but there's certainly positive signs there to note.

Turning to some numbers. We have been making good use of our intellectual property to take advantage of the growth opportunities that these markets offer. And therefore, we have continued confidence in our ability to grow from here. The key driver, of course, is both sales and reserves. And if we can grow our sales and importantly grow our reserves, then the new business and in-force profit growth will surely both follow. And we believe that those growth opportunities and dynamics remain firmly in place for us.

On the left-hand side, you'll see that GIfL sales have begun to improve, and I've just explained why we think that that growth should continue in the medium term. The outlook for DB sales, as I mentioned, is as robust as ever, although very clearly on the chart, the extraordinarily strong performance in the fourth quarter of 2015 through Defined Benefit drove, therefore, the rather quiet quarter in the first quarter of 2016, and it has set us up for rather a challenging comparator for the 2016 fourth quarter, of course.

But as I mentioned, the DB market is picking up, and we took the rather unusual step perhaps of announcing that since the 1st of July that we have written more than £330 million of DB business, and that means so far we've written more than twice the level of the whole of the first half. And that was especially driven by the interest in the market as what would happen post-Brexit.

The DB price - pipeline, as I mentioned, is as strong as it's ever been, indeed stronger, and we remain confident in the medium-term growth prospects for that product. Recognizing, as Simon tells you every time, it is a lumpy product in terms of sales from quarter-to-quarter. Now, that is the sales side and then, of course, that's before we look at margin improvement and our future cost savings.

On the right-hand chart, we have shown good growth in reserves which is our key profit driver, even before the clear one-off jump of including Partnership into the group. Reserve growth drives growth in in-force profit as we release the rather prudent margins that Simon and the actuaries insist on setting aside.

And on a pro forma basis, just to give you an interesting statistic, the JRP Group has achieved average growth in reserves each of the calendar years over the last five years of 25%. So, in terms of, are we a growing insurance company? I'd submit the 25% per annum growth in reserves for each of the last five years, perhaps satisfies that criteria.

Importantly, our inflows have significantly exceeded our outflows even during the difficult period of 2014, 2015 when people obviously had a concern about the company's prospects after the budget. And our inflow is more than double our current outflows at the moment. That will drive future growth in reserves and therefore future growth in in-force profits.

Moving then to my last slide before I hand over to Simon, the usual KPIs I'll take you through on the six months trading. Obviously for us, the highlights are the strong growth in operating profit and the embedded value per share, which I've mentioned. We're certainly proud, by the way, that we've managed to maintain our sales volumes despite the DB business being pulled forward to 2015. And of course, when anyone does a merger, there are potential scope for merger-related disruption in terms of sales. And we've been positively received in the market both from an employee benefit consultant perspective and also from IFRS, so that has not materialized.

The operating profit growth shown there is up 40%, and that was driven by more than doubling of new business profit on a pro forma basis compared with the two companies added together in 2015. Of course, the margin that we've highlighted to you, the return of margins to pre-pension freedoms level has clearly driven that. And that was brought about by the market pricing changes that we led in November 2015 and that has been supported by strong mortgage yields throughout the first half.

Importantly, there is no synergy benefits included in the results to the 30th of June, so there will be more to come. The embedded value is up on the chart on the far right by 12% year-to-date. Importantly, that is strongly boosted by bond markets, you've analyzed the economic variances. But it does tend that a start £2.27 per share and the net tangible asset value at £1.53 per share, I think, is a start comparative to the share price before 7 o'clock this morning.

Our 3% sales growth on the left-hand side was boosted by very strong start to mortgages. And you are well aware of our broad target of 25% mortgages in relation to retirement sales. You can do the sums. Importantly, what that means for us is we have a very strong warehouse filled with mortgages ready to be absorbed by second half-year retirement sales. And, of course, I've already shown you that DB sales have doubled already.

So, the key message for me is the merger is working. It's already boosted our trading performance in the first half and that is before we reaped any of the benefits of cost savings which we've increased, of course, to £45 million. And I do believe the warehouse and the margin improvement sets us up nicely for a strong second half to this year.

So, (21:02) time being. Simon, will you please take the guide through the results in more detail? And then, David will take us through the capital.

Simon George Thomas {BIO 15219564 <GO>}

Thanks, Rodney and good morning. I'm going to take you through some of the key financials and then hand over to David for him to look at our capital position. So, let's get straight in looking at the analysis of operating profit.

As Rodney has already said, underlying pro forma operating profit rose by robust 40% to £68 million in the six months to June. This impressive increase was driven by more than doubling of our new business profit, supported by a more modest increase in the in-force profit. The 121% increase in pro forma new business profits of £31 million was driven by a significant increase in the margins. Retirement income sales, which excludes mortgages, actually fell in the first half because of DB. But this was more than offset by margin expansion. And as usual, I'll cover this in more detail in a moment.

The 7% increase in the in-force profit to £37 million was driven by 5% increase in opening pro forma reserves and broadly stable in-force margins. Below the underlying operating profit, we saw some small negatives in operating variances and normal group company results. Reinsurance and bank finance costs rose slightly to £11 million from £9 million in the comparative period and this is a result of including both JR's higher level of senior debt and Partnership's hybrid debt for the whole period.

So, our pre-tax operating profit has risen by 12% on a pro forma basis. Although, I'd also note that statutory operating profit rose by about 55% given the first-time inclusion of the Partnership earnings stream for the second three months of the reporting period.

Now, just looking at the top-line in more detail. Pro forma sales were up 3% in the six months to June. This was driven by strong increase in the GIfL and lifetime mortgage sales, which was largely offset by expected lower DB sales.

Rodney has already touched to the reasons for our growth in GIfL. The key is that the OMO is beginning to recover and it looks set to continue as the internal vestings companies review their models.

On the mortgage side, we took advantage of buoyant lifetime mortgage pricing conditions in the first half to right around 50% of our Retirement Income volumes and that's well ahead of our normal target level of 25%. Now, this will naturally fall back over time, but we already have plenty of mortgages in the tank to fuel second half Retirement Income premiums.

As for DB, the 49% fall is hardly surprising given the rush to write business ahead of Solvency II, which accelerated business into Q4 2015 which would otherwise have fallen to the first half of 2016. But as Rodney has already said, we've made a strong start to the second half.

So, if I just talk about DB in a little bit more detail, we are always saying it, DB is a lumpy business. And Q1 and Q2 proved this yet again. If you see from the blue bars how the Q4 spike has been followed by relatively quiet Q1 and Q2.

On the other hand, the quarterly trailing run rate shown by the gold bars has maintained the roughly £200 million per quarter rate we established in Q4 2015. I've also shown on this chart how the £330 million we've already written in Q3, now means that the quarterly average is moving up and will do so even if we write no further DB business in September. This means that Q3 2016 will be our highest ever quarter outside of the Q4 seasonal piece.

Rodney has already explained the structural drivers and the structural growth drivers in the DB de-risking market. In the nearer term, I can say that our pipeline continues to grow. Our sense is that many trustees are now beginning to accept that low yields are here to stay. In other words, they're de-risking now rather than holding out for the market to reverse. Provided they've already put their pensioner liabilities into gilts and corporate bonds, the affordability of the transaction is more or less unchanged from about a year ago.

Now, turning to new business margins. I'm naturally very pleased with the 121% pro forma new business profit increase from £14 million to £31 million. This was driven by a significant increase in the margins from 2% to 5%, which has more than offset the decline in the DB volumes. This is taking us back to the old - the levels old JR used to achieve prior to the pension freedoms.

Now, in terms of the key drivers of this increase, I'll probably flag three things. Firstly, we benefited from the market-wide GIfL price increases that took place in Q4 2015. These have generally stuck. There've been pricing discipline that's being maintained within the market. Secondly, the margins were also helped by attractive mortgage yields which have been assisted by falling risk-free rates.

And finally, you may recall that the low new business volumes depressed Partnerships H1 2015 margins due to cost overruns, which creates a slightly flattering comparative. As usual, we only assume that 25% of the premiums are invested in mortgages for the new business profit purposes.

Now looking ahead, I'd probably suggest to you that assuming there's no significant change in economic circumstances, the full-year margin is likely to increase to around 6%. Now, I say that because pricing discipline appears to be maintained in the first few months of the second half.

However, on top of that, there are a number of other positive factors that I'll point to. Firstly, we've highlighted the DB volumes in the second half are going to be higher than the first half. This will naturally create positive operational leverage which will improve the overall new business margin.

Secondly, we'll also start to see the incremental benefits of our synergy savings start to come through, albeit only in the final quarter.

And thirdly, the other thing I've mentioned is the fact that mortgage yields have continued to be strong in the first few months of the second half, as I would also flag the competition has just picked up in the last month or so.

And finally, you'll recall that indexation means that the DB is a better fit to our mortgages than the GIfL product and, therefore, captures a slightly better margin. The greater proportion of DB in the second half is also likely to lead to an increase in the overall margin itself. As ever, we'll give you a better view later in the year.

Now, just turning to in-force margins, it's good to see that the 5% increase in the opening (28:48) reserves has driven a 7% increase in the in-force profits with broadly stable in-force margins. This margin stability follows our recent decision to recognize mortgage returns on a compounding rather than a straight line basis, as we mentioned and explained back in March. I just wanted to remind you that this didn't change the overall economic return on the mortgage. But so far as in-force profits are concerned, it does slightly delay profit recognition. This is why the in-force margin is lower now than it was in 2013 and 2014.

Now, just to touch on merger benefits. We're delighted to be able to announce significant progress so far on the synergy benefits of the merger. On the left-hand side of this chart is a reminder of our commitment when we announced the deal to drive £40 million worth of savings and in what parts of the company these savings could potentially fall.

You'll see that we also originally targeted 30% in the first year or a run rate of about £12 million. As at the end of August, we've already achieved synergies with an annualized run rate of £14.9 million. So, we're well ahead of the £12 million target.

We've also achieved a greater understanding of the merged cost base, which has allowed us to raise our cost saving target from at least £40 million to at least £45 million. So, there are more savings to make than we expected. And so far, we're making them faster than we'd hoped.

Finally, from me, I just wanted to touch on the statutory view. You may have noticed that our pro forma figures stopped at the operating profit level, so here is the statutory operating profit. It's slightly different from the pro forma version because (30:41) includes three months of partnership. However, I just wanted to highlight the below the line items and these are dominated (30:47) two large credits. First is the £145 million investments and economic profit.

This is the line that we typically don't spend a lot of attention on, as it includes the effect of economic changes on our balance sheet and this volatility normally flattens out over time. This year, we've seen a significant reversal from the previous year.

As you know, we saw heightened interest rate volatility in the last six months. The current period saw a substantial 90-basis point fall in gilt rates, which was especially pronounced in the few days following Brexit vote. But note, the comparative periods saw an increase of about 30 basis points. These interest rate falls have increased the value of our surplus assets and our interest rate hedges. This line also includes the effects of prudent yield deductions from our expected new business margin and sales mix restrictions. And it also includes the effect of bond spread changes.

Given that we match our assets and liabilities, we always show market volatility lightness (31:54) below the line even though this time, it drove a large gain. The gain on acquisition of Partnership is a bit of an accounting anomaly, reflecting the fact that on the day the merger was actually settled, the value of JR shares, issued in consideration was slightly below Partnership's fair value of net assets. Accounting principles mean this gain has to be taken straight through the P&L account.

That's it from me. I'm now going to hand over to David, to discuss the capital and dividends.

David Louis Richardson {BIO 18045016 <GO>}

Great. Thanks, Simon. Good morning, everybody. So, let's start off with the capital position. As you can see, we had a Solvency II capital coverage ratio of 134% for the group, as at the 30 of June. This comprise own funds of approximately £1.9 billion and an SCR of around £1.5 billion, giving a surplus at June of £491 million.

The equivalent ratio was 136% at year-end 2015. So, overall, it has fallen by just 2% over the first six months of the year, which is a resilient result during a time of unprecedented falls in risk-free rates. It's important to note that JRP's own funds comprises only £100 million of Tier 2 capital at the 30 of June, meaning that Tier 1 accounts were approximately 95% of the group's own funds.

To put this in context, in the bottom charts, you can see how JRP's capital position compares to other companies in the life sector if we look at just Tier 1 capital. So, what we've done here is for each company calculate the Solvency II capital coverage ratio using unrestricted Tier 1 capital. And on this basis, the gold bar in the middle, you can see that our capital position at 127% is right in the middle of the pack.

You may also remember the debt capital markets are on the agenda at some point together with other capital management tools available such as reinsurance and asset optimization for the new Solvency II environment. So, there is scope for further improvement. But we think that we are already moving in the right direction on capital in a number of respects.

At first of all, as I just said, our current capital position is comfortable both in terms of its level and also its composition. And we've also demonstrated its resilience at a time of unusual volatility. Second of all, stronger margins have significantly reduced new business strain helped by firmer pricing of Solvency II. And thirdly, as Simon had just explained, we should see further modest margin expansion due to the merger expense synergies although competition in the lifetime mortgage may partly offset this.

Taken together, this means we are making good progress on the capital front. And this is a topic that we'll cover in more detail at our Capital Markets Day in 20 days' time.

Let's move on to sensitivities. Here we summarize our Solvency II balance sheet sensitivity to a range of possible movements. As there's been understandably a lot of interest in what impact falling swap rates can have on the Solvency II position of JRP and our peers. So, to help provide greater transparency on this, we have shown the impact of a 50 basis point fall in swap rates on two different basis. First, without any recalculation of the transitional measure on technical provision or TMTP; and, secondly, showing the impact of that recalculation.

Significant to the choice of 50 basis points to this sensitivity is that the PRA has stated that it will consider a sustained change of 50 basis points or more in risk-free rates to be a reasonable trigger for recalculating the TMTP. What those interest rate sensitivities show is that we can absorb changes of 50 basis points or less without any changes to the TMTP. And it also show that the capital coverage ratio is relatively insensitive after taking into account the recalculation of the TMTP.

Equity falls and credit spread widening are not a concern for us. We have no equity investments and Solvency II mechanic means spread widening is, actually slightly beneficial as you can see in the sensitivity.

In relation to property, we already conservatively reserved for a 10% fall in property values over the next 12 months. And the sensitivity in the chart shows the effect of a further 10 percentage point drop, implying a total hit of 20% compared to current property value.

As far as longevity is concerned, a 5% one-off increase would clearly have an effect, but recent trends in broader population longevity and our own experience do not suggest any immediate concern in this area. And just for the avoidance of doubt, none of these scenarios makes any allowance for management actions with the exception obviously the TMTP recalculation one.

And then, finally from me dividends, the board has proposed an interim dividend of £0.011 per share, covering the six months from January to June 2016. Technically, this is our second interim dividend for the 18-month accounting period to December 2016. In each of the last two calendar years, Just Retirement paid an interim dividend of £0.011 and a final dividend of £0.022 per share, but in fact the timing was the other way around to this year as Just Retirement was then using a June financial year-end.

So without preempting the decision of the board for the final six months of 2016, we are reiterating that JRP will continue with Just Retirement's previous policy which has been to pay an interim dividend of around one-third of the total amount for the year.

So, with that, I'll hand back to Rodney for some closing remarks.

Rodney Malcolm Cook {BIO 14008420 <GO>}

Thank you, David. So, to sum up, if I might remind you of what we see as a very attractive equity story. Our chosen markets retain fundamental growth drivers. The individual guaranteed income for life market is improving. And the long-term growth drivers are also intact there. In addition, a shift away from internal vesting market going forward after pension freedoms put this on hold, the trend is now reasserting itself and we look forward to growth in that while customers have a wider choice to make it retirement.

We have spoken of the £2 trillion DB de-risking opportunity, which surely must be compelling and it implies a much larger market than we currently have around £15 billion. And we do look forward to many years of growth here.

Our unrivalled intellectual property continues to enable us to price most effectively. And we use that IP to create competitive advantage in both the individual GIfL market and the DB markets. And we intend to share further details on an update to our intellectual property at the Capital Markets Day on the 5 of October.

Fourthly, David has spoken about our resilient capital position, from which we have the opportunity to grow, especially given the relative low level of gearing that he's clearly set out for you. As Simon pointed out, margin expansion is reducing our new business capital strain and that is before we see the benefits, which should come through from the cost synergies we're achieving.

He also highlighted the rapid pace at which we are tackling those cost synergy opportunity and we were delighted to announce the increase in the target after just six months to £45 million for 2018. The savings we have already achieved will make a material difference to our P&L in 2017 with more to come.

So, from my perspective, a reasonably good productive year so far, with real confidence with respect to the second half of the year. And Simon has given you guidance with respect to the margins we would see if the trends continue. And his guidance was with respect to the whole year, and not just the second half.

So, before we open up for questions, I want to highlight the Capital Markets Day. We'd like to take interested observers and investors through. It's being held here on the 5 of October at Numis in the morning and we will be going through our business model in more detail. And while we think we can win in those structural growth market. And we do hope that you can join us then.

So, we'll take questions first from the floor before checking whether we have any questions.

Q&A

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

Yes. Gordon.

Q - Gordon Aitken {BIO 3846728 <GO>}

Thanks. It's Gordon Aitken from RBC. Annuities are, I think is great opportunity and ultimately very profitable business, but they are capital intensive and the more you write and the solvency will go down. So, firstly, what level of solvency margin would trigger a need for more capital? And secondly, I mean (42:32) view the shares are where they are it's because the market (42:35) acquisitions, I mean, David mentioned you have options here, so you mentioned debt issuance, you mentioned reinsurance and asset optimization. Can you confirm that you will explore all of those probably in that order for equity issuance?

And just finally on debt, can you talk about your progress towards getting a credit rating and what do you think your debt capacity is and maybe (43:03) number that we expect which is £250 million? Thank you.

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

Okay. If I just comment on the debt, there's a lot of questions there. And I'll pass the other over to David. So, clearly, the reason for going to the point of showing our equity backed ratio is to, hopefully get across to the market that we see ourselves as well-placed, vis-à-vis our competitors, in terms of the equity we've already received kindly from investors. So, yes, we don't believe when you see that chart that there is any need, at this point, to ask our equity investors to move our position and that the options that David clearly set out in terms of reinsurance and the debt markets are that the options we would pursue to give ourselves greater flexibility or to grow even faster than what we might otherwise plan.

The limit to your Tier 2 debt is 50% of the SCR and there was a chart. Forgive me. I won't recall exactly the amount, but it's very substantial.

Q - Gordon Aitken {BIO 3846728 <GO>}

(44:22).

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

So, the SCR is £1.4 billion and we've issued £100 million of debt. So, however, the other constraint there, Gordon, is your leverage ratio. So, we would be mindful of what the market would see as a reasonable leverage ratio, vis-à-vis our competitors and it might be 25% to 30% range rather than you can do your own sums if you use £700 million of debt. That might be the limit, but that's not what we would think to pursue. But I think that would answer your question is, is £250 million the limit, we would think that it's not as low as that. And you can do the sums to work out what 25% to 30% leverage might be.

So I'm happy with the order that you said which would have further equity write-down at the bottom. And I think this clearly shows – and while David obviously saying right in the middle of the pack, I don't actually call that much difference between 128%, 128%, 129% and 127%, recognizing that the (45:38) 132%, 134% and 151% are obviously higher. David, can you just pick up on the capital consumption?

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

Yes. So, let me just build on Rodney's comments, just the avoidance of doubt. Looking at asset optimization in the Solvency II world and reinsurance is kind part of the day job. It's just that the metrics and the rules of the game of Solvency II have changed, so we're taking a fresh look at that and particularly as a merged entity doing that.

In terms of an absolute solvency level or a particular trigger. And I think what we'll say in that point at this stage is the board is comfortable with where the company is at the moment and comfortable with the level of resilience that we're demonstrating through the sensitivities. So, we will continue to explore the better option that will, frankly as – I think Rodney has covered most of it give us additional flexibility. We see no need to kind of deviate from that track.

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

And as we promised, the 5 of October is when we are going to give you a much big exposé on capital and plan for this morning. Yes, Greig.

Q - Greig N. Paterson {BIO 6587493 <GO>}

Good morning, gentlemen. Greig Paterson, KBW. Three questions, as usual. The warehousing of the lifetime mortgages as they get transferred across to the new business margin, that should boost the Solvency II ratio if I'm not mistaken. I wonder if you could just sort of quantify the effect once you've used up the warehousing this year.

Second question, we've seen Scottish Widows enter, we've seen Canada Life come back, we've seen Legals write its first medically underwritten annuity. And we've heard Aviva say that they will sharpen their pencil in the second half of the year. I was wondering if you're seeing any of those fix or any views on where you see competitive forces for the more important second half of the year in bulk?

And then a third question, assuming that you issue, what I think is about £400 million of debt (47:53) reinsurance market, it should boost your ratio to round about 150, 170. At that point, I'm trying to understand what your sort of level of annuity growth can be, because I think that's a key rewriting catalyst and how that fits into the dividend policy, because you're being rather quiet on the dividend policy and unfortunately that's the other lever. So, I mean, the key question you've heard is, how quickly – what's the sort of CAGR (48:18) you can actually finance once you've pulled all the (48:22) levers? That's what I'm interested to know.

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

Okay. Well, I'm not sure we're going to actually give you an exact number, but on the 5 of October, we'll enable you to calculate more of this. If I do the last one, clearly, we've spoken about the debt opportunity and the ability that that will give us in greater flexibility. David will answer the questions on warehousing. And also, he is the Managing Director of our Defined Benefit business, so he can talk to you explicitly about the DB competition.

The critical issue on warehousing, Greig is that we are only recognizing 25% of those mortgages. So, you can do the sums. Of course, we have written more mortgages since July. We didn't explicitly cover those, because we thought the volume of DB was the important one to highlight to the market. So, we're pretty well placed we feel for the volumes that – of DB business and GIfL business that we'd like to write for the balance of the year.

And it is, as Simon said, the operational leverage is important to the margin as well. So just simply the absorption of my costs and Simon's costs, we get paid the same and spread over half the business or twice the business, all of those costs come through. I think you can do your own calculations as to what the – if you add £300 million, £200 million, £400 million onto the debt, you can do your own calculations to what the ratio would be.

But, David, I think it is important you let Greig understand the one important thing, Greig is, we do actually have to hold capital with respect to those unmatched mortgages. So that mortgages writing has already consumed capital, that's why we're comfortable with the resilience of the ratio, that extra mortgages has absorbed capital and then it comes – the margins don't come until we match.

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

Yeah. Yeah. So, (50:55) specific point. You're absolutely right, Greig, you do take a bit of a capital strain if you're writing more mortgages than you can match to annuities, either GIfL or DB. And so, there will be a little bit of a benefit from that in second half, but it's not going to be a material amount. And because what we absolutely only reflect 25% of the new business profit in the IFRS numbers, we do aim to match our assets and liabilities as efficiently as possible in our Solvency II balance sheet. So, it's not like we're rigid in the 25% matching. We will utilize much of those cash flow as possible. (51:31) but it's not material amount.

On the DB markets, I mean, first thing to say is we do welcome competition. I think ultimately this is going to be a supply-constrained market rather than a demand-constrained market. So, as seen Canada Life, Scottish Widows participating in the market and overlapping in some of the size of transactions that we look at is actually something we welcome, because that still tend to simulate market activity in itself and tends their trustees via their advisers to put blocks up for trade.

In terms of how to translate into pricing though, it's been pretty flat the pricing post-Solvency II in terms of what the trustees will see. But I would point out that we have been seeing a pickup in our mortgage yields. So, at the end, (52:26) trustees are seeing the same price that can sometimes translate into a better margin for us, because of the pickup on the lifetime mortgages. (52:33) ebb and flow as well, but overall, we're pleased with the margins of getting on the DB space. And the outlook for the rest of the year is good. It is always helpful to get your runs on the board early, so the fact that we've done over £330 million in Q3 is again something which we're happy to have achieved.

The last thing, just one small point to clarify on reinsurance, Greig, and just to manage expectations. Reinsurance is not aimed at improving the existing ratio, because anything you do on the back book will pretty much get diluted away on the transitional (53:07) trigger as it was a material transaction recalculates transitional. It's more about minimizing the capital strain on new business that they look at reinsurance management.

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

Just to conclude, I'll throw back up slide four which is the DB market. It came to our attention from some questions probably not from this floor, but from actual investors, investor fund managers, there was a thought that we concentrated on small schemes. What I want to clarify to you is that we've concentrated on small transactions. So, we're quite comfortable £200 million maybe £300 million size of transaction. But people thought that that might have implied that we were dealing with companies and schemes that had less than 1,000 members.

Just to be absolutely clear, these big schemes and we've dealt with 20 very large companies that have had a lot more than 1,000 members because they are de-risking in tranches. They're de-risking their pensioners. And you can have a Fortune 100 (54:23) company de-risking £100 million, £200 million. Sure, we wouldn't take on the whole scheme at £3 billion or something, but we have done multiple deals with 20 large schemes in the UK. Just to be clear, some people do think that that our addressable market was only tiny (54:46) companies. That is not the case and most particularly in top slicing. Oliver.

Q - Oliver George Nigel Steel {BIO 6068696 <GO>}

Oliver Steel, Deutsche Bank. So, three questions. First, the sort of assumptions you used between the two original companies on your new business margins...

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

Yeah.

Q - Oliver George Nigel Steel {BIO 6068696 <GO>}

...before you merged were seemingly quite different. So, I was wondering what the new business margin you're now reporting on, what sort of assumptions you're using relative to the original JR and Partnership assumptions and what's changed there? Don't make it too complicated, because (55:31).

Secondly, you've got I think 22% of your bond portfolio in bank bonds. So, I'm wondering if those count for the matching adjuster (55:43) and actually (55:44) doing holding bank bonds given that you're a highly leveraged financial to begin with.

And then, the third question I've got is the capital, the SCR as a percentage of the gross liabilities increased from 8% to roughly 10%, I think it's actually 8.2% to 9.8% actually to be fair. I know it's a bit more complicated than that. But I wonder if you can just talk us through what the increase was other than the (56:12)...

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

So, Simon, can you...

Q - Oliver George Nigel Steel {BIO 6068696 <GO>}

... (56:13) business?

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

...can you quickly cover the assumptions? And David, the SCR? Just to be clear, of course, we're pretty comfortable with the fact that the PRA has helped to ensure that the banks that we invest in are in a much, much stronger position this year than in 2008 and 2009. And the holdings we had with them, none of them let us down at that point. So, we're not uncomfortable with investing in UK banks given the capital scrutiny that they're subjected to bit like insurance companies. Assumptions, alignment of assumption, Simon?

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

Yeah. Oliver, we took a look at the different approaches associated with the calculation of the new business margin. And essentially, we've adopted the JR approach, which essentially caps the amount of mortgages that you can count into the new business value at 25%. Previously, Partnership used to take a higher percentage through and particularly for some of the DB schemes with some higher percentage through. So, we've taken that approach to have that consistent across the (57:23).

And the second thing in JR, we also took what I would describe as the prudent deductions for asset yields and also the mortgage yields. We put some deductions through against the new business value, which then we've done effectively to make sure that the actual yield (57:41) sustainable. And if we got those yields, they would naturally come through the economic variance line below the operating profit. That has continued and that's what other things that's coming to (57:49) £145 million.

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

We might remind, everyone, Simon, that the JRL company is writing all long-tail business JV in GIfLs and the Plateau Partnership life company (58:03) is writing Care and Protection. So, it was appropriate to continue with the JR approach.

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

So, the approach has been consistent from one period to the next of the JRP (58:13).

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

Right. David, just quickly, the SCR, 10%, 8.2 (58:17).

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

It's almost entirely driven by the fall in risk-free rates. So, the fact that you've got a much lower discount rate respectively inflate the whole balance sheet to make the assets, liabilities and the capital that bigger.

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

Right. One last question here. Andrew, and then we'll check on the phone and then come back to the room.

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

It's Andrew Crean, Autonomous. Three questions, actually. On the embedded value, you don't reconcile the free surplus from the start to end year. So, we can't work out what's happened to free services. Could you reinstate that and could you tell us what the free surplus was at June?

Secondly, in very simple terms, could you just tell us in Solvency II wealth (59:01), how much capital was needed to write the business you wrote in the first six months and what the net outflow on business which maturing was it (59:10)? It must be possible to give us very simple numbers.

Thirdly, in terms of further use of transitionals if interest rates fall further. As I'd understood, the PRA states that you can't take further transitionals if benefit – if the capital under Solvency II basis falls below the Solvency I basis. Are you restricted on that? And therefore, is that sensitivity pertinent to you?

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

Right. So, Simon if you answer the question on free surplus or you can call on David to help if that's required. Andrew, unfortunately for today we are not giving detailed numbers on capital consumption. That is being saved for the 5th of October and we will go into much greater detail. And David, transitional explanation there, the movement. So, Simon first on the free surplus.

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

On the free surplus, we haven't got that disclosure in here. We will look at that possibly for year-end. We will consider that.

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

In Solvency II.

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

Yeah.

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

(01:00:22)

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

We will consider that possibly for October 5 and we'll come back to you on that. Okay?

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

So, on your question on the transitionals. You're absolutely right. There is a limit applied to how much transitionals you can bring through the balance sheet, and such that the total financial resources that you set aside in Solvency II must be at least as great as they were under the old Solvency I regime. And so, what happens, Andrew, is that as risk-free rates fall, what you would have had to hold in Solvency I increases as does Solvency II. So, you recheck that comparison every time you do it, a transitional recalculation. So - and the fact that that limit needs to be checked each time is reflecting the sensitivities that you've got.

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

It doesn't move pound for pound, but they moving in the same direction.

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

Exactly.

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

Can I check? Is there anyone on the phone who's keen to ask a question because we have one more question here.

Operator

No questions on the phone line at the moment, sir.

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

Okay. (01:01:27).

Q - Jon M. Hocking {BIO 2163183 <GO>}

Thank you. Jon Hocking for Morgan Stanley. Two questions, please. I just wonder whether interest cover was the only constraint on the additional debt issuance? First question.

The second question, just thinking about interest rate risk to capital, obviously, the transitionals are protecting the back book. But (01:01:48) the reserve growth you've got and you're not fully reinsured, I just wondered whether the interest rate risk becomes a bigger issue going forward for the rates down? Thanks.

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

Simon, do you want to do debt and the one on the debt interest rate coverage?

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

Yeah. On the debt considerations, yeah, you're right, Jon, clearly, one of the key consideration, no matter the fact that you could go up to £700 million theoretically, is the interest rate cover slides. And, obviously, in terms of pitching the right sort of level, we've got to take accounts as to exactly how much we can service on an ongoing basis. And, of course, underlying to that is the coupon (01:02:28) itself that were likely to go in the marketplace because that will be part of the consideration as to when we look at the debt market at any particular point in time.

Q - Jon M. Hocking {BIO 2163183 <GO>}

What rates are you (01:02:37-01:02:43)

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

I would love to target the highest rate I can possibly (01:02:44), to be honest with you. But no, we haven't got any target in that sense. But, clearly, we are – as we said previously, we're exploring the options on the debt capital market side and it's something we'll continue to do.

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

There have been successful unrated issuances in the past.

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

They have in the market over the last couple of years.

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

Can – David, can you pick up that (01:03:09) issue with respect to...

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

Yes. Yes. You're absolutely right, Jon, and the transitionals only apply to business that was in-force as of 31st of December 2015. And to be absolutely clear again, so when we showed the sensitivities here with the recalculation of transitional, that recalculation is not applied to the business written since then.

So, you're absolutely right. That is an element to the equation that we'd need to factor into when we're considering where we want to be positioned on interest rates. So, you'll see us at 30th of June, we were still positioned very sensibly on interest rates. It was broadly new - actually very small positive if rates fall. And we keep that position under very close review. It's obviously a - we've seen in recent events, it's a very jumpy market, so we're not making any sudden moves there, but we'll keep it under constant review.

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

I think critically, Jon, if you look back, you'll see a number of times when Just Retirement has recaptured very substantial amount of business from its previous finance based reinsurance. That is not the case for new business in 2016 going forward. So, we have no further reinsurance financing that would be recaptured. We have traditional reinsurance slots effectively. So that coverage lasts forever, for the life of those customers. And we are 45% reinsured for individual business and 55% reinsured for all Defined Benefit.

So, we will reexamine our total reinsurance exposure including on the past. But as David said, we wouldn't necessarily expect the PRA to let you put through a big derisking transaction without also revisiting your transitional. So you're absolutely right, to sort of draw like a strong line in the sand at the 1st of January. How is our time? So, there's a question on the back.

Q - Vishal Govindram Bhatia {BIO 6868890 <GO>}

All right. Vishal Bhatia, J.O. Hambro. A generalist question for you, not a specialist here. It's very rare that you actually see a company like to double the amount of business they wrote in the first half in about two months of the third quarter. You did that with higher margins. You did that with pricing being better. Is that the business taking share? Is that the business actually showing the strengths? Can you actually tell me the drivers exactly of why exactly is the business doubling the size in about two months at higher margins, and is it sustainable? Because you're talking about 6% margins for the full-year and you've just done 5% in (01:05:59) the first half. So, is this the business showing that medically underwritten side having sustainable advantage over competition? And I heard earlier that there is increased competition in the market. So, this is all quite rare from a generalist perspective. If you can talk through it.

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

Okay. So, of course, it was a huge challenge for us on the 19th of March 2014 when the Chancellor stood up and bid now (01:06:24) and had to buy an annuity anymore. And a lot of people thought that that would be significantly damaging for our company both as - in the manifestation of both Partnership and Just Retirement. Importantly, both of the organizations had entered the Defined Benefit De-Risking sector a year before. Of course, we were brand new players and when you see the results of what the group achieved going forward, we are incredibly proud that we managed to capture a 10%

market share of the entire DB market within 18 months of joining. So, we've been able to enter and play in a very big boy's game.

In terms of the underwritten, we talk about 75% market share between us of the underwritten sector. We are pleased that there is continuing to be underwritten business especially on a top-slicing basis. Hopefully, you're familiar with what that means. It could be really big scheme but they'd like to derisk the 100 biggest pensioners, not by their girth but by the size of their pension liability.

And so, both – the companies, L&G, and hopefully some of the other companies like Aviva who do medically underwrite will continue to participate and drive that. But we would put to you, as a combined group, the intellectual property of Partnership and Just Retirement combined, we believe, is preeminent in the marketplace. So, that gives us a strong basis.

The other tool what we have used is the yield enhancement for mortgages which flows through in Solvency II to matching adjustment and so on. So, we've used those two tools, intellectual underwriting property, bloody (01:08:20) good service, which is another thing.

Between us, we wrote 51 deals in the DB marketplace. It's small transactions but that gave us contact with all of the EBCs. That was more deals than anyone else in the open market. L&G write more because they've got a direct link through LTM (01:08:42) cases that don't come on to the market.

So, yeah, we are proud of entering a new market, capturing 10% share within18 months, being the largest writer by numbers of deals. And that's where we want to continue to provide that level of service and support to the schemes and their advisors, who they're consulting, consulting actuary firms. Any further comment, David, as how we're getting to see off the competition?

Hello. Sorry, the market, as I said, we're de-risking £10 billion to £15 billion. L&G announced – we're not going to announce what our pipeline is. But I'd confirm today, it's bigger than it's ever been. L&G announced that they had a pipeline alone of £13 billion a few weeks ago. So, we can confirm their observation that the pipeline is bigger than it ever has. So, David was highlighting that it's probably supply-constrained rather than demand-constrained. Any other, David?

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

And just, obviously, – and further, as Simon has already said, which is the timing of DB completion is lumpy from quarter-to-quarter. So, the fact we're seeing £330 million in Q3 doesn't mean you can kind of multiply that up. It does depend on where these deals fall.

The point of customer service is important. Of the £330 million deals we've done since June, a third of that had been repeat transactions. With trustees, we've already done transactions with, and I'm very happy with how it went. So, there's a number of things that contribute to that.

Q - Vishal Govindram Bhatia {BIO 6868890 <GO>}

(01:10:25) 75% is quite high.

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

Sorry. That's only if you've underwritten (01:10:29). And just to be clear, we're only at about 10% of the total, so...

Q - Vishal Govindram Bhatia {BIO 6868890 <GO>}

But I don't think...

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

... don't (01:10:34) write-down of 75% of the market now.

Q - Vishal Govindram Bhatia {BIO 6868890 <GO>}

(01:10:38-01:10:47).

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

Well, Simon would get beaten up if he misled you. So, when he said he was comfortable to point towards 6% of the total year.

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

Full year.

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

Not the half year. So, you can do your own maths with respect to what the two halves may.

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

You can work it out.

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

We're not making any guidance. By the way, for 2017, there are ups and downs. The competition you've talked about, there's competition for mortgages. But for the view for the next six months, we are comfortable with what we've given. I think – Greig. And then we must conclude.

Q - Greig N. Paterson {BIO 6587493 <GO>}

Two elements (01:11:35), the other stuff being the capital generation. One is you've mentioned sort of a throwaway comment about legal and general ramping up competition in the last month and a lifetime mortgages. I want to know if you can translate that into, all other things being equal, the hits on margin in 2017. And second point is obviously, the new longevity from mortality improvement tables throughout there and are you going to move to them? And what would be the impact on the margin in 2017 when you do that?

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

Yes, I'll do the first one, you do the mortality table. Just so you know, the trend, Greig, you've observed in terms of male (01:12:24) longevity improvement has been trending down over the last seven years. And David can share stats with you offline, but that shows that, so we think that part's quite good. I don't think we want to tell you precisely because we can't tell what our competitors are doing or going to do. What I can tell you is that the mortgage market has grown 20%.

So, yes, L&G is creating competition but when you have more competitors in a market that's just growing 20%, the impact isn't to the same extent. And importantly, I'd highlight on the positive side for margins in 2017 is the cost synergies none of which are in the 6% guidance. So, I'm afraid you'll have to take a balanced view on the positives and the negatives.

And David, just to finish off on that.

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

Yeah. And so, I think as we've flagged (01:13:30) before, the key part and the key benefit of the merger is that integrating the IP data sets of the two companies and that's a big project that's going on at the moment as part of the integration. The reason I mentioned that is just to manage expectations about whether we move to CMI 2015 or not. It would be - we need to be very careful about not changing one element of the bases, whilst we're looking at integrating the rest of it.

So, it's something we will look at later in the year. I think the point you're getting to is one which Rodney has mentioned which is there has been a very discernible reduction in improvement rates, which is you can see in CMI 2015.

The other thing because I know you love your mortality, Greig, has highlighted that CMI is revisiting the whole way that it constructs its improvement tables, and that's going to come out in March 2017. So, again, that's not a consideration for year-end. You want to make a change just before that new table comes out early next year.

So, we'll take a view on that part of our normal year-end process in Q4.

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

Right. Ladies and gentlemen, that brings our session to a conclusion. Thank you very much for your questions and attendance. And we certainly look forward to seeing as many of you who can attend on the 5th of October as possible. Thank you very much.