S1 2019 Earnings Call

Company Participants

- David Richardson, Interim Group Chief Executive Officer
- Guy Horton, Chief Pricing Officer

Other Participants

- Alan Devlin, Analyst
- Andrew Crean, Analyst
- Edina Rozinka, Analyst
- Gordon Aitken, Analyst
- Greig Paterson, Analyst
- Nicholas Johnson, Analyst
- Oliver Steel, Analyst
- Unidentified Participant

Presentation

David Richardson {BIO 18045016 <GO>}

Good morning, everybody, and welcome. And, I'm David Richardson, the interim CEO of Just Group plc, and I'd like to welcome all of you joining us here today, including those on the webcast. And I'd like to thank our host for this morning, Nomura.

Since my appointment on the 30th of April, I've met and listened to all our major shareholders. And the clear message from them is that they want us to deliver a sustainable capital model and optimize our current position, so we can take advantage of the strategic options available to us. I agree and that is what I plan to do as CEO.

Now I'm delighted Andy Parsons will be joining the team as Group CFO and expect him to start in January. Andy brings a wealth of experience as Group FD at LV=, together with previous experience in senior executive finance roles at Lloyds Banking Group, AXA and Friends Life.

However, you'll be pleased to know I'm not flying solo today, I'm joined by Chris Gibson Smith, our Group Chairman, and some of my wider management team. In the front row, we have Guy Horton, he's our Group's Actuarial Executive who, amongst other things, leads the management of our capital position. So very relevant for today. And also David Cooper, who is responsible for distribution and marketing. I think well known to you all, and he also heads up our HUB businesses.

So I may well involve them in the Q&A, and they will also be available for a coffee for any one-to-one questions you have for them afterwards. So, let's get started. Here's the agenda for today. There's been a huge amount of change to the business since the last set of results. And since then, we have established across the group what I would call a radical focus on reaching organic capital generation by 2022. It's a message that is being cascaded right down through the whole organization, and the result is already evident with more to come.

But let me start by reiterating my commitment to hitting that 2022 target. As many of you will recall, the group has already proven that it can adapt to sudden and significant regulatory change. Today's presentation will show that we are doing it again in response to the changing regulatory landscape. You will hear how we have reduced our new business volumes, reduced our expense, repriced our products and de-risked our backlog, all of which are contributing to a markedly reduced new business capital strain and strengthening our capital position.

And there's much more that we can and will do on this front. The list of current projects is long and is intended to afford us increased future capital flexibility, including the development of a capital-light origination business via a new defined-benefit partnering model, further reinsurance option for the front and back book to reduce the capital intensity of the business and a pioneering, no negative equity guarantee risk-transfer solution that has already been transacted and where we are discussing with the PRA how it should be treated in Solvency II.

But we are also determined to maintain as much value for our own shareholders. To highlight the stock of value we've already accumulated in the business, today we are disclosing our surplus emergence for the first time. More on that later, but we believe that it confirms the significant value in our existing book of business, which is not currently reflected in the share price.

And the final item on the agenda item is the financial results. The reported Solvency II coverage ratio as of 30th of June was 149% and has subsequently increased to 152% on a pro forma basis taking into account developments since the 30th of June.

First half IFRS operating profit developed in line with our guidance and demonstrated our capital discipline in action. We were particularly selective on DB business written in the first half and our patience is being rewarded. We have targeted a lower percentage and a more capital-efficient mix of mortgages. And as expected, this capital-first approach did result in a drop in headline profits. It's simply the short-term effect of our transition to a sustainable business model using our capital bases wisely.

Now dividend. We said in March that we expected to recommence dividend payments for the 2019 financial year at around one-third of the amount paid in 2017. Given the uncertain political macro and regulatory environment, the Board felt that it was prudent to defer any interim dividend until we receive further clarity. We expect an outcome on CP7/19 in the fourth quarter, and we await developments as the Brexit process unfolds.

This will allow us to revisit our dividend policy with our full year results informed by the capital position and outlook at that time. So let's turn to the main topic of today, which is capital. Before we step into numbers themselves, I just want to sum up what we've achieved so far and what is to come next. On the left, in terms of capital actions completed, I'd like to think we are building some credibility that we can deliver the initiatives shown on the right-hand side of the slide, which are in progress or future actions.

Our focus on cost control continues and we continue to nudge our mortgage exposure down in the front book through a changing investment mix and in the back book via a completed NNEG risk transfer that is serving its economic purpose. A range of reinsurance options remain available.

Now let's step into numbers. This table shows the development in our Solvency II surplus over the first six months of the year. Just to note that all figures are post notional TMTP recalculation and they are after tax. Our opening surplus was GBP577 million, a coverage ratio of 136%. The ratio was reduced by just 2% through organic capital consumption in the first half. The limited organic capital erosion was more than offset by positive non-operating items. I'll go through those items in a few moments.

This meant that our solvency ratio increased from 136% at the start of the period to 149% at the balance sheet stage. There are also some actions we have taken since which affect the surplus figure, and I'll come back to those later too. But first, let's go into further detail on the organic capital consumption and how we see this developing.

So Slide 6, this GBP36 million of organic capital strain or 2% reduction in coverage ratio was made up of five principal components shown in the table. We will go into further detail on in-force surplus, new business capital strain and expense reductions in subsequent slides. In the dotted box in the right-hand side of this slide, we've broken out the expenses. We plan to eliminate expense overruns of GBP9 million, and we plan to do that by 2021.

Just note that the finance cost of GBP25 million post-tax represents Tier 2 and Tier 3 interest cost during the period plus a month of RT1 coupon. We expect a total of around GBP60 million in this line for the full year 2019. Let's go into some of these items in a bit more detail.

In-force surplus generation is developing in line with expectations. This represents the gradual release of the prudent margins required by Solvency II, including risk margins and Solvency Capital Requirement and allows for amortization of transitionals.

We expect the annual net surplus generation figure to grow by low double-digit rate per annum over the next few years on an underlying basis. This is the result of the back book growing at a mid-single digit as we build reserves, with TMTP amortization being flat. The component parts are in the dotted box in the top right-hand side.

And note, though, that as we complete some of the capital management actions that we'll talk about later, this may change the shape of future surplus emergence. The growth of in-force surplus means it will over time outstrip new business capital strain and the other costs we saw on the previous slide, including financing costs. And this is the key dynamic propelling us to organic capital generation by 2022 provided we remain disciplined on new business capital strain. And so let's turn to that on the next slide.

We've reduced new business capital strain by half over the past 12 months. So in pound terms, that's a fall from GBP95 million to GBP47 million, so a 50% reduction. How have we done that? We've made multiple price increases to compensate for the additional capital we're now required to hold and to mitigate the impact of lower risk fee rates. And by the way, we're already pricing for a 13% volatility and 1% deferment ratio.

We've changed our business mix as well as our prices, and are writing shorter-duration liability business with an increased emphasis on impaired Guaranteed Income for Life or GIfL lives. We've also reduced our exposure to the most capital-intensive lifetime mortgages by targeting older borrowers. And to decrease new business capital strain further, we've reduced the LTM backing ratio and targeted customers who have sufficient income to service their interest.

All these changes are adding up to make a big difference. This means that even in new capital regime, we are again delivering our target mid-teen returns on shareholder capital deployed in new business. So we've acted decisively and quickly. Our markets and our distribution network remain healthy and under my leadership, we will take advantage of our expertise in these growing markets by selecting the most capital efficient opportunities available. We will not focus on top line growth.

So now let's move onto costs. Given our shift to a less capital intensive and lower new business volume model, we have re-examined the cost base. We expect to achieve GBP16 million of cost savings in calendar year 2019, equivalent to a 10% reduction in the expense base compared to last year. Rightsizing the cost base is a key management focus and we have further initiatives planned for 2020. That GBP9 million of expense overrun we saw earlier has got to go.

We've already highlighted our decision to close the US Care business in May and that the income drawdown product will be outsourced during the second half of this year. In addition, we have consolidated our property footprint in Reigate and will move shortly to new London premises.

These savings will start to become effective in the second half of this year and should become visible in our new business, other group companies and development expenses lines in the IFRS operating profit analysis and also to a degree in the non-operating cost lines below the line. We are actively managing this and we'll keep you updated as we make further progress.

Now, after the June balance sheet, we increased the amount of longevity reinsurance from 70% to 100% for our post-Solvency II DB business. This transaction has reduced the amount of capital we've had to hold in relation to back book longevity risk, resulting in a GBP118 million increase in surplus at an attractive implied cost of capital. However, it will affect other financial metrics. We expect a one-off IFRS charge of GBP10 million pretax, which will come through the full year P&L in the operating and experience variance line, and a GBP48 million reduction in embedded value.

We are also increasing the longevity reinsurance on future DB business. From the 1st of July this year, our treaty has been amended so that 90% of standard underwritten business and 75% of medically underwritten new business is longevity reinsured. This is expected to further reduce our new business capital strain and improve internal rates of return.

It will have, though, a small cost to IFRS new business margin. The transaction demonstrates that further de-risking and wider reinsurance options on the in-force business are available. So let's move to Solvency II non-operating items. First, we have six months of accelerated TMTP amortization, which we talked about previously. We expect a further GBP21 million in the second half of this year and around GBP25 million for full year 2020, falling to zero thereafter.

Next, you have the economic items. These totaled minus GBP49 million broken down in the dotted box on the right-hand side. The largest component was a negative property variance of GBP96 million. This represents a difference between the negative 1.9% house price deflation across our portfolio in the first half of the year compared to our long-term assumption of positive 1.9% house price inflation for the half year.

This property variance includes the impact of the effective value test, or the EVT, on our regulatory surplus when two key variables; house prices and risk-free rates, are moving against us. Just to be clear, we had no actual NNEG shortfalls and very little change to expected future NNEG shortfalls, but a large increase in the time value of NNEG which is magnified by the new Effective Value Test.

Next, interest rates. Recognizing the risk, we proactively took out a number of swaps to reduce the sensitivity of the Solvency II balance sheet. The result is there was no impact on surplus from rates down, however, lower rates increases the SCR and own funds by the same amount, and hence, the SCR coverage ratio is diluted slightly and fell by 3%. Lastly, there were other economic movements, which totaled to a positive GBP47 million, offsetting some of the property value movements. The details of this are in the bottom of the slide.

So look, there's a lot to digest over the last few slides, so I'd like to reiterate the key messages. First, we've made very good initial operating progress with our focus on capital efficiency. And secondly, we have an unbending commitment to organic capital generation by 2022, but we have been negatively impacted by economic effects, which have been magnified by the new effective value test.

Next, let's move to some of those Solvency II sensitivities. This chart shows the sensitivity of our capital positions to key risks that the balance sheet is exposed to. And again, as before, note the figures presented here assume a notional TMTP recalculation. We've included the pro forma adjustment as part of the analysis, thus the starting point is a surplus of GBP888 million and an SCR coverage ratio of 152%.

So first of all, interest rates. Although rates down would increase our own fund, it would increase our SCR by more. The chart on the left shows a rates down 50 basis point sensitivity with TMTP recalculation as at the balance sheet date. Recognizing the movement in risk-free rates, we subsequently entered into additional hedging over and above what we did in the first half to provide downside protection to the regulatory balance sheet falling rates.

So for your modeling purposes going forward, in a scenario where rates fell by 50 basis points, you can assume there'll be about a GBP20 million reduction in excess own funds and a 5 percentage point reduction in coverage ratio, as mentioned in the bullet point on the right-hand side there.

Our exposure to property risk, as you're all aware, relates primarily to the no-neg guarantee on lifetime mortgages. The property stress represents a 10% immediate fall in house prices with no recovery. This stress would have reduced SCR coverage ratio by 20 percentage points, an increase from last year due to the additional sensitivity created by the Effective Value Test.

And as for longevity, the 5% uniform increase in longevity shown here would represent a surprise, but is a risk we could absorb. The figure reflects the recent DB longevity reinsurance transaction, and thus this sensitivity has actually fallen since the year-end.

Okay. So back to our actions. And we've just covered the coral squares on the left-hand side of the page. We've made good progress towards achieving our organic capital generation target, but we have faced economic headwinds. So my main two priorities are; first, to continue to make progress on organic or underlying capital generation; and then secondly, to continue to de-risk our balance sheet to provide some buffers in a potentially challenging economic and regulatory environment.

The blue boxes on the right-hand side show some of the key initiatives which are in motion and which can achieve those aims. I've already touched on what we've done on cost savings and the scope to add to it. This is closely linked to our commitment to eliminating operating losses in our growing HUB Group businesses, building on the actions we've taken on other group operating losses, such as U.S. and FPP.

I've also made it clear that although we have made progress on derisking via reinsurance, we aren't finished yet. We also have work to do on derisking our investment portfolio in such a way as to reduce capital requirements. So it's too early for us to go into detail on all of those areas. But there are two of the initiatives on the right-hand side which are probably worth spending a bit more time on, and that's the development of a capital-light DB partnering business, which will further reduce new business capital strain, and an update on NNEG hedging.

Let's turn to the first of those, the partnering opportunity. We are using our excellent standing in the DB market to develop a fee-based business that will further diversify our source of profit and reduce new business capital strain. We intend to target transactions above GBP250 million with this transaction, which would not complete with our core target market which is typically transactions below GBP250 million.

For potential partners, Just offers a relatively quick, low-risk way to enter the DB market by leveraging our award-winning new business franchise and where direct entry is challenging and very time-consuming. Initial feedback from employee benefit consultants and trustees have been encouraging, and we have started to build a pipeline of potential transactions.

EBCs welcome this additional capacity in what is shaping up to be a record-breaking year with over GBP30 billion of expected DB buy-in and buy-out activity in 2019. Our development we're talking about here won't happen overnight, but initial progress is encouraging.

So let's talk a little bit more about NNEG and the potential to hedge that risk. So first of all, I illustrated earlier that the Solvency II property sensitivity is high. And here in this slide, we contrast this with the expected long-term cost of no-NEG shortfalls.

Now to be absolutely clear, I'm acutely aware that the Solvency II treatment of the no-NEG very directly impact our business. However, what we're doing here is highlighting the difference between the regulatory treatment and expected outcomes for two reasons: First, to illustrate in a very simplified way how most of the Solvency II volatility is expected to be a timing issue; and secondly, to explain why no-NEG risk transfer makes economic sense with counterparties who are in a position to focus on the economic view to a greater extent than us.

So the first number to note on the slide is GBP26 million. This is the present value of the cost of expected no-NEG shortfalls under our central property growth scenario. On the chart, you can see how far in the future these no-NEG shortfalls emerge. The expected NEG [ph] shortfalls peak 30 years from now and overall involve relatively small numbers. If we assume a sudden one-off 10% hit to house prices and no subsequent recovery, the cost of the no-NEG shortfalls obviously goes up, but it only goes up by GBP27 million.

The contrast with the impact to the Solvency II excess own funds is stark, a one-off 10% hit to property prices, as you saw in the previous slide, results in a GBP312 million reduction in Solvency II surplus. That is more than ten times the expected economic cost.

Now, I do accept this is a simplistic way of presenting the expected long-term cost of NNEG. In reality, house prices won't develop in a straight line and there will be regional and individual property variances. However, it demonstrates that most of the Solvency II volatility relates to time value rather than intrinsic value. The key components driving this time value, the deferment rate and volatility assumptions, we believe are both set at conservative levels and that's echoed by the Institute of Actuaries and the Association of British Insurers.

It turns out that the EVT's assumptions are also conservative compared to hedging costs on offer in the market. So no-NEG risk transfer makes economic sense with counterparties who are in a position to focus on the economic view. This means there's a strong incentive for us to explore no-NEG hedging options. They may come at a modest economic cost, but provided this is low compared to the amount of capital released, we should explore it.

So what we've done is we've already transacted a pilot GBP200 million no-NEG hedge with a well-known counterparty. This proof-of-concept transaction forms the basis of discussions with the PRA regarding its eligibility for appropriate matching adjustment and SCR treatment in Solvency II.

The pilot is achieving its economic purpose, but its regulatory treatment is subject to the conclusion of CP7/19, which we expect to be published either at the very end of this quarter or in the fourth quarter. If successful, applications to PRA would pave the way for larger hedging transactions in the future. At the moment, we anticipate that we would focus such hedging on post-Solvency II LTM business. However, it may also be beneficial to hedge pre-Solvency II business as the TMTP amortization progresses.

So let's move on next to a focus on value. We've introduced this slide for the first time to show how the Solvency II cash emerges over time and to help you understand the dynamics of our existing book of business. It shows the expected Solvency II cash flows of the existing book of business, i.e., excluding any new business that we wrote from July the 1st onwards. It also excludes a day one surplus of GBP840 million and debt cash flows. But otherwise, it's similar to the EV cash flows.

You can see the significant levels of cash that the existing book throws off, but also the drag that TMTP amortization causes until 2032. In the first few years, we need to adjust to the PS 31/18 regulatory requirements, that's the orange bars. But after that, you can see that the black line, the surplus generation, settles down to GBP150 million or so per annum and adds up to GBP1.35 billion over the TMTP amortization period.

This then shoots up to GBP200 million or so per annum after the amortization finishes. In the first ten years post-TMTP, this amounts to GBP1.8 billion of additional surplus generation. Now please note that these surpluses have not been adjusted to reflect the impact of either the new DB longevity reinsurance contract or the impact of CP7/19, both of which has happened since the June balance sheet date.

And remember that this shows the back book run-off only. The markets, as you know, are very healthy, particularly DB. This and the strength of our distribution capabilities has meant that as we have repriced, we've been able to select the most capital efficient and profitable business -- profitable opportunities available rather than simply focusing on top line growth.

And by already completing some of the management actions available to us, our objective is to take advantage of the strategic value of our new business franchise, which is in addition to the value of the existing business shown in this slide.

Okay. So let's move to the final part of today's presentation, which is the financial results for the first half of the year. First, solvency. As you've already seen, our solvency ratio increased from 136% to 149% in the first half of the year. The Solvency II balance sheet calculation continues to comply with the EVT that forms part of the MA calculation. It was also good to see Fitch refresh their A+ or strong insurance financial strength rating recently, and in fact to reaffirm all of their ratings on us.

Now, I want to spend some time on a couple of third quarter developments and what they mean for our solvency outlook. I've already mentioned the DB longevity reinsurance transaction that we recently completed. This had an effective date of the 1st of July and was not included in our reported 149% coverage ratio. If it had been, it would have added GBP118 million to surplus or 9 percentage points to the ratio.

Second, we have included an adjustment regarding our internal model and the treatment of LTMs. We expect to increase our SCR by GBP70 million in the second half of the year for that. So the pro forma Solvency II coverage ratio at the 30th of June would have been 152%, taking both of these items into account.

Next, I want to try and quantify the incremental impact of CP7/19 for lifetime mortgages, which I know is causing significant uncertainty for many investors. We and the industry engage constructively with the PRA as part of the consultation process. Since the consultation period ended in July, our thinking around these regulatory changes has continued to evolve. The final outcome remains uncertain, but we are planning on the basis of an increase in our SCR of approximately GBP130 million for existing business by the end of 2021.

The consultation part of the process, as I mentioned has concluded and the figure could be higher or lower. We expect to hear the outcome, as I said, probably during the fourth quarter. And of course, we note here that the cost of CP7/19 which affects the SCR will be in addition to the cost to our matching adjustment of strengthening the EVT to 13/1, which we've talked about previously.

As we have shown with the DB longevity reinsurance transaction, there are multiple capital management actions available to us, which can offset these regulatory changes. Next, we'll get to the IFRS operating results. Underlying operating profit fell 27% to GBP114 million as a 39% decline in new business profits was partly offset by a 15% increase in in-force operating profit. The new business profit decline reflect the 30% fall in retirement income volumes and lower margins as flagged in the prelims in March.

Operating variances and assumption changes were not material, but I would flag a GBP10 million pretax cost at the full year stage as a result of the DB longevity transaction. We haven't updated any of our assumptions, and as usual, we'll do a full review of those at the year-end.

Next, we expect that other group company losses would start -- should -- excuse me, should decline as startup losses in our HUB Group businesses are eliminated and reflecting that US Care is now closed and our income drawdown solution is outsourced.

Development expenditure will reduce further, not to nil, we do still expect to incur costs as we adapt our proposition to a changing environment and continue to developing the pool of customers for our new business franchises.

So let's look at new business and in-force profit in a bit more detail. As previously guided, our new house price inflation and volatility assumptions resulted in a roughly 1% reduction in the new business margin compared to 2018. In addition, shorter-duration LTM mortgages and a marginal reduction in the LTM backing ratio reduced our new business margin by a further percentage point.

And finally, volumes were lower in the first half compared to the corresponding period in 2018, and so there is an element of negative operating leverage which absorbs some of the initial benefits of our cost reduction program. However, this was flagged to you at the prelims in March and overall new business margins have developed as expected.

Going forward, the impact of the additional DB longevity reinsurance is expected to slightly reduce the H2 new business margin, but offset by operating leverage due to a greater weighting towards H2 volumes. So we're expecting a similar full year '19 new business margin of around 9%.

In-force operating profit increased by 15%. Opening insurance reserves were 4% higher, while our surplus assets were higher following the March capital raise. Furthermore, we increased the yield on these surplus assets a little and expenses reduced. So overall, a pleasing in-force result.

Next we'll look at some of the items below the line. The fall in the operating profit was more than offset by gains from non-operating items. This meant the profit before tax actually rose from GBP46 million in the first half of last year to GBP125 million this year. The swing was driven by the replacement of a GBP59 million economic and investment loss last year with a GBP68 million gain this year.

As the analysis on the right hand shows, this was driven by the positive impact from falling risk-free rates, less the somewhat smaller negative impact of lower property prices. We just contrasted in the commentary there the difference between some of the IFRS and Solvency II impacts. So you can see that the IFRS result, we get GBP100 million benefits from risk-free rates. That's in contrast with the Solvency II picture, which is a zero impact. And on property, they're both directionally the same, but IFRS shows a negative GBP57 million compared to GBP119 million on a like-for-like pretax basis in the Solvency II reconciliation, and that again is due to SCR effects and the magnification of the Solvency II impact by the Effective Value Test.

Finally, a very brief update on the asset portfolio. You can see from this slide that our bond exposure is conservative from a credit perspective with an average rating of A and just 0.6% of the total portfolio below investment grade.

On the right-hand side, you can see the asset portfolio by sector. The GBP12 billion corporate credit portfolio had 521 issuers with an average size of GBP22 million, with the balance lifetime mortgages and liquidity. Now we just look at how our portfolio is constructed to match our retirement income liabilities. On the left-hand side, you can see the proportion of liquid, that's is blue, and illiquid, that's in coral, assets contained in our total GBP21 billion portfolio.

Private placement and public bonds are predominantly used to match shorter-duration liabilities, whilst lifetime mortgages provide a strong match against longer-duration liabilities with infrastructure and commercial mortgages slotting nicely in between. Now by using shorter-duration bonds, we do have the added benefit of reducing the risk of ratings migration.

On LTM, we see no deterioration in credit quality with a portfolio LTV of 34% and it remains well-diversified geographically. The usual disclosures are in the appendix, but just to highlight that the loan to value on new business was 28.7% with an increasing focus on older borrowers.

On the right, we've provided a geographical breakdown for the first time of the GBP11.5 billion corporate credit portfolio. Just 42% of this portfolio is U.K. corporate credit, so the majority is non-U.K., primarily from Europe and North America which account for 28% and 18%, respectively. 79% of the portfolio is denominated in sterling and any non-sterling cash flows are swapped back into sterling.

Our investment approach in 2019 reflects the focus on reducing the capital intensity of new business. We've adapted, as I said, to regulatory changes by tapering the LTM backing ratio, targeting older borrowers and investing in slightly longer-dated credit infrastructure and commercial mortgages to compensation.

Now, I'm very conscious I've shared a lot of new technical detail with you this morning, and that's very deliberate. However, I also think it's important to pause and restate our Company's purpose and take a moment to remind everyone why we do what we do here at Just. Our purpose is very clear: We help people achieve a better later life. Every colleague across the group contributes to this purpose, whether they're serving the customer or providing the support to someone who is.

At a time when individuals and organizations are faced with much uncertainty, we use our unique skills to provide certainty. Whether that's to a retail investor who wants a security of a guaranteed income for life, a pension scheme trustee wanting to transfer risk and improve the level of security for its members, or a homeowner seeking to improve their later life or that of their families, and also to our corporate solutions and distribution businesses in the HUB Group where we deliver regulated advice and guidance to provide peace of mind to our customers.

Now our group businesses have leadership positions in attractive segments of the retirement income market. We achieve this leadership by deploying our intellectual property, which ensures we are able to fulfill our purpose and to do so by providing great value and outstanding service to our customers. That purpose motivates me and over 1,000 of my colleagues at Just every day.

So my concluding remarks before we move onto Q&A. Hopefully it's very clear that capital is our number one priority. It's simply the right thing to do for our business given the changing environment. You've seen how the strategic imperative underlies the whole presentation today. We are already making strong progress towards organic capital generation and are taking significant steps to derisk the back book.

The focus on capital efficiency is also improving shareholder returns on a new basis. Our new business has already been re-engineered to achieve mid-teen IRRs and shareholder capital. We will strive to improve this further via our DB partnering business and other initiatives.

You'll know the regulatory environment towards LTMs is challenging and has changed given the prevailing economic conditions which arose following the unexpected results of the EU referendum. On CP7/19, we are planning on the basis of an increase in our SCR of approximately GBP130 million for existing business, which will become fully effective by the end of 2021. By the way, the figure we have provided has been carefully thought through and is on a best-endeavor basis.

As we've highlighted today, through the GBP118 million benefit from DB reinsurance, we have a number of management actions available to us to offset these impacts. And importantly, we have time to put these in place as the regulatory changes are phased in by the end of 2021.

The first half this year has not been easy for our business or for shareholders as we have faced economic and regulatory challenges.

However, we have made real operating progress and I take pride in the way the business is responding. I particularly want to recognize the response of our colleagues across the group in their agility to respond to the rapidly changing environment. Our focus remains the maximization of shareholder value with no options excluded.

We are adapting our business model to ensure it is economically attractive in a challenging regulatory environment and are making good progress towards a sustainable capital model. However, we are developing other strategic and business options to enhance shareholder value in parallel. Whilst preserving our strategic options, all our energies are devoted to this objective.

So with that, we'll move to Q&A. And I'd like to invite Guy and David to join me up at the front here. Obviously, a lot of new information today, there may well be a few questions. So if I could try and ask you to limit it to two questions. And the first one goes to Gordon.

Questions And Answers

Q - Gordon Aitken {BIO 3846728 <GO>}

Gordon Aitken from RBC. On the capital-light bulk new model, I mean you set things out, but I was just wondering when do you think you could do your first deal and if you'll also indicate what you think the strain would reduce to under this new model?

And second question is on the no-NEG hedge. What are your expectations that this gets approved for capital reduction by the PRA? And really why -- what was your thinking in showing the capital charge under CP7/19 when you don't know whether or not you're going to get PRA approval or not, assuming the numbers would change?

And just maybe an observation, you feel happy to set out the expected charge under CP7/19, but you didn't say -- set out any expected mortality gain. It's quite different to maybe some of your larger peers who feel they don't need to flag the negative, but are very happy to flag the positive, and maybe what was the Board's thoughts there?

A - David Richardson {BIO 18045016 <GO>}

I missed the last bit of that question, Gordon. I think it's the microphone. But can you just --

Q - Gordon Aitken {BIO 3846728 <GO>}

Well, you're very -- you set out all the negatives, you haven't set out, say, a positive, which might be a mortality release. But I mean your larger peers really did quite the opposite. They haven't set out the negatives, but have set out the positives.

A - David Richardson {BIO 18045016 <GO>}

Okay. So, and what I'll do is I'll give you a little bit of an answer in each of those, and I'll invite Guy to come in on the no-NEG hedge as well as to why that does need to kind of wait for CP7/19.

In terms of the DB partnering, two elements to that question, when do we expect to have that in place? Well, we're making very good progress. I'm not going to set a self-imposed deadline because it is subject to commercial negotiations with our partners, but we're having really good, deep engagement built with our partners. And also as I said, we've not -- we're not just doing this in a vacuum, we are road-testing this with EBCs. They're very enthusiastic about what we're doing here.

And if you think about and step back for a second, at a time when we are capital constrained and where we have to live within our means, using our award-winning new business franchise and being able to tap into this business where we're having to constrain our activity just makes absolute sense. And what we can offer our partners is, if they don't have a presence in the DB market, and they may not be PRA regulated, and that's a very long, expensive road to get to that point, we provide a very good entry point. So I think it could be very encouraging.

You asked how much might it reduce the strain, again that's a little bit subject to commercial negotiations. The idea will be to get it down to negligible levels though. So if you're predominantly a fee-based business, you would need to set aside some capital for things like counterparty risk as you pass the risk onto your partner. But that would be the objective.

On the no-NEG hedge, look, first of all, economic is absolutely achieving what it set out to do. We've transferred the risk over about a 35 to 40-year period. And it covers no-NEG shortfalls, not immediately in the money, but a little bit out of the money up to a level, and it really does make absolute sense from a risk transfer perspective.

However, it's not straightforward how that applies in Solvency II rules because you have to pair a hedge with the restructured notes that you have on lifetime mortgages in a Solvency II world and how that flows through the matching adjustments and the SCR. So it isn't straightforward.

Guy, I don't know if you want to add to that.

A - Guy Horton

To add the little bit, I think you asked about why we think it will get appropriate treatment was one part of your question, Gordon, is that right to say? So it works like a hedge. If experience goes against us, then it would pay out. So we think that underlies any sort of treatment of a derivative of the hedge. CP7/19 refers to other assets and SPEs, which is what this is and doesn't write it out. It doesn't say you can't have such things. What it says is the treatment needs to be resolved.

Really the area of the greatest doubt is the treatment in the MA. The treatment in the SCR is not really in doubt because in a stress event, it's really clear how it would pay out. So it's really about how you treat it in the own funds that is the piece that matters greatly.

And everyone's trying to work out how you allow for EVTs in your own funds and then transfer it through to SCR, which relates to our CP7/19 comment around SCRs. How do you adjust your internal model for all the changes that happened over the last few years.

A - David Richardson {BIO 18045016 <GO>}

And then your question around why are we giving, as it were, a forward estimate of the potential impact to CP7/19. And this is something we did debate, because as I said in my comments, it is our estimate, or more accurately what I'd describe it as it's the outcome we're planning for.

So all our capital plans and how we're planning to manage our capital position is based on an assumption that we'll have to increase the SCR by about GBP130 million for that. And we've done that because it's an uncertainty out there. A lot of the feedback I get when I talk to shareholders is, look, with the regulatory uncertainty out there, I just don't know what number to put against that.

So it comes with a little bit of risk as to will it really be that number, but we just think it's the right thing to do to help investors. Why are we not putting out some -- anticipate a positive and a number on that to offset it? And it's because specifically on longevity, I'm not indicating that we've set aside a whole load of kind of margins in our assumptions at the moment. More generally, what we're trying to emphasize is we've got a full suite of capital management actions that are -- we anticipate to use in our capital plans and that can help us to manage the position over the next couple of years.

And I hope that by delivering this DB longevity reinsurance of GBP118 million, which more than offsets the first step towards increasing the SCR, shows that those are credible actions.

Q - Gordon Aitken {BIO 3846728 <GO>}

Thanks.

Q - Unidentified Participant

(Technical Difficulty).

A - David Richardson {BIO 18045016 <GO>}

Okay. So I'll take those in turn. So I just want to be really clear, we're not saying that if you put a NNEG hedge in place, the sensitivity on Solvency II will drop from GBP312 million to GBP27 million. I wouldn't want you to take that away. What we're just trying to emphasize is that there's a massive gap between the Solvency II sensitivity you're seeing and how expected claims might move around or shortfalls might move around.

And just to bring out the point that if a counterparty can look at more of the underlying economics, there's a big gap between that GBP27 million and that GBP312 million, where you should be able to find a sweet spot where we can release capital and it makes economic sense for them to provide our cover.

So that's the theme. Absolutely, we don't expect to find a counterparty who can take GBP7 billion of LTMs. We will focus on the LTMs we've written, as I said in the first place, since Jan 1, 2016, and the first step towards that is we've just done this relatively small GBP200 million proof-of-concept transaction.

And once we get, as Guy said, the technicalities agreed on that, we would seek to scale it up. Not realistically that we'll get to GBP7 billion or anything like that, but you could generate meaningful capital releases, number one, and number two, reduce the volatility of the balance sheet. So you get a day one release from these transactions if you get the right treatment and then also, subsequently, if house prices were to move down, you get protection on the downside because you just take some of that GBP312 million volatility away.

And on the projected cash flows, yes, we're obviously very clear that we have not shown the debt because the intention is not that you repay the debt as it falls due, the intention is that you refinance that as you go along. And equally, of course, we didn't show an immediate release of the GBP800 million surplus -- the GBP840 million of surplus in that cash flow profile either because it's not realistic to assume you could release that immediately, too. So it is balanced on both sides of the equation. I think you were just first, Oliver, by a nanosecond.

Q - Oliver Steel {BIO 6068696 <GO>}

Oliver Steel. Two slightly technical questions. So the first is going back to Slide 18, you've got GBP50 million of surplus emergence in the second half. I think that compares with the GBP72 million in the first half. So I'm just trying to work out why the GBP72 million gets down to GBP50 million. It looks like as if it's larger TMTP.

Second question is, in working out the new business strain, your guidance is mid-single-digit percentages. But when I'm looking at the sort of premiums I apply that to, the premium shown in the roll forward of the liability is 6 8 7 and the premium shown in the IFRS accounts is 8 3 3.

And I noticed that second half, there was a similar gap. So why is the premium and the roll forward of the liability so much lower, because the new business strain on the higher figure is 5.7% but the new business strain on the lower figure is 6.8%?

A - David Richardson {BIO 18045016 <GO>}

Okay. So on the first of those questions, yes [ph], and why is it not exactly the same as in the table? I can't, off the top of my head, think what might be in that other than maybe it might be some exceptional items. But that's a detail we can certainly get back to you on, Oliver.

And the strain should be pretty mechanical. So the 5.7% times the new business premiums that we report in the RNS should get you to the GBP47 million.

Q - Oliver Steel {BIO 6068696 <GO>}

(Technical Difficulty).

A - David Richardson {BIO 18045016 <GO>}

Premium in the IFRS accounts?

Q - Oliver Steel {BIO 6068696 <GO>}

(Technical Difficulty).

A - David Richardson {BIO 18045016 <GO>}

So rather than us wait -- so your --

Q - Oliver Steel {BIO 6068696 <GO>}

(Technical Difficulty)

A - David Richardson {BIO 18045016 <GO>}

Yeah, okay. Okay. So again, I think that's a detail we'll take offline. Maybe Guy might be able to work it out whilst we go onto the next question, but that's quite a detailed question on the note. It's probably best to submit those offline. Alan?

Q - Alan Devlin {BIO 5936254 <GO>}

Thanks. Alan Devlin from Barclays. Two questions. First of all, on the -- I think you reiterated your sales guidance for sales to be in the H2 '18 run rate. Will the DB partnering scheme be additional sales above that or will you be replacing some of the existing DB sales with more capital-light sales? And then the second question is on your last slide, you've got a -- your last comment is no options excluded.

Given you're writing business of mid-teens ROE, which is -- or IRR, which is well below your cost of equity, at what point do you think you'd take more radical actions? Thanks.

A - David Richardson {BIO 18045016 <GO>}

Yeah. So in terms of DB volumes and will the partnering as it were, we certainly don't expect the partnering will cannibalize what we currently write at the moment because it's in a different target segment of the market. So it's focused on transactions over GBP250 million, whereas we predominantly write transaction sizes below that level.

So what it gives us is an option. If we can get that partnering to work, we can get an option, to your point, Alan, whether we kind of continue to write the same volumes on our balance sheet and top us up with this maybe neutral or even negative strain partnering business.

Or we might -- depending on the overall capital position, we might substitute a bit. But it's very much a choice and an option for us. So we're not updating our guidance on sales or anything like that at this stage. On the no options excluded, yes, clearly the implied ROE on our such a depressed share price at the moment is something which is quite a demanding target.

And one of the reasons we're highlighting the underlying cash flows today is just to show the gap between just the stock of value that is there today and the underlying share price. And that for us tells that the -- the share price doesn't represent the value that's in this business.

And so instead if we look at it more, I would say, objectively and look at the actual money we're investing in new business, so the GBP47 million plus margin on top of that, that is earning a mid-teen return as we put that to work.

And we think based on a more normalized cost of equity, that is well, well in excess of what a normalized cost of capital would be. So we think that makes sense economically to do so. Have you got the --?

A - Guy Horton

Look, I don't -- I haven't done a calculation to the nearest penny, but do I understand correctly you're asking why is it that the increase in liabilities to new business sold is not equal to the premium (inaudible)? So there's two points of which you would normally expect a difference. One is the IFRS margin on new business. So you sell the premium, it's not all going to go into liabilities, that's how you make a new business profit. And the second one is new business expenses. I haven't done a check if they would line up completely, but it feels roughly that it would.

Q - Edina Rozinka {BIO 16575765 <GO>}

Edina Rozinka, Goldman Sachs. Can we just go back to your debt comment. Obviously, you mentioned that you are planning to repay and we know that your next call or bond which is coming up for call is the prime bond 9.5%. So just wondering if you have a preference, given the Brexit, to get this refinanced sooner or later?

Or you want to show the Q3 results with the progress which you outlined, and then perhaps come to the market on that?

A - David Richardson {BIO 18045016 <GO>}

Yes. So yes, we do. We've got a GBP100 million bond, Tier 2 bond, which has a call -- first call date in March of 2020. And so our mind is turning towards refinancing that. We do have some options there. So we do have capacity technically to do more Tier 2 if we wanted to even up to benchmark size.

However, I think we need to balance that against our overall leverage ratio and also demand in the market and cost in the market. It's not going to be the cheapest time to refinance with Brexit looming. So we'll take all those factors into the round as we step towards that stage. But -- and we've stated in our RNS, refinancing that bond is very much on our mind.

Q - Nicholas Johnson {BIO 1774629 <GO>}

Hi. Nick Johnson from Numis. On the reinsurance transactions that you've done, obviously they more than neutralize the GBP70 million capital charge in the pro forma number you've given. Could you say whether you see future reinsurance options being potentially greater or lesser than the GBP130 million that you flagged today? Thanks.

A - David Richardson {BIO 18045016 <GO>}

Yes. So I don't say that's because some of our reinsurance partners are in the room, but reinsurance really is a wonderful tool because it can allow you to achieve a number of different outcomes and it allows you to take advantage of the different risk profiles and cost of capital that our reinsurance partners have compared to us.

And the reason I mentioned that just as an intro, Nick, is because we could absolutely could do more longevity reinsurance on some of our existing business and there's a lot of unreinsured business on our GIfL lines. And so there is definitely some scope there. But you can also use reinsurance for different tools, which is why I said it's quite a useful tool.

And you might look at transactions which involve transferring both longevity and asset risk to reinsurers who will have less onerous capital requirements on some of those assets, or at the very least a lower cost of capital. So when we talk about a wide range of reinsurance options available to us, it's not just more longevity reinsurance, it could be beyond that. Greig, yes?

Q - Greig Paterson

Two questions, but I just got a request -- two requests first. One is that slide up there, free cash generation and your EV number, which is a single number, we don't know what the underlying assumptions are for your real world there. We don't know what your EV assumptions. And to be very truthful, I just disregard those things because I don't know what's in the black box at all, and history has taught me that we've had some unreliability just [ph] with these type of numbers.

But in terms of -- and that's request one, if we can have some color, please. And the second thing is in terms of your sensitivities having circa 50% in non-LTM credit, and we've got very low spreads and I know you've had some upgrades, but there's worry there'll be some downgrades. So I wonder if you could add a sensitivity that includes the combination of higher spreads and sort of circa downgrades because to me that's the next concern re., your stock in the next two years.

And so in terms of -- so those are two requests. In terms of questions, one is you very kindly gave an estimate of what you think the CP7/19 impact is for your SCR and EVT. How would it impact the -- because you provided sensitivities, but I'm more concerned at the end of the year, how is it going to impact the interest rates and the property sensitivity? Because that's what we're going to use for the full year forecast. So if you can give us some color on how the sensitivity churns.

And the second thing is in terms of the embedded value, your post balance sheet adjustments for the DB reinsurance and the CP, I think it was a CP13/18 adjustment on the matching account. Could you just tell us what -- you've given us the IFRS headwind, could you give us what, in terms of EV per share, what the headwind is going to be for these post balance sheet things?

A - David Richardson {BIO 18045016 <GO>}

So on the requests note, we'll take those back. And I hope what you've seen today is a lot of additional disclosure and the focus of that has been very much on capital. And so hopefully that helps you understand what's going on in the business and with our number one priority. So that was really the priority for today, but we'll take those additional requests on board.

The impact of CP7/19 on our sensitivities is -- I'll ask Guy to chime in on this as well. But I -- just worth bearing in mind and that the requirements of that will not become effective until 2021. So we have time to manage to wherever that lands, both in terms of impact on the balance sheet and any impact or otherwise it has on sensitivity.

I'm not sure, is there much else based in it, just in the combination to add to that at this (Multiple Speakers)

A - Guy Horton

Let me just check. You're talking about the GBP130 million SCR icing that we're talking about?

Q - Greig Paterson

Yeah, in October, when (Technical Difficulty).

A - Guy Horton

It doesn't -- I wouldn't presume that it necessarily does exacerbate the property interest rate sensitivity. It depends what the parameters look like and how the PRA would indicate that it might modify them in terms of stress.

So the PRA has removed or CP7/19 removed the 13% and the 1% as the long-term numbers and says it'll publish in September. But it also says it'll publish volatility every year thereafter and it'll publish deferment twice in a year thereafter.

And it has indicated that looking at those, by the time you get to 2021, you will have an idea of how they might be thinking about changing their parameters over time. That would be useful. If they publish any methodologies, that's useful. But it depends whether they -- if they've also talked in CP7/19 about wishing to remove some of the, for example, interest rate sensitivity that's produced by it. And so seeing how deferment rate changes will be informative there.

The zero percent floor, of course from SS3/17 remains. So if interest rates go down to a significant degree, then it feels like there won't be a lot of flexibility unless the PRA changes, although you never know what will happen with volatility. So those are the two parameters that matter. How they apply in stress matters. I'm not sure we'll have the end of the story in September or October when they publish. I think we'll have a great insight, but I don't think we'll have the end of the insight.

A - David Richardson {BIO 18045016 <GO>}

Thank you, Guy. And then your question I think, Greig, was along the lines of the DB reinsurance, how might it affect future metrics.

Q - Greig Paterson

(Technical Difficulty)

A - David Richardson {BIO 18045016 <GO>}

GBP48 million. GBP48 million. That's right. I think we've got time for one more. Andrew?

Q - Andrew Crean {BIO 16513202 <GO>}

It's Andrew Crean, Autonomous. And just could I echo what Greig's saying. I've been asking for credit migration sensitivity every single time and you've promised to take it away every single time, and it's never come back again. So please could we actually do that, because it is important.

Questions. You're talking about a target cost base of GBP145 million. How much lower should we anticipate that going in 2020? Secondly, could you give us the impact on your Solvency II coverage of market moves since June? I know you gave some indication on interest rates but there's obviously property market moves.

And then finally, you promised to review all options. One of those options would be to close the new business. Could you give us the cost? If you did decide to take that route, what would be the redundancy and rationalization cost to take out the front end?

A - Guy Horton

Okay. So -- and the question on expense base moving forward, we're not going to give a pound amount forecast on that. But I think the relevant thing that I wanted to draw your attention to in forecasting is that will eliminate the expense overrun by 2021. So I think that's hopefully helpful for you.

In terms of market moves since the 30th of June, I don't think we want to get into the habit of kind of giving updates, but the idea is with the sensitivity that you can work it out yourself. The interest rate, one of the things that's obviously moved around most since 30th of June with significant falls, and we flagged in there that given the hedging we've put in place, 50 basis points reduction in rates would be a 5% impact on the ratio.

In terms of, yes, no options excluded. And look we don't see it binary that, that statement involves doing what we're doing, closing some new business. There's actually a whole range of options to us. So I think the important thing from a value perspective, as you can see that the stock of the existing value whether you discount those cash flows, whether you look at our TNAV of 162 pence per share, there's no representation to the share price at the moment.

And -- So look, thank you all very much for your time today. I take it from your lack of questions that you're all very happy with our HUBs coming along and our underlying markets. But thank you, David, for joining us. And we're obviously available for any one-to-one questions afterwards. But thank you for your time and support.

A - David Richardson {BIO 18045016 <GO>}

Thank you.