S2 2012 Earnings Call

Company Participants

- Clifford Abrahams, CFO
- John McFarlane, Chairman
- Pat Regan, CFO
- Trevor Matthews, Executive Director

Other Participants

- Andrew Crean, Analyst
- Andy Broadfield, Analyst
- Ashik Musaddi, Analyst
- Barrie Cornes, Analyst
- Colin Simpson, Analyst
- Gordon Aitken, Analyst
- James Pearce, Analyst
- Jon Hocking, Analyst
- Marcus Barnard, Analyst
- Nick Holmes, Analyst
- Oliver Steel, Analyst
- Unidentified Participant, Analyst

Presentation

John McFarlane {BIO 1509370 <GO>}

Good morning, everyone. Now it's just one month since I last spoke to you about the plans through to 2014. And as you'd expect, while there's been a lot of activity inside the Company in that period, the consequences of that are going to find their way into announcements, not today but over the coming months. So first let me deal with the interim result.

Operating performance was largely in line with expectations. Of course the main new news was the write-down of the goodwill in the US following a view of its recoverability. As I also said last month, there was a desire to hold the dividend and that's what we've done in the half. So notwithstanding the subdued external environment, a number of our businesses performed well, including the UK, Canada, Poland and Singapore. And so that's been good. Others were affected, for example by currency, in particular Europe.

Turning to the Company overall, last month we announced the results of our strategic review of 58 main businesses within the Group. I'll remind you that that concluded that we had 16 businesses that were non-core to be exited, 15 were standout, and there were 27 that operated around our cost of capital. We also announced our intention to bring our capital levels up from current levels to a range of 160%, 175% coverage, to reduce the volatility of capital at the same time, to reduce leverage and to lower our costs by GBP400m.

As a result we ceased writing bulk purchase annuity transactions. We brought down our holdings in Delta Lloyd to below 20%. We've completed disposals in Hungary, Czech Republic and Romania. Our Italian debt holdings have been reduced by EUR2 billion and we plan further reductions in that when the circumstances permit. The yield is sitting at 5.82 [ph] in the tenure at the moment, so we really need that to drift down a little bit so that we can do that without an impact on our P&L. So that's our thinking on that.

We also began the process of disposing or running down the non-core businesses. We've appointed investment banking advisors to 10 that are planned to be sold and are in the process of reducing capital levels in capital-hungry segments. We're also considering plans to improve the returns of the 27 medium-return business cells.

On expenses, we're nearing the finalization of the delayering of the Group. There were announcements this week. And when completed should save a significant part of the total target savings. We've also begun a review of head office, support activities and non-staff costs across the Group.

As part of instituting individual accountability, each of the Group executives now have revised performance objectives. And they'll be held accountable for delivering these and that will form the basis of their variable remuneration. We've also eliminated all unnecessary committees and meetings to allow people to spend more time on our business and more time with customers. We've also reduced the distance between the CEO and the customers, which was quite deep before. And finally we continue to evolve the Board, which is now down to 11 people. And we expect further movement over the remainder of this year and into next year.

Anyway, it's my sense that we have got the right agenda. We've got the right people in place to execute it, although we are needing to appoint a CEO. We are broadly on track with the program we set out last month. Over and above the actions we've already taken, you can expect further announcements in the second half and other announcements next year. And I remain confident that we'll do exactly as we said we would going forward.

Thank you. And now I'll pass you to Pat.

Pat Regan {BIO 15131018 <GO>}

Great. Thanks John. Good morning, everybody. Nice to see you all here again. I did notice actually we'd got some Team GB chocolates for everybody to enjoy in the bowls, if you hadn't seen.

On the results, as John said, operating results I think broadly in line with expectations. GI a little bit better than expectations. Life partly impacted by foreign exchange, euro versus sterling. We booked some additional operating cost in the first half, Solvency II and the first wave of implementing the Simplify program. We have taken the decision to write-down the goodwill in the US. I'll come back to that obviously in a bit more detail later.

Operating capital generation up about GBP100m, less capital consumed in new business. New business profitability staying at pretty steady levels, both General Insurance and on the Life side. And our economic capital and IGD ratios pretty stable versus both what we told you a month ago and versus the First Quarter.

Looking at the operating profit in a little bit more detail, and we've tried to put a reconciliation big picture what's going on here. So General Insurance is up. I think probably given we'd sold the RAC and we had some additional weather costs, that's come through a bit stronger than generally expectations. And Life, UK good, slightly offset by eurozone and FX.

So big picture, some underlying profit growth generally in the General Insurance area. Last year we made just under GBP50 million from the RAC, so sold that, that comes out. In weather, this is just versus last year. So if you look at it against our long-term average, actually it's slightly above our long-term average, but not much. But it's more than last year. Last year was quite benign. And that's mainly in the UK, a bit in Ireland. Foreign exchange, both the euro and the zloty impacting profits. Then the higher restructuring cost, as I said.

On restructuring cost, you can see GBP186m. Within that you've got about GBP70 million of Solvency II costs and the remainder being the cost of Simplify, Ireland transformation, removal of the regions and the first wave of our delayering cost as well. For the full year I'd expect that number to be a bit more than double the GBP186 million as we get through to the next phase of the Simplify program.

Looking at the Life side, there's a couple of things here. Firstly is there's now seven businesses that really make up our Life results. There's three in General Insurance, seven in Life. And that's Aviva really. Biggest obviously is the UK. UK, Singapore and Poland are the really high-returning businesses, returns significantly in excess of our cost of capital. France and Spain, resilient operating profits, about around our cost of capital. And Italy and Spain below our -- sorry, Italy and Spain -- Italy and the US below our cost of capital.

In terms of the rec [ph] versus last year, modest profit growth in UK, US and Singapore. And I'll talk more country by country in a moment. Ireland we talked a bit about on July 5, tough place to do life business at the moment, the economic environment, new business profitability etc. Mainland Europe is actually reasonably resilient. When you strip out the FX impact, you're down a couple of percent in those businesses. So what you've seen there is some lower new business sales but good customer retention, good retention levels, good in-force business flowing through to pretty resilient operating profits.

Just going through that business by business, starting with the UK, our biggest business. A 2% increase in operating profit, GBP469m. A couple of trends going on there. At the start of the year we had lower -- obviously lower market values from the back half of 2011. So slightly lower unit-linked values and lower unit-linked income therefore in the first six months. That was then offset by higher annuity in force. We've grown our annuity business over time, our earnings flowing from annuities and a lower expense base. So the net of those three items gives you the 2% profit increase.

Big uplift in operating capital generation. There is a one-time item in there I think I mentioned at the First Quarter, of around GBP100m. Even if you strip that out, a good increase in operating capital generation in the UK.

One of the themes that we are going to talk about, and this is linked to pulling out of bulk purchase annuities, is bigger translation of operating profit to capital generation and then to internal dividend flows as well, and slightly therefore dialing back annuity business and slightly dialing up things like the workplace pensions.

In France, on a constant currency basis down about 5%, again really reflecting lower opening reserves in the wealth management business, but pretty resilient profits. Retentions are good, slightly better than they were at the end of 2011. And again good operating capital generation, up 16% there as we slightly dial back the more capital-intensive new business and good in-force reserves as well.

A similar story in Spain. New business is down in Spain, but that's mainly the -- something close to a 50% reduction of our new business with Bankia as we go through the arbitration process. New business in our other partners is actually down a little, but not too much. Again, strong customer retention in Spain, therefore your in-force reserves are pretty solid, flowing through to operating capital generation and operating profit. There was a little bit of a one-time item last year, so the underlying in Spain is actually pretty flat.

And very much the same story in Italy as well. New business profit -- sorry, new business volumes down a lot, probably 60% down from a couple of years ago. And that's very much actions we've taken to dial back those more capital-intensive products. Customer retention's high though so you can see that at a consistent operating profit level. And with those lower new business sales, the operating capital generation now for the first time really flipping to a positive contribution.

The US, profits up slightly. We had a small one-time item last year, but overcome that by increasing the margin on our in-force business there. You remember in the US product we can go and re-price the back book each year to a higher spread margin coming through in the US. On the operating capital generation we had a one-time negative of around GBP100 million (sic-see presentation slides "GBP98m"), a little over GBP100 million in 2012. And that was the introduction of something called AG33, which is new local stat reserving basis.

We just put down here actually just a bit of additional information, the returns on the US are around a 4% return on capital, IFRS capital there. If you did look at it through a local lens, what would you see? It was about an 8% return there.

Poland and Singapore are two terrific businesses. Poland, you remember, we built up over about 20 years. Really been primarily a pensions-based business. We got to number two in the market there. With the change in regulation we're now selling more of the life products. That's worked very well. About three-quarters of our sales are now non-pensions type business and that's good new business profitability. And again, on a constant currency basis we're flattish on operating profit.

Singapore, a younger business. It's grown strongly over the last two years, particularly in partnership with DBS there. With the wranglings [ph] you can't really see those average reserves growing over that period of time, but that coming through and generating operating profits and now a positive contribution on operating capital generation.

So a couple of comments on a big picture from our profit drivers. What we've got on here is broadly flat income. Unit-linked down a bit, as I said. Spread margin up a bit. And slightly lower expenses as we've managed that, and that's obviously a theme with our simplify program that we'll be looking to drive these numbers down going forward. And this is really reasonably broad-based, but particularly in the UK business again. Underwriting margin pretty consistent again, pretty broad-based. New business income, slightly lower volumes, as I talked to, but slightly higher pricing as well. So our new business margin, valued divided by APE, is up a couple of percent in the first six months.

In terms of investment return, again you see here, unit-linked reserves down 10%. There's about 5% in the UK, which is pretty much all market values, quite a lot of which has come back in the first six months. More like 15% in Europe, which is a bit of FX, again a bit of market value, a little bit of net flows, but mainly market values and FX. Then you can see offsetting that in the annuity income, if you like, higher volumes in the UK as we've grown our annuity book, and really a big increase in the spread margin as we continue to push the US back book for profit. Our return on shareholder assets, obviously that reflects slightly lower investment income, so investment yields, and slightly lower income from the reattributed estate.

Turning to General Insurance, as I say, a slightly better than expectations result. Managed to grow profit, notwithstanding losing GBP50 million from the RAC and higher weather cost this year versus last year, really coming from our two big businesses, the UK and Canada, which had a really standout result. Again we've tried to do the rec just to be moderately helpful there. Weather impact was about GBP40 million in the UK versus, again versus last year, and other, which is mostly related to Ireland.

Business unit by business unit, if you ignore -- adjust for the impact of selling the RAC, the UK's up about 17% profit-wise even after those higher weather costs.

What you've got going on there is, again, strong performance on personal lines. All the personal lines in the mid 90s. Continued growth of personal motor, so we added about another 185,000 policies in the first six months, up to about 2.4 million in-force policies on motor now, and again particularly reflecting the success of Quote Me Happy and multicar insurance. We also saw a nice improvement on commercial lines. If you remember last year's commercial lines combined was about 105; it's now down to 101. And particular improvement in commercial motor where we've taken a lot of rating and risk selection actions.

Canada posted a great result at 90% combined ratio. Operating profit's up nearly 50% versus last year. A little bit of a reserve release in Canada. But mainly we introduced what we think are proprietorial [ph] underwriting and pricing techniques in Canada. And that particularly has seen evidence in our motor and household results in Canada, so a terrific result there.

Partially offset by the results of our smaller General Insurance businesses. And again something that we're very focused on, just to improve the results of those smaller businesses, and that's definitely part of David's program.

In the profit drivers for GI, just a couple of things really. Commission ratio slightly higher. That really is just the impact of pulling out the RAC which had no commissions. And the claims ratio lower. If you go back two or three years, that was more like 67% a few years ago, so that's really the evidence of the improvement of the general insurance result over that time.

Our operating capital generation, a pretty simple story really, up about GBP100 million versus last year. The in-force generated is very consistent, about GBP1 billion from Life, about GBP300 million from General Insurance, and we've consumed less cash in new business. If you remember going back a couple of years, we had about GBP1.5 billion as our annual run rate for new business capital consumed and we're down to actually a bit less than GBP400 million now, both less volume to a capital-intensive business and our overall efficiency percentage improving as well.

Just turning then to the bottom line and really I guess the bit to talk about here is the goodwill amortization point there, goodwill write-off point. So on the back of going through the work that we described to you on July 5, the key point that we made in that was around capital allocation and allocating capital to the most profitable parts of the business. Obviously that means allocating capital away from other parts of the business, whether they be things in non-core or whether they be some of the things in improve.

So as you allocate less capital to the future, that means lower profit streams, which means as you assess goodwill recoverability, that has some different impacts for it. So as we went through that exercise, there were two adjustments. A very small goodwill adjustment in Italy and a larger on for the US, where we deemed on the back of that the goodwill was no longer recoverable and therefore we wrote it down. It is literally no more or less than that. It is no -- not designed to be a write-down to market value or anything like that. And I think we've got the US now on the books, David, at net assets of around about 2.3 billion -- something like 2.3b.

That then obviously is the major movement in the net asset values. You've got profits flowing through and then the impact of around 30p of the goodwill write-down.

Just on capital then, couple of things to pick up. If you pro-forma, if you allow me to pro-forma the impact of selling down Delta Lloyd, which we did just after the half year, the ratios improved to 142% or about GBP4.7b. The improvement from the year end is about half market movements and about half actions we've taken.

On the market movements, I at least was interested in we've got a positive coming through from there which was different from the direction of travel from a couple of our competitors. I think the reason for that is we've obviously got a positive impact of slightly lower spreads, but we're not as impacted by lower interest rates in terms of economic capital movements.

Second thing in terms of management actions, we said to you that we'd try and take, as we grow our capital base, that'll come from both disposals, but also a series of, I think I said, clever things that John Lister will do. So he's done some clever things in the first half; not enough yet. So these are small credit risk reductions, small amounts of reinsurance, that kind of thing, obviously as well as the impact of selling down Delta Lloyd. As of today, that ratio's still about 142%, John, isn't it?

IGD, pretty stable, GBP3.1 billion or 150%. As of today that's about 160%, partly reflecting the impact of the Delta Lloyd sell-down.

On sensitivities, we published our sensitivities to economic capital on July 5. They're basically unchanged from that date.

The other topic in terms of capital volatility is the volatility in IGD. Obviously Delta Lloyd now being less than 20% takes out one source of volatility.

The other one just to update on is the now introduction of Regulamento 43, I'm sure somebody can say that better than me, Regulamento 43, which in Italy removes the volatility of Italian government bond spreads moving around from Solvency 1. So you do not count that volatility in your Solvency 1 ratios going forward. So that last year was quite a big source of volatility for us. Just by way of a reminder, Italy's about, what, GBP720 million of our net assets, so about 6% of our Group net asset value and about 6% of our Group operating profit.

More broadly on the overall program, John talked to this, we laid out our GBP400 million cost-saving program. It's pretty much on track. We've announced level five of the seven layers; we did that this week. And we're on track over the next few weeks and we'd hope to finish that by about October for level six then seven.

Ireland transformation is on track. And we're putting in place very specific plans for each of the 58 cells. For 16 of those were deemed non-core. One of them, Delta Lloyd. We know what happened there. For 10 of them we've got banks appointed to help us exit those markets. And for the last five there's a variety of actions we're taking. The one most specifically we can talk about is stop -- we've already stopped writing the larger bulk purchase annuity deals and we'll look at various other options, both front book and back book for those other five cells.

In summary then, I think operating performance generally pretty much in line with expectations. GI coming through pretty strongly. Higher restructuring costs as we're getting on with the Simplify program. Capital strength pretty stable, but obviously this is an area that we're continuing to focus on over the next months and into the future. And the environment does remain challenging, but we have a plan and we're on track with the delivery of it.

So we'll now open it up to Q&A. Right, I think we've got our usual roving mics [ph] in the audience. Nick, do you want to?

Questions And Answers

Q - Nick Holmes {BIO 3387435 <GO>}

Nick Holmes, Nomura. A couple of questions. Firstly is on the US. I'm a bit surprised by the improvement in the annuity margin, especially in the low interest rate environment and also the strong growth in sales. And I just wondered if you can give us a bit more color about the competitive environment and whether you think the level of performance is sustainable.

Then turning to the -- turning to Solvency II, wondered if you could give us an update on the matching adjustment debate, whether you think that satisfactory resolution is likely on this. There seem to be different views on this.

And also whether your decision not to write the large bulks is connected with your views on this. Thank you.

A - Pat Regan {BIO 15131018 <GO>}

Yes. Good question. Shall I take those? On US annuity market, the, obviously the lower interest rate environment has quite a big impact generally across the market for all players in our part of it, which as you remember is equity indexed annuity market. Generally pricing is moving broadly in concert, so everybody's doing the same type of actions, whether you're Aviva or Allianz or some of the local players as well.

In terms of volumes, we put through a pricing change earlier in the year. And the way that happens particularly in that market is there's -- people know you're making -- you post that you're going to make a pricing change so everybody buys the product before it's changed, so you get a little bit of a, if you like, a volume surge. Therefore over the course of the year, the remainder of the year, I would expect annuity volumes to be a bit lower than they were last year.

In terms of the back book, yes, we're very focused on, whilst maintaining decent levels of customer retention, just squeezing out a little bit of margin off the back book. And we've been able to do that successfully without really any change to the retention levels.

On Solvency II, obviously they weren't able to reach agreement in the trialogue [ph] process in July. I think the use of some form of matching adjustment I think is a given in the program, and that would be astonishing if that was removed.

Part of the debate that was how broad that extends and I think my view is there are some countries wanted to extend that more broadly across products that have --- where you can lapse, and there were parts of the trialogue that were uncomfortable with that and didn't believe that met the principles of Solvency II. And I think that's one of the key debates to have is do you have a more narrow one that meets UK/Spanish, or do you have a broader one where you can say these block of cash flows are relatively certain so you can apply it to those cash flows? And that's one of the key debates. That's one of the key parts of this impact assessment they'll go through over the next few months.

Q - Nick Holmes {BIO 3387435 <GO>}

And sorry, the last question on BPAs.

A - Pat Regan {BIO 15131018 <GO>}

On BPAs? Yes and no. Obviously we're mindful of possible impacts of Solvency II, but I think the -- I think you've got a pretty good rule for how it's going to impact UK annuities. I think the debate is generally around the other products and more Continental Europe. And I think our view was much more dictated by the -- our own economic capital view of it.

A - John McFarlane {BIO 1509370 <GO>}

Yes. The return is zero, economic return, so it's no-brainer.

Q - Nick Holmes {BIO 3387435 <GO>}

But I think most companies would say it depends on the case, the ---

A - Pat Regan {BIO 15131018 <GO>}

One company I think would say that.

A - John McFarlane {BIO 1509370 <GO>}

We generated our -- we're working on a weighted average, long-run weighted average cost of 9% and that's what they generate. There's no excess returns.

A - Pat Regan {BIO 15131018 <GO>}

I think as an overarching statement we are looking for a balance of risk income, annuity income. That's definitely going to form part of our income streams and a balance of savings-type income, slightly lower capital-intensive. We believe as you do that there are much better returns in the individual annuities than there are in the big bulk.

Andy, do you want to?

Q - Ashik Musaddi {BIO 15847584 <GO>}

Yes, hi. Ashik Musaddi from JP Morgan. Just a couple of questions. One, your individual annuity sales increased significantly quarter on quarter. Can you put some color on pricing there?

And secondly, the reserves in France, life reserves in France have gone down significantly, I guess partly due to ForEx. But can you give us some color on the outflows and the impact of that on that? Thank you.

A - Pat Regan {BIO 15131018 <GO>}

Yes. Thanks. Yes. As you know, we've -- there's two bits of the individual annuity market we've been successful on, obviously converting our existing pension customers into annuity customers and historically we've been also successful in wining probably close to 40% of the open market option going there. Our returns on the individual annuities have been extremely strong, north of 30% and I think that's still true to date, John, isn't it? So the returns on individual annuities remain extremely strong. What you're balancing there is just moderating the amount of credit risk and overall capital you want to take on in the business. But the returns remain strong.

Within France, as you say, yes, part of the movement in reserves is really -- is foreign exchange. The other part then is -- retention in the first half of the year is better than it was in the last half of 2011. We saw some outflows in the back half of 2011. Our creditor rate on, particularly on the AFER product now, is competitive. It's not the best, but it's competitive in the market and that's given us more stable retention levels in the first half.

Andy, do you want to --

Q - Unidentified Participant

Yes. Couple of questions would be good. The first one was on General Insurance investment income. I think I asked you the same question at the year end and you were pretty confident that investment income in the GI side wasn't actually coming down. It doesn't actually seem to have come down so fair play to you. But I'm just wondering what's going and where it is from now, because I think you said at the year end the reinvestment rate was something like 3% and your peers -- sorry, 3.5%, and your peers who said 3% have now reduced that to 2% for new money. So I'm just wondering what's your view on that component of the earnings stream would be going forward.

A - Pat Regan {BIO 15131018 <GO>}

Yes. New money, Clifford, what would you say?

A - Clifford Abrahams {BIO 7425676 <GO>}

About 3%.

A - Pat Regan {BIO 15131018 <GO>}

About 3%. We've got bigger assets back in it as well is the other thing. In the UK we've probably got another GBP700 million or GBP800 million versus a year ago partly, as you know, as we've grown the motor book. That's slightly longer duration than some of the other book as well. So it's a combination of those.

Oliver, do you want to?

Q - Oliver Steel {BIO 6068696 <GO>}

Oliver Steel, Deutsche Bank. Just a couple of questions. First is, okay, so you've written off the US Life goodwill, but you haven't really written off anything in Europe and particularly not in Spain. So I was just wondering about the rationale for that. The simple answer is obviously that you see no need to do it, but I wonder if you could give us perhaps a little bit more detail in your thinking on that.

The second question is on restructuring costs. Perhaps you'd just give us a little bit more detail on how you expect the timing of that to develop beyond this year.

A - Pat Regan {BIO 15131018 <GO>}

Yes, good question. On the Spain one, yes, you've got a couple of things going on there. Obviously we have one arrangement that's going through the arbitration process on Bankia so I probably won't comment a lot more on that individual case. On the other arrangements, we've got lower sales, not as profound as they are in Bankia; they're mid teens. The profitability remains strong on that. The IRRs are still mid teens, maybe upper teens on new business. We're seeing a little bit lower volumes.

So the key -- one of the decisions you make is how long will that last? What are volumes in the future? If they stayed at today's volumes, is that okay? And the broad answer is it's a good business. It's very efficient. New business profitability remains good and therefore the goodwill remains recoverable. That's the broad answer.

On restructuring costs very much what we are trying to do is get as much as possible done this year. So you've got two bits to that. You've got the simplification program. There is probably a little bit of that will go into next year David I would say. Much lower amounts than we are talking about this year. Then similarly Solvency II where again similarly we need to finish most of that this year, partly for our own sanity and partly to make sure the costs don't flow much into next year. So I think 2014 you really should expect not much at all, a little bit into '13 but a lot less than this year.

A - John McFarlane {BIO 1509370 <GO>}

Yes, one of the things we are not using much discretion here when it comes to goodwill impairment. We are actually doing what we are required to do and reassess them. And we've reassessed them all at the half, and we've done what we are required to do basically. It's as simple as that.

A - Pat Regan {BIO 15131018 <GO>}

James, do you want to go next?

Q - James Pearce {BIO 16758460 <GO>}

Morning. James Pearce from UBS. A couple of questions. First of all on the disposal program, can you tell us are you more, less or about as confident as you were a month ago as to executing the disposals?

Second, can you talk about cash flow from your European businesses? Are you able to get cash out of those businesses? Are you paying dividends to the parent from them? Are you being required to put cash in?

Then thirdly in Ireland I notice you blame the deterioration on the weather, but in the detail it's come through the motor account. What's going on, on the non-life in Ireland?

A - Pat Regan {BIO 15131018 <GO>}

Okay. Alright, shall I take two and three? Do you want to do number one?

A - John McFarlane {BIO 1509370 <GO>}

Yes. There is a month gone by therefore we know more than we did a month ago. And so our confidence level is higher than it would have been a month ago because we know, we actually know more. We've got more certainty on what's happening.

Some of the smaller ones we're well on with and hopefully we'll get some announcements pretty soon on those. The bigger ones we have more information, we know who the potential buyers are and so again that's progress. So we made more progress. We know more. The certainty is increasing. The uncertainty is obviously price and that's what we are working through, and ultimately we'll end up negotiating that. We're not at that stage yet. We are in some of the smaller ones.

A - Pat Regan {BIO 15131018 <GO>}

I'll take the last two then. On Ireland that was more factually noting the weather has been higher, but the weather has been higher for three out of the last four years in Ireland, so whether that's a good explanation or not.

There's two things we need to do in Ireland and the team is very focused on. One is reducing the cost base and we're part of the way through that. So it's certainly not showing up in the results yet. That's really going to flow through and to start happening in 2013. But we've taken out a lot of expense because our expense ratio's at least 10 points too high. But it's not just expense. There's some capabilities. There's some things we are better at risk selection in, in the UK business than we are in Ireland and that's a little bit manifest in the results as well.

On the dividends, yes, in 2011 our operating capital generation was pretty good in all of the countries and that allowed us to flow dividends out of all of our major businesses with the exception of the ones in the eurozone.

So as you go through, and hopefully a little bit clearer you can see this, operating profits turning into operating capital generation, that's working pretty well in most businesses. Operating capital generation turning into dividends, that's worked pretty well in all our businesses historically. The kind of check you do is, what's the regulatory environment and what's the macro environment, does that allow you to translate operating capital generation into dividends? Last year in the second half of 2011 that was more difficult than the eurozone, candidly, in Italy, Spain and to a certain extent France.

As part of our performance improvement as we go forward we are very focused on positioning not just those countries but all of them to really translate the operating capital generation into dividends. So again in UK Life we're looking for actually much higher dividend flows, and that's part of the reason we are talking about the proportion of annuities, and certainly bulk purchase, and certainly in France, Spain and over time in Italy as well. So it was more of an issue in 2011. We're expecting that to be less so as we go forward.

A - John McFarlane {BIO 1509370 <GO>}

I might say something more about disposals. When you think about what is it we're trying to achieve here, clearly we're running the organization really from a 2014 onwards view, and trying to get the run rate 2014 and beyond as high as we can get it. That's the essence of what we are trying to do and that's important.

And in that context clearly the Company is going to get a little smaller. Earnings are going to go down from the things that we dispose of. But at the same time we've got some positive forces. We've got a cost reduction program. We've got tighter capital management within the Group. By that point in time we'll have probably finished with Solvency II implementation cost because we want to be ready by the end of 2013. So that will roll off and -- most of it will roll off; some of it will continue. Our expenses are clearly going to be lower and restructuring costs will have been taken care of. And so there's a lot of moving parts there, but so we are working back from 2014.

But there are two other priorities here. One is about financial strength and that is in the short run by far the most important priority. It's the thing that shareholders have said to us that they want fixed as a primary objective. That's the thing. The second object of course is to generate enough profits and then cash flows in order to cover the dividend. And I've partly covered that just in my previous comments.

And so building that capital strength is really fundamental. And clearly this is not a great market in which to dispose of assets, everybody knows that. On the other hand we are reasonably confident it's not going to get a lot better anytime soon and so holding on and waiting isn't really strongly in our minds either. But the trade-off is going to be the price that we get and any write-off against book or tangible book versus an enormous capital benefit. Its enormous the capital benefit that we get. Broadly it would take us right into the beginning of our range, all other things being equal if it all goes to plan.

So we're going to have to make some trade-offs at some point in time going forward, but we understand the logic of what we are dealing with and we understand the priorities of what the shareholders are telling us that they want us to deal with. And so clearly excess returns going forward by repositioning the Group, having enough cash flow and cover to sustain the dividend. But in the very short run its about capital and so we're just getting on with that.

A - Pat Regan {BIO 15131018 <GO>}

Andy and then Andy. Do Andy first and then we'll come back to, well, Gordon and then Andy afterwards.

Q - Andy Broadfield {BIO 7273415 <GO>}

Hi, thanks. Andy Broadfield from Barclays. Just a bit more clarity on the capital position, on the economic solvency position. You've given us the walk from yearend to the half, but it's come down from the last disclosure. I think 145 I think was the number. I don't know if that was an approximate number when you last disclosed it, but it was 145 at Q1 I think.

A - Pat Regan {BIO 15131018 <GO>}

Yes.

Q - Andy Broadfield {BIO 7273415 <GO>}

And if you take out Delta Lloyd business you've had about 4, 5percentage points decline in the quarter. I was wondering whether you can explain a little bit about what the main drivers were there. I appreciate you won't want to do a whole reconciliation, but is that just a market movements thing?

A - Pat Regan {BIO 15131018 <GO>}

Yes. So we were taking some positive actions in the Second Quarter. But you also saw spreads went out a little bit generally. Obviously Spanish spreads went out a bit more. So it's mainly a credit spread impact in the Second Quarter, which a reasonable positive in the first was slightly negative in the second.

Q - Andy Broadfield {BIO 7273415 <GO>}

Okay. Then the second question is just on Solvency II and the progress there because I think talking to people involved with the project externally I think it's been a difficult project. I'm sure it has been for everyone, but it's been an expensive project. Just wondering whether it's where you thought it was going to be in terms of your internal systems progress on Solvency II because I appreciate it's hugely complex, what the cost has been, what it's likely to be and the tail on it? I know you want to get it done by end of -- I thought these things will have a cost tail that will go on for longer than '14, but that's the plan. So what are the numbers for that please?

A - Pat Regan {BIO 15131018 <GO>}

Okay. We're broadly where we expected to be. Yes it is complex. There's a lot of things you have to do. In a dramatic over-simplification, you need to build a super-industrialized robust model that can calculate things really quickly and in a very efficient manner across your group using economic capital principals in a much more, as I say, industrialized way. So there is a systems element to that on both the Life and GI side. That's broadly going according to plan. We are using the same tools that most of the market are using in terms of the systems we are using for that.

The second bit then is ingraining deeply the use of economic capital and how you make decisions across the business. And that then flows into your use test [ph], it flows into your model application stuff. You can see when we did the July 5, that's very much at the heart of how we are running the business. So in many ways I actually feel quite good that we are well positioned, that it's clear to everybody that we are using economic capital and how we run the business because that's how we presented it.

So I think we are broadly on track with those. But the bit I would say is its costing a lot of money. It's costing probably more money than we thought when we started. There's a resource shortage in a few areas that is the same for us as it is probably for other companies, particularly on the actuarial side that means it costs you an arm and a leg for certain specialist resource. So I'd say we'll probably spend as much again in the second half as we did in the first half.

From then it is really important in lots of senses that we transition to a BAU mode. So what we are doing in each of our teams is setting up, here is our model for how we operate Solvency II just in a normal mode and we're building that into our plans whether you are in the UK GI or UK Life or whatever. So the bulk of it this year, but second half is probably going to be similar to the first half.

A - John McFarlane {BIO 1509370 <GO>}

Clearly we've got enough understanding of economic return and capital allocation to our businesses that we can sharpen that up of course. But it wouldn't cost anything like this amount of money to do it. So if this was voluntary we wouldn't make this investment because we can already do what we need to do, perhaps maybe do it a little better.

The other reason we need to get it done by 2013, other than we're required to do it by 2013, is we want to get it out of the way and get on with what we really need to be doing in the business. And so we really need to get it out the way. And so we're not going to slow it down. If there is any delay to the program we'll just get it done in 2013 to draw a line on it.

A - Pat Regan {BIO 15131018 <GO>}

Okay. Thanks Andy. I think it was Gordon next.

Q - Gordon Aitken {BIO 3846728 <GO>}

Yes, Gordon Aitken from Royal Bank of Canada. So three questions. Firstly, UK pensions is bigger than any other country in terms of sales. You said your moving more into the fee business. Can you just let us know what percentage of the sales in the first half are commission paying?

And with the RDR up and coming at the end of this year, what should we expect for volumes in 2013 in pensions?

Secondly, bulks versus individual annuities. Now you seem to love the individual market but you're obviously pulling out of the bulk market. But this product, you can think of bulks just as a collection of individual annuities so is this simply come down to price? Is it a case that consultants are just keeping the pricing a lot tighter in the bulk market than the individual market?

And finally just staying on bulks, so you're not writing any new bulks but that in itself is not going to close the solvency gap for you. We've had a few reinsurance transactions recently with other companies. Is this something you're looking at?

A - Pat Regan {BIO 15131018 <GO>}

Sure. On the first one, yes, so we've increased our workplace savings sales, gosh, probably more than 100% versus 18 months, two years ago. Most of that's in the smaller scheme end and some of the developments we are trying to do are to make us equally successful in the more than 5,000 lives at the bigger scheme end.

As you know, the bigger scheme end, we are winning some of those. And so probably half of our business is the commission-free business in the larger scale and about half of it is still commission paying. That's really coming from the larger IFAs versus the larger consultants. Therefore, logically as you go into 2013, would you expect to see that growth fall away a little bit before we really ramp up towards enrolment? Yes, I think that's a reasonable assumption.

On bulk purchase annuities, yes, we said we would stay in the very small end of BPAs because they do behave much more like pricing of individual annuities. But generally speaking, yes, at the larger end pricing is much thinner because of the dynamics you described. That's just the market force.

Individual annuities we do think it's not just about the market pricing. It's also about the ability. We believe our expense base is lower, we believe the assets we can use make us more effective and also some of the techniques. The team that run that used to work in the general insurance business and they brought a lot of the pricing techniques across from that into the individual annuity business in a way that we think is more sophisticated than most in the market.

A - John McFarlane {BIO 1509370 <GO>}

I think I'm right is saying that the returns on the individual annuities are actually very attractive generally. The new business is more attractive than the old back books basically. But it is attractive and so a rational thing for us to do is to do lots of it because it's very good.

But then you get this other problem which is they're very capital hungry and that's an issue for us. So if we had excess capital we wouldn't -- could be constrained. The bulk is different because the prices --the returns are lower. And so we would do much more than we're doing. The problem is we are making this trade-off between capital and return all the time and in that sense there has to be some subduing of it even though the market opportunity is there for us.

A - Pat Regan {BIO 15131018 <GO>}

I think your last question, would we look at opportunities to look at back book deals? Yes. You're sitting next to the right man. So yes, we'll look at that and see if there is an opportunity there for us. Everybody is looking at you now Jason.

Barrie then I'll come to Andrew.

Q - Barrie Cornes {BIO 2389115 <GO>}

Morning. It's Barrie Cornes at Penmure Gordon. I just want to talk about GI insurance, particularly the UK. I think your weather losses were a lot less than some of us going for. A lot of the floods occurred the last three days in June. Have they been put back into July some of these claims simply because looking at your market share it's much higher in homeowners than perhaps one of your large competitors who came up with such a large figure?

A - Pat Regan {BIO 15131018 <GO>}

Yes. I'm not going to comment on their numbers or estimates. Ours is a straight up number. We don't think there's a lot flowing into July at all, do we, Clifford? So I think our tell of that tale would be we genuinely think we've got better flood mapping and therefore risk selection than perhaps others have in the market.

Q - Barrie Cornes {BIO 2389115 <GO>}

Thank you.

A - John McFarlane {BIO 1509370 <GO>}

And the first (inaudible).

A - Pat Regan {BIO 15131018 <GO>}

Yes, I mentioned that to him.

A - John McFarlane {BIO 1509370 <GO>}

Five months they were pretty good.

A - Pat Regan {BIO 15131018 <GO>}

Andrew?

Q - Andrew Crean {BIO 16513202 <GO>}

Good morning. It's Andrew Crean here from Autonomous. Could I ask three questions? Could you give a little bit more color on the timing of the expense savings in which lines that they'll fall into over which years?

Secondly could you explain a bit more about the GBP4.8 billion of internal financing from the General Insurance business in the UK? Who are you lending to within the Group, what is the interest cost and what collateral do those businesses require?

Then thirdly, on your definition of required capital on your economic basis is just your internal capital. Could you say whether the FSA requires additional buffers, and how big those are?

A - Pat Regan {BIO 15131018 <GO>}

Great. Thank you, Andrew. On the timing of the expense savings, what we said on that is we're in execution mode now so a lot of it --- we're booking the restructuring costs, we're going through the program, we're working through the delayering the regions, so that's really 2012. Some of that's then into your run rate as you go into 2013, particularly in the second half of 2013. Then we're really thinking all elements of that will be in the run rate going into 2014.

On the intra-divisional balance, as you remember, it's, I think we showed in the appendix last time, it's a balance between two divisions of one legal entity. So it's not a formal loan arrangement, perhaps as you said. You've got the General Insurance business and you've got the other half of the same legal entity so there are no collateral arrangements or anything like that. It's a notional balance within one legal entity.

Other required capital, I think you asked me the same question actually on July 5, and I'll give you the same answer, which is it is our assessment of required capital. I hope actually we are putting out as much detail, at least as much as anybody else in the broad European markets on that, and more than anybody else in the UK market. It's our assessment of capital. It's based on the 1 in 200 calibration, plus 1 in 10.

As we've constructed our target capital range we've born in mind a lot of things to be honest. We've added a bit. Just for kicks we've added an extra buffer. We've added an extra buffer to say what's happens in various scenarios of sovereign debt, what happens in various scenarios of pension risk, all of those kind of things. So they've all informed where we've landed in our target capital range. So that's, but that's how I'd characterize it.

A - John McFarlane {BIO 1509370 <GO>}

I think they're broadly consistent. If we reached where we're trying to get to then we'll be comfortable, the FSA will be comfortable as well. So that's not -- and as they're lower we're each as uncomfortable as each other. So in a sense there's not a material difference here.

You might say something about the mix of the expenses because the first question --

A - Pat Regan {BIO 15131018 <GO>}

Yes, so we've got, in our GBP400 million we've got about GBP300m# or so that will be people related and about GBP100 million or so that's non-staff related. I think actually our early estimates are we've probably got a bit more --- this done our new targets, just to be clear. But there is probably a little bit more we can go on, on the non-staff certainly as we really get into the guts of the program. But that's how it -- the split of the GBP400 million is about GBP300 million people related, about GBP100 million non-people related.

A - John McFarlane {BIO 1509370 <GO>}

We actually think we can do better, but we need to work it out.

Q - Andrew Crean {BIO 16513202 <GO>}

And by line?

A - John McFarlane {BIO 1509370 <GO>}

Which lines?

A - Pat Regan {BIO 15131018 <GO>}

I haven't got it by line Andrew or maybe -- we'll talk to you offline, but I haven't got it off the top of my head by line. We'll do Colin first then we'll come back to you, Andy.

Q - Colin Simpson {BIO 15894636 <GO>}

Thanks. It's Colin Simpson from Goldman Sachs. Could I actually ask your take on gender-neutral pricing that's coming in at the end of the year or the beginning of next year? This is -- could be hugely disruptive. And I imagine with all the management change that's happened in Aviva and people are worried about their jobs, and you have large market shares, is it fair to say that you could be one of the big losers from gender-neutral pricing?

A - Pat Regan {BIO 15131018 <GO>}

Are you suggesting we are not gender-neutral in our management changes? Was that your question? I can confirm --

Q - Colin Simpson {BIO 15894636 <GO>}

Are you saying something about your future CEO?

A - Pat Regan {BIO 15131018 <GO>}

We've been entirely gender neutral in our management changes. Sure, it affects everybody in the market in terms of how you look at risk selection and pricing. We've been thinking about this for some time, Clifford, haven't we, so I don't know whether you want to grab the microphone and just add.

A - Trevor Matthews {BIO 2001261 <GO>}

This is not a problem. There are some countries around the world that had already had gender-neutral pricing of course. We've got teams of people not just in the UK but in some of the continental countries as well who've been working on this for some time. And they've got good plans in place and we're very confident that we'll do very well out of this. In fact we're looking to be one of the winners. Don't forget we've got this strong analytic capability which helps us also as we look at rating through a different set of lenses going forward. So we're in good shape I think.

A - Pat Regan {BIO 15131018 <GO>}

Thanks Trevor. Andy, then we'll come to Jon.

Q - Unidentified Participant

Great, three questions if I could. The first one is about the breakdown of IFRS operating profit. Could you possibly break it between core and non-core or at least ongoing and non-sustainable just to see how the core and improving bit is actually moving over time?

Second point is unrealized gains in the IGD. I think John said you might have answered that question in the July 5 if I asked it so I am definitely going to ask you now. So how much of the IGD surplus related to unrealized gains in the French business?

And the third question was about following on from Oliver's question. Some companies include the goodwill in Spain in their IGD surplus. Do you do that? And if you were to write off the -- you know, okay.

A - Pat Regan {BIO 15131018 <GO>}

Yes. No on the last one. There's no goodwill, certainly obviously there's no goodwill impact from the US either, but there would be none if we reassessed Spain.

I think I told you last time that we weren't going to give country by country IGDs. I'll give you the same answer on that. I think it's order of magnitude around EUR1 billion that kind of order of magnitude, so maybe I did give you the answer on that.

I think what we'll do, we -- it's a good question on the core/non-core. What I think we'll do is we'll -- our intention will be to do that at year end. Just was a little bit quick this time around to do the split of core versus non-core and how they are trending over time. So that is something we've a mind to do Andy, but not at the half year. We'll probably pick that up at the yearend.

Jon?

Q - Jon Hocking {BIO 2163183 <GO>}

Yes, morning. Jon Hocking from Morgan Stanley. I've got three questions please. Can you remind us of what the cross-border holdings are of Italian and Spanish debt at the end of the first half? That's the first question.

Second question, the revised performance objectives for management, can you talk a little bit about how that varies compared with existing score card? Then what do you do? Presumably you can't change this in the middle of the year. How do you make sure everyone is sort of pointing in the right direction given they might assessed on something else for the rest of calendar year 2012?

Then the third question. On UK commercial lines, could you give us a little bit of a running commentary sort of segment by segment where pricing is, where volume is, how you see rate etc?

A - Pat Regan {BIO 15131018 <GO>}

Sure. Why don't I -- I'll pick off one and three and then I'll let John talk to the objectives. On the cross-border, it's still -- our Italian holdings -- Spanish holdings are primarily in Spain. We've got a tiny bit in France. On Italian holdings in pound terms we've got somewhere between GBP1 billion and GBP1.5b. It's close to GBP1.5 billion cross-border and the rest of it is domestic in Italy.

On the UK commercial lines the area we've seen the most price increase is in commercial motor. It's one of the reasons we've been able to pretty significantly improve the performance of commercial motor by -- from 113 or so down to 101. We've probably seen, what, about 6% now, something like that in commercial line rates. But property and liability is still pretty flat.

A - John McFarlane {BIO 1509370 <GO>}

Yes, on objectives, my own philosophy about this is if you ask somebody to do 16 things you're asking them to do nothing basically because they'll come back and say I did eight of them brilliantly and I did eight -- I was weak on these eight. Then you have to say well so what's that then? And so I like three and although people in Aviva seem to live five, which is a different matter, so we've been negotiating with each individual.

We have changed them all part of the way during the year because if you think of objectives, even take the financial ones, which we're not changing the structure of those because they are the obvious ones that you would think that would be in place including cash generation and so forth, so they're automatically there. However, when you put a plan together historically we'd have put that plan together starting about now for next year.

The problem with that is as soon as you produce the document it's a complete waste of time because time has moved on. By you get to December it's not worth anything. So we're delaying the start of that to later in the year so that we've got more top-down starting points reinforced by the bottom up to make sure that -- and then we'll iterate it.

As you go through the year you find that the plan that you had in place actually is productive marginally, but as time goes on you move further and further away from it as new information comes in. And so it's very important that you have a rebalancing process, or even on the financial targets during the year. And that's something that David's negotiating with all the individual businesses at this point in time. So there're even going to be changes not to the structure of that, but to the targets. Because if somebody's ahead of plan and they say that they're actually going to meet plan, well you need to say -- that's not good enough; you're ahead of plan we are going to lock that in; now what are you going to do?

So one of the changes we've made is we used to do a half year actual and a full year forecast. And when you do it that way it kind of looks as if you close the whole company down in the second half when you strip as to -- you take the difference. So we've stopped doing that. We're now saying that's the first half; what are you going to do in the second half, and we'll add it up. And so in other words you can't sandbag the second half forecast. So that's a change we've made.

Then finally on individual objectives what I've done with each individual I've asked them to draft it, but actually I've made quite significant changes to those drafts. So I've asked them what if, not just in the next six months, but what are the most important things beyond the financials that you have to deliver for this Company standing back from it? And it's different for every single individual and certainly the people who report to the CEO. So it's different. And so basically I've edited it to the extent, changed it to the extent these are the three or four or five things that each individual has to do to make this company successful. They then have to cascade that down.

So we've got all those right. They're all qualitative. They're not necessarily all for just the second half. Some of them might even be through to 2013, 2014, but we'll measure them on an ongoing basis. You can be assured that these are the things that they have to do. We will track it. And whatever they do, clearly it's important that they meet their financial targets, but don't come back and say you haven't met your three or four or five objectives. That's what we are going to measure you against.

If you have not met them and a reasonable person would have met them, you've failed. So if you've not met them and a reasonable person because of circumstances outside your control couldn't meet them then that's fine; you've done exactly what a reasonable person would have done. And so there's a sort of judgment on how reasonable the objectives were and how reasonable the progress are, but nevertheless as objective as we can make it.

And I've had this conversation internal. Failure, material failure on these objectives and/or your financial objectives is failure. It does mean you cannot stay in that role. And therefore somebody else, because a reasonable person would have done better, somebody else would have done better. And therefore that's what it -- that's why we're moving to this personal accountability. It's really important. And so it's very focused and when you add it up you get the right thing for the Group, and there are consequences. If you really do incredibly well then your variable compensation will be linked to that too. So there is a big upside as well, as well as the downside.

I might just -- I know -- I don't want to bore you with this, but we are changing the nature of how we evaluate people inside the Group. We have a forced ranking now of a 20/75/5 and we've got a nine-box matrix with up here's performance and along here's potential. We expect in the top three boxes to have 20% of the people roughly, the bottom two boxes down here on the bottom line we expect 10% of the people, and 70% spread around the rest of the matrix.

There is an issue here in that the first time, the first cut of that we ran there are 40% of people in the top 20%. Isn't that interesting? And so our ranking's not very good because if we have 40% of people really in those top three boxes we wouldn't be performing the way we are so that can't be right. And so we will readjust that and force it into that distribution. So we then now know who are the most valuable people to us, who are the least valuable people.

We're then going to change the differentiation. We're actually going to pay the most valuable people more than the middle group and more -- so we're effectively placing a ceiling on average performers and a floor on the most valuable people in actual pay. That then gears up into the baseline for their bonus so that's even highly geared, and then that's geared up into their stock allocation. So the most valuable people will be differentiated and will end up with the most.

Now bonus is slightly different in that it's about how you did this year and that. So there's a slightly different process but it still a meritocratic basis. So I don't know if that's all helpful, but that's how we're running the place.

A - Pat Regan {BIO 15131018 <GO>}

Marcus.

Q - Marcus Barnard {BIO 2103471 <GO>}

Yes, Marcus from Oriel Securities. Pat, can you explain the GBP90 million increase in the DAC amortization charge because against GBP1 billion of operating profit that's quite a material increase. And I note the point you make on page 12 about spread margins in the US and one-offs in China, but is this the level we should factor in going forward or is it a one-off in half one '12?

A - Pat Regan {BIO 15131018 <GO>}

It's -- the main dynamic there is it's almost automatic. As you make those higher earnings in the US, particularly driven by the higher spread margins, you get automatically a higher DAC charge. So it is one goes with the other. So if you assume what I said earlier, that the higher spread margins are sustainable, then you'd have that higher DAC as well, yes. The two go hand in hand.

Alright, terrific. Thank you for coming in everybody. Nice to see you all again. Enjoy the next couple of days. Last bit of the Olympics to enjoy.