Q3 2011 Earnings Call

Company Participants

- Andrew Moss, Chief Executive
- Igal Mayer, Chief Executive, Aviva Europe
- Pat Regan, CFO

Other Participants

- Andrew Crean, Analyst
- Blair Stewart, Analyst
- Duncan Russell, Analyst
- Gordon Aitken, Analyst
- Greig Paterson, Analyst
- James Pearce, Analyst
- James Shuck, Analyst
- Marcus Barnard, Analyst
- Nick Holmes, Analyst
- Oliver Steel, Analyst
- Raghu Hariharan, Analyst
- Toby Langley, Analyst
- Tony Silverman, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. And welcome to the Aviva announcement of Q3 results 2011 analysts' update conference call. (Operator Instructions) I would now like to hand over to the chairperson today, Mr. Andrew Moss, Chief Executive. Please begin your meeting, sir. And I shall be standing by.

Andrew Moss {BIO 3628034 <GO>}

Good morning. Welcome to Aviva's Third Quarter IMS conference call. I'm Andrew Moss, as you know. With me today are Pat Regan, our CFO. And Igal Mayer, who runs the European region for us.

I'd like to spend a little bit of time talking to you on three key areas. First of all, let's talk about operating performance. Then, given the volatile markets we've been trading in, I'll hand over to Pat to talk a little bit about the balance sheet and capital position. Then I'll come back with a brief update on progress against the strategy refresh that we set out last year.

So let's go straight to the operating performance. I think it's been good, during what, of course, has been a tough time economically, particularly in the Eurozone.

If we start with general insurance, really pleased to see that we continue to see that positive momentum that we saw at the half-year. So sales up 9% to GBP7b. The combined operating ratio ahead of our target, 96% across the Group. If we look at Europe and Canada, sales were up about 7%. But the standout performer remains the UK general insurance business, with a 12% growth in sales, achieving a combined operating ratio of 95%.

So the tough action that we took in the UK in 2008/2009 is paying off; one of the lowest expense ratios in the industry. And moving away from some of that low-margin business, then, that's earning through for us now. And I'm really pleased to see, again this year, 300,000 more motor customers into a market which of course has seen a sharp ratings improvement. And our brand recognition levels now at their highest ever, here in the UK.

So all of that is encouraging. We've also launched quotemehappy.com, a new offering in the aggregator space. And that's started well for us. But don't underestimate; we're still seeing better penetration in the direct to Aviva offering and through our broker markets. So through all distribution channels doing well. I think the outlook for general insurance remains relatively positive. And we're pretty confident that we're going to at least meet our 97% combined operating ratio target this year.

Now, if I move across to the life business, we've got a new business internal rate of return of 14%. That's up 1% since last year. Sales are down, down about 8%, to GBP23.6b. UK sales, though, have increased. They're up 6% to over GBP8b. We've seen higher pension sales in the run up to RDR. And we're increasing our market share in the Group personal pension space, up to 15% from 11% a year ago. So very pleased with that; really important, before we move into the auto enrollment period.

Now, we're also seeing good volume in the individual annuity market. We've pulled back a bit on the bulk purchase annuity market. But we continue to be happy to write in the individual annuity space. That's going well. And overall in the UK, IRRs remain well ahead of our target at 15%.

Now, in Europe, I think we just see the same patterns continuing that we saw in the first half. Sales are down about 18%. And that's really still primarily due to action that we're taking to improve profitability, which is not to say that one or two of our markets have seen reductions in the overall market in 2011, notably France, for example. But we continue to achieve internal rates of return above our target at 13%.

Overall, I think the demographics and the wealth characteristics in Europe remain very compelling in the medium and long term. So profitability in the first half was good in Europe. And we expect that to continue through the second half. We do expect, I think, in one or two places in the short term demand for life and savings products to be a little more subdued. I think that's only natural, given the market volatility that we've seen in the Third Quarter.

In other areas, Asia Pacific, sales up, margins up. Really good to see, I think, particularly high growth in Singapore and South Korea. So pleasing across the Asian business now to see IRRs at 14%. And that's really, as we go into the cost base that we've had there, to invest in the region. So that's pleasing.

And meanwhile, again, in the USA, the same sort of pattern that we saw at the first half. A reduction in annuity sales. But the life business doing well. But overall, that is action which is taken to increase profits, both from new business and the in-force book. And I think a continuation of what we saw in the first half through the Third Quarter.

So in summary, I think from an operational perspective really good continuing progress, profitable growth in general insurance, strong generation of profits and cash flow in the life business. We are managing persistency well. That has to be a priority in these sorts of markets. And I'm pleased to say customers absolutely are staying with us. Costs are remaining tightly controlled. And of course the assets which drive our earnings remain resilient, with minimal actual impairments this year.

Now, let's just talk about the balance sheet and the capital position. Of course, that is an area of focus for us when markets are as volatile as they have been in the last few months. Pleasing to see the IFRS net asset value per share increasing to GBP4.48. And overall, we are confident in both the level and the strength of the regulatory capital surplus in the balance sheet. But given the movements in the quarter, I think it's just a good idea for Pat to give a little bit more color around some of those changes.

Pat Regan {BIO 15131018 <GO>}

Thanks, Andrew. Good morning, everyone.

First off, I think it's probably worth saying that obviously we're focused on delivering a number of things, including our short-term financial targets, particularly our operating capital generation target, while continuing to manage the balance sheet.

A few overall headline messages. Our IGD regulatory capital surplus, whilst down from the half-year, is not far off what it was at the First Quarter, as I'll talk to you in a moment. It's more resilient at this level. We have a range of actions in place to more than offset the impact of the upcoming call on the hybrid debt.

As Andrew said, the underlying impairment performance on the asset portfolio remains very strong. And we continue to experience minimal actual default levels. The level of liquidity at the Group center is very strong. And we're on track to deliver that GBP1.5 billion to GBP1.8 billion operating capital generation.

Starting, then, with the NAV movement, IFRS NAV increased by 23p in the Third Quarter to GBP4.48 and, again, that was driven by obviously profit generation in the quarter, increasing unrealized gains in the US business, an increase in the pension scheme surplus. And there was actually a couple of things there.

One of the things we really benefited there was not just the discount rate moves. But also having a lower level of risk-seeking assets, which is something we've done over a long period of time to de-risk the pension scheme, obviously helped us in the quarter as well. That was obviously partially offset by credit spread widening in Europe, including in the UK, as well.

From an MCEV perspective, NAV was GBP4.79, down from GBP5.54. Again, probably worth noting that if you measured that today that would be up about 50p from that GBP4.79 level.

On a regulatory capital surplus basis, IGD was GBP2.7 billion at September 30, compared to just over GBP3 billion at the First Quarter. Obviously, we increased IGD levels quite significantly during the Second Quarter, up to a GBP4 billion level. And that served us well in a period of heightened volatility.

The movement from the half-year is due to a number of things. And probably four things I'd point out. One is movements in unrealized gains in France, primarily due to credit spreads widening there. Second is, similarly, credit spread widening in the UK. Third is we still take our share of Delta Lloyd's movement. So particularly coming through on things like their equity portfolio. And lastly, some FX movements.

Now, IGD, as you know, is not a risk-based measure. And it's quite an idiosyncratic measure. Not particularly comparable across countries, or indeed companies. But just worth dwelling on that, on each of those four.

In France, for example, we've taken through the unrealized gains. Not everybody will -- sorry, we've taken through the reduction of unrealized gains. Not everybody will have done that. The way the rules work there, there's really much less impact of that going forward than we saw in the Third Quarter.

Similarly, in the UK, we took a quite formulaic approach in the Third Quarter, in terms of spread movements there. And the net result of that was to increase our provisions against the annuity book up to GBP1.6b. And given the sheer size of those provisions, obviously we'll look at that as we go through the Fourth Quarter.

Similarly, Delta Lloyd, given the positioning of their hedging program, their futures hedging program and their put options, as well as our own futures hedging program, has much limited impact, downside impact, going forward. Obviously, also, IGD doesn't take into account things like the GBP2 billion of unrealized gains we have in the US.

Plans are in place to more than compensate for the impact of the repayment of the hybrid debt, which we'll do in November. A number of actions there, including things like (inaudible) agreements for the closed book transaction in the US. We've already completed the restructure of UK legal entities, which gives us a couple of hundred million pounds benefit. And various other relatively small balance sheet actions.

In terms of economic capital surplus, you'll obviously remember we had a GBP6.9 billion surplus at June 30, our highest ever surplus. The movement since then is broadly in line with those MCEV movements I gave earlier. Probably, if you exclude the impact of the pension scheme, which was about 25p positive to that MCEV NAV, other than that the movement in MCEV NAVs gives you pretty much the movement in economic capital surplus. And again, it's worth remembering we're up about 50p since the end of the Third Quarter.

Lastly, as I mentioned earlier, the overall performance of the asset portfolio remains strong, limited impairments against those asset classes. And as I say, that GBP1.6 billion provision now against the UK annuity book looking quite conservative there.

We've expanded our disclosures today, including new bank debt disclosures. And again, just worth noting we have just GBP200 million of sub-debt exposure in Italy, Portugal, Ireland, Greece or Spain in banks. So around about GBP113 billion of shareholder assets. We hold a healthy GBP2.3 billion of cash at the Group sector.

With that, I'll hand back to you, Andrew.

Andrew Moss {BIO 3628034 <GO>}

Thank you very much, Pat. Just a few words on strategy. I think further delivery in the Third Quarter. Good progress on the restructuring of the portfolio. We completed the sale of the RAC. So we received just under GBP1 billion in cash just four weeks ago. We announced the sale of Aviva Investors business in Australia. And pleasing to see the sale of Delta Lloyd's loss-making German business, which I have to say we've been pushing on over a number of years.

But more than that, I think progress with our objective to deepen in our chosen markets. And I don't think there's a better example of that than in the UK. We're seeing market share gains in all the areas where we've really wanted to, over the course of this year. So well over 20% market share in individual annuities. The Group personal pensions market, we wrote, I think, something like 564 new schemes so far this year, with about 137,000 lives. So market share increasing to 15%. And as I say, that's very important for us as we move into the auto enrolment world.

Good returns on new business still in life, at 15%. And we think that's sustainable for the foreseeable future. And of course the great advantage we have relative to our life peers is our space from general insurance business. And we're seeing profitable growth there, particularly in motor. And a combined operating ratio across the book which is beginning to look better and better, relative to our UK competition.

So in summary, I think strong operating performance, good momentum in general insurance, good profitability in life. We're right on track to meet our financial targets this year, particularly generating between GBP1.5 billion and GBP1.8 billion of net operational capital. Good further delivery against strategy. And the focus which of course we have to have on ongoing financial strength in what we expect to continue to be, in the short term, a challenging economic and market environment.

Okay. With that, thanks for listening. Let's hand over to you now. And very happy to take any questions that you may have.

Questions And Answers

Operator

Thank you, sir. (Operator Instructions) And our first question comes from the line of James Shuck from Jefferies. Please go ahead with your question, sir.

Q - James Shuck {BIO 3680082 <GO>}

Thank you. Good morning, everyone. I had a couple of questions, please. On your economic capital, you've done -- you've mentioned that the MCEV per share is a proxy for the reduction. So I just wanted to check my maths on that. So you have 170% at H1. And the relative decline between H1, in the MCEV per share this is, H1 to nine months, would suggest that if you deduct the pension scheme benefit, you're on about 140% currently. Can you just talk around what has actually led to that decline, because if I look at your MCEV disclosure then lower interest rates actually have a positive impact on your MCEV? So I'm just interested to know actually what's driven that.

And also, connected to that, you talk about capital benefits and debt repayments of the hybrids. If we think about the XXX and the UK benefit and the repayment of the debt, then what is that 140% also on a pro forma basis, if possible, please?

Secondly, I just wanted to ask about your exposure to Eurozone bank debt, because you show the shareholder proportion of that. That's a very interesting disclosure on the last page of the press release. I was just wondering what the Italian policyholder share of that is, please.

A - Andrew Moss {BIO 3628034 <GO>}

Okay, James. Thanks very much for that. I think you squeezed more than two questions in there, actually. But we'll take them all, don't worry. Pat, do you want to talk on the economic capital first?

A - Pat Regan {BIO 15131018 <GO>}

Yes, sure. Thank you. Hi, James. It's pretty simple, really, James. The single biggest movement, as you would expect, is credit spreads widening. The movements there were quite profound in the Third Quarter. And we and everybody else who publishes economic capital numbers will have seen an impact from that. I think ours is pretty proportionate to what you've seen from others. And as I mentioned earlier, you can see that coming back in the month of October and the consequent movement of the MCEV positively in the month of October, which would have benefited us. So that's all -- I think that's all good stuff.

In terms of the -- I won't give you a precise pro forma number, as I say, partly because, as I mentioned there, the biggest single impact for us is credit spreads. There's been some more positive movements on that subsequently to our quarter end. So rather than give you on and offs, what I would say is obviously we're very confident of managing -- we're confident we can manage all of our capital surpluses, whether it be IGD or economic capital. And we started at a good solid surplus at the Second Quarter.

Lastly, in terms of the banks' disclosures, I think in terms of the Italian business, the product, as you remember, there is primarily a pretty vanilla savings product. So primarily what we have invested there is the Italian government bonds. So the actual holdings of a bank would be incredibly small within the participating business, actually.

Q - James Shuck {BIO 3680082 <GO>}

Great. Thank you very much.

Operator

Our next question comes from the line of Andrew Crean from Autonomous. Please go ahead with your question.

Q - Andrew Crean {BIO 16513202 <GO>}

Hi there. Morning.

A - Andrew Moss {BIO 3628034 <GO>}

Hello, Andrew.

Q - Andrew Crean {BIO 16513202 <GO>}

Three questions. Firstly, the fall in new business margin from 2.7% to 2.3%, have you reflected lower bond yields in that, because obviously I think your sensitivity to lower risk-free rates is substantial?

Secondly, could you tell us what the uplift between MCEV and EEV was, as at September? I think it was about a GBP1.7 billion uplift at June. But that may have changed, given the swing round in spreads.

And thirdly, coming back to James' question, can you give us the economic capital coverage ratio at September, because I think the 1.7 at June, certainly by my calculations, was a bit optimistic?

A - Andrew Moss {BIO 3628034 <GO>}

Sure. First of all, let's start with the margin, Andrew. I'll ask Pat to talk about that. The answer to your question is yes. But there's probably a little bit more detail to pull out in respect particularly of the US.

A - Pat Regan {BIO 15131018 <GO>}

Yes. So the reason for the movement, Andrew, is -- hi, Andrew. The reason for the movement is almost exclusively because we have reflected that. So you'll have seen in the UK it's remained very strong, at 3.5%; similar story in Europe. Actually, we saw a nice increase in Asia. So the reason we had a decline was purely reflecting the lower risk-free rates, particularly -- well, in the US. So that was the reason it declined. And reflecting the lower yield environment.

Q - Andrew Crean {BIO 16513202 <GO>}

Great. Thanks.

A - Pat Regan {BIO 15131018 <GO>}

On the MCEV to EEV, we haven't updated that. But use broadly the same numbers, I would say, on that one. And the last question was?

A - Andrew Moss {BIO 3628034 <GO>}

Coverage ratio on --

A - Pat Regan {BIO 15131018 <GO>}

Oh, coverage ratio. Yes. We haven't updated that for now, Andrew. But again, you can do the same maths. That's just flowing through the GBP6.9 billion to roughly what that would be now, albeit, as I say, it would have gone up again in (multiple speakers).

Q - Andrew Crean {BIO 16513202 <GO>}

Yes. But Pat, the question was -- what I was questioning was the 1.7 times coverage at June, which then makes it more difficult to --

A - Pat Regan {BIO 15131018 <GO>}

Yes, I think it was my -- we didn't write that down. I think it was my quote, wasn't it? So I think, yes, the maths would be a little bit closer to 1.60 than 1.70 as of June. You're not wrong there.

Q - Andrew Crean {BIO 16513202 <GO>}

No.

A - Andrew Moss {BIO 3628034 <GO>}

Okay. Thanks, Andrew.

Operator

Our next question comes from the line of James Pearce from UBS. Please go ahead with your question, sir.

Q - James Pearce {BIO 16758460 <GO>}

Morning, everybody. A couple of questions. First of all, could you talk a little about the cash flow that makes up your targets. And particularly what the cash flow experience from your European operations is so far this year and how you expect that to develop?

And second, one of your competitors is complaining about finding it hard to make money in general insurance mid-market lines in the UK. Could you say what your experience has been in that area?

A - Andrew Moss {BIO 3628034 <GO>}

Yes, for sure. I'll answer that in a moment. On the cash flow or operating capital generation, I think you're talking about there.

A - Pat Regan {BIO 15131018 <GO>}

Yes. So as we said today, we're on track on that. I would tell you. And Igal who's sitting next to me would tell you as well, he's been very focused on that in Europe. And that's been very good. And you can see that reflected in our product mix sales, our product focus and the volumes of product, the guarantee levels, all of that good stuff. As we've talked about a few times, our generation numbers are very resilient. That's one of the nice features of our business. We have big in-force blocks, whether that be in the UK or Europe. Retention levels are high. Igal's very focused on managing expenses. So all of that is positive features, I think.

A - Andrew Moss {BIO 3628034 <GO>}

And I think on the general insurance in the UK, we're very pleased, actually, with the overall results in the UK, James, the 95% combined. I think we benefit from having a diverse business. On the personal line side, we've done really, really well in the last couple of years. And that's come through into earnings this year. More than 2 million motor customers, growing by more than 700,000 since the beginning of 2010. And growing at a time when rates have been moving up and we've been tucking in behind some of the competition, frankly. And gaining market share at good profitable rates. Household's been good too. It's been a kind year in terms of weather in the UK.

I think on the SME side of the book, yes, we wouldn't disagree with that assessment. We haven't seen as much upward movements in rating, or getting the rating that we would have liked to have done this year. Retention has been good in that book for us. But I think the forces at work there, there is more than one. The reality I think is the volatile financial markets, as people are planning for 2012. You might hope that that might lead to some upward movement. But we've been saying that for a year or two now. I think the realistic assessment is that people running small businesses in the UK are looking to save money everywhere they can. And given that sort of economic factor at work, I think it's going to continue to be tough.

So it's not that we're not making money there. But we'd like to be making more and making better returns. But right now, at the moment, the game is retention. We're still very strong in that business. Our relationships with brokers were proved again, I think, this year. So I feel very positive about our position in the market. But we'd love to see a bit more movement in that market over time.

Q - James Pearce {BIO 16758460 <GO>}

Okay. Thank you very much.

Operator

Our next question comes from the line of Duncan Russell of JP Morgan. Please go ahead with your question, sir.

Q - Duncan Russell {BIO 15944951 <GO>}

Good morning. Just one question, which was in your comments you talked about the success in the individual annuity market in the UK and you said you'd pulled back a bit on the bulk market. And I was just wondering why the difference between those two things? And what is it about pricing in the bulk market which you don't like, given that credit spreads are obviously quite wide, currently?

A - Andrew Moss {BIO 3628034 <GO>}

Yes. Thanks, Duncan. Morning. I think it's fairly simple, the answer to the question, in as much as obviously the diversity that comes with writing individual annuities is more attractive to us. And because of our own reach in that space, we're able to write business at good rates. And because of the costs we've taken out of our business over a period of time, we're very, very competitive right across our life book, which is allowing us to win share. And we think we're pretty much the lowest-cost provider there now. And that's a real benefit to us.

On the other side of that, the fact is that the capital requirements in the new Solvency 2 world are still uncertain. So writing large lumps of bulk purchase annuity at the moment is something which we're just steering away from at the moment. It's not that we don't have capital to deploy in those markets. I think we do. But we're just making sure that the returns take into account any uncertainties there are about the capital requirements.

Q - Duncan Russell {BIO 15944951 <GO>}

Okay. Thank you.

Operator

Our next question comes from the line of Nick Holmes of Nomura. Please go ahead with your question.

A - Andrew Moss {BIO 3628034 <GO>}

Morning, Nick.

Q - Nick Holmes {BIO 3387435 <GO>}

On sales, please. Firstly, in the US, seems to have been strong sales growth in Q3. I just wondered what your appetite is for further growth, given the low interest rate environment, which I guess must be putting pressure on margins.

Then, secondly, looking at sales in Europe, I just wondered, are you finding that your bancassurance partners are getting a little bit less keen on insurance, because they want small deposits to satisfy the Basel 3 liquidity requirements? Thank you.

A - Andrew Moss {BIO 3628034 <GO>}

Thanks, Nick. On the US, let me go there first. Yes, look, we did tweak the pricing and crediting rates as we came into the Third Quarter. And we're seeing a bit of an upward tick. What we're trying to do is strike the right balance between the right levels of new annuity business. And your comment on margins is absolutely right. But of course what that doesn't take into account is the credit spread earnings that we actually make which actually comes through.

So we think we're striking the right balance there. The profitability of the business is strong in the first half of the year. We want to just dial it up a little bit in terms of volumes on the annuity side, make sure we're servicing our distribution across the US market. And so I'm quite pleased with the balance that we've struck there.

I think, on Europe, the simple answer is no. I'll bring Igal in. But the reality is that customers still walk into the branches; they still go about their business. That includes the buying of insurance. And the commission earnings which banks earn from insurance are attractive to them.

A - Igal Mayer {BIO 15440055 <GO>}

Morning, Nick. It's probably best to just illustrate that by just talking about three countries and what's happening in our three big bancassurance countries. If I look at France, our relationship with Credit du Nord, we're seeing rapid sales. So they are all the initiatives that we've done this last year are delivering very nicely.

If I go to Italy, we're actually taking the management action there. So if you look at what we've done there, we have been, for the last two years, driving down the with-profit sales. They're down about 47%. And a very nice shift towards the protection business is the trend there in Italy, with cooperation from all our bancassurance partners.

Spain, if you're aware of what's going on in Spain, the mortgage market is down significantly, some would say almost closed. Now, despite that, we're working very well with the caja partners there to really drive individual protection business. And I think the overall result, if you look at the numbers we published today, despite that contraction of the mortgage market, Spain very resilient with sales roughly flat with a year ago.

Q - Nick Holmes {BIO 3387435 <GO>}

Right. So you're finding that banks have good appetite for protection?

A - Igal Mayer {BIO 15440055 <GO>}

Yes. But I'd also -- appetite for protection. But Credit du Nord is a good example of still a relationship where we're able to drive both unit-linked and in terms of the savings products, ones that we're happy with. So we're driving sales there. Contrast that with Italy, we absolutely have to lever on the with-profit sales.

Q - Nick Holmes {BIO 3387435 <GO>}

Great. Thank you very much.

A - Igal Mayer {BIO 15440055 <GO>}

Okay.

Operator

Our next question comes from the line of Greig Paterson of KBW. Please go ahead with your question, sir.

Q - Greig Paterson

Morning, everyone. Three questions. One is you made some comments, I think at the half-year and at some of the conferences, about the Board reviewing the scrip dividend. I was wondering, in the context of the IGD hit, whether that's still on the table.

The second thing is obviously there's been a dramatic drop in interest rates in the Fourth Quarter, or up to the end of the Third Quarter. And you -- margins you determine are set on the starting quarterly interest rates. I was wondering how much that 5.5 margin on US will be hit by the starting -- lower starting interest rates in the Fourth Quarter. So the Fourth Quarter margin in the US.

Then, the IGD hit, I was wondering -- you mentioned comments about 600 basis points or whatever, that Italy would have to phone up the head office and ask for GBP200 million to GBP300 million of cash. I was wondering if that phenomena or a portion of it has occurred in the form of the lower IGD numbers, whether there's a significant Italian hit on that lower IGD number.

A - Andrew Moss {BIO 3628034 <GO>}

Yes. Let me answer the scrip question first. Obviously it's a question we get asked frequently. We have said that prior to certainty on Solvency 2 emerging, you can probably expect us to stay with the scrip. It's interesting to note that on the interim dividend 42%, nearly 43% of our shareholders took up the scrip. So there is genuinely a balance of interest and a balance of views around that. But I think, given recent market volatility together with the uncertainty that we're still in on Solvency 2, I think we're wise, frankly, to maintain our stance. That isn't to say that we won't review it over time; we'd certainly like to do that.

On US interest rates, Pat.

A - Pat Regan {BIO 15131018 <GO>}

Yes. The fact of the matter, Greig, is it does have an impact. But the team are working actually really quite hard to look at other factors to offset that, whether that would be income rises or various other items.

On the IGD question, no; the short answer is no. The Italian government bonds movements haven't hit IGD. And the reason for that is this Regulamento 28, which essentially says that for Italian solvency purposes you don't count the moves in Italian government bonds. When we talked about those sensitivity analyses, we had assumed Regulamento 28 doesn't exist for forever. But for the moment, the Italian regulator is extending the time duration on those.

A - Andrew Moss {BIO 3628034 <GO>}

Thanks, Greig.

Q - Greig Paterson

Thank you.

Operator

Our next question comes from the line of Raghu Hariharan from Citigroup. Please go ahead with your question.

Q - Raghu Hariharan {BIO 15133573 <GO>}

Thank you. Good morning, gentlemen.

A - Andrew Moss {BIO 3628034 <GO>}

Good morning. I just had three questions, all on capital, if I may, please. The first question was just on the IGD. I think if I read the press release right you're saying that 4Q earnings will more or less be offset by the call of the hybrid debt, which means that the IGD is more or less exposed, I guess, to market movements. So my question was at what level of IGD surplus would you have to start thinking about the dividend, or is it early days yet?

The second question was trying to pick on what, Pat, you were saying on the credit default reserves. I thought this was just a function of where the corporate bonds spreads are, it's just a mechanical number. And therefore it's pro-cyclical, i.e. when spreads widen your credit spread defaults just go up. So just wondering if you could expand on what you meant by you have options to look at that reserve.

The third one was just a request. Since the IGD is very sensitive to corporate bond spread movements, I was wondering whether you could give us the bond spread sensitivity to the IGD surplus, please. Thank you.

Okay. Do you want to take two and three first, Pat. And I'll come back on the first one.

A - Pat Regan {BIO 15131018 <GO>}

It genuinely, without appearing to be unhelpful, at the risk of being unhelpful, is really quite hard to do that, Raghu, because of the movements -- because the rules differ country by country, it is a very hard thing to do, to give you an overall sensitivity. Maybe we'll work offline with you. I'll just look at David, to just try and give you a little bit more sense around that.

In terms of the credit, you're right and wrong on the credit default. What we did was literally what you said, of applying a formulaic percentage of spreads. So as spreads -- corporate bond spreads moved out in the UK, that increased the provision in the quarter up to that GBP1.6b. I think you will find that is not what everybody did in the UK market. Let me just put it that way.

So Andrew (multiple speakers).

A - Andrew Moss {BIO 3628034 <GO>}

On the first one, Raghu, I think we're very comfortable, actually, with where the IGD is. The way we manage this is that for GBP4b, frankly, we don't put a lot of effort into managing the downside for the first GBP1 billion or so. So the hedging programs that we have in place cut in, to provide us with more protection as we get down below the GBP3 billion mark, closer to GBP2b. And therefore militate against those moves. And we've found that to be an effective way for us to manage it over time. So that remains the case.

The dividend decision is some way off. We were 5% up at the first half. And the Board will review that when it sees the full-year numbers.

Q - Raghu Hariharan {BIO 15133573 <GO>}

Could I just follow up real quick on this one? I was wondering, from the -- given the formulaic [ph], is there any issue around fungibility of dividends from your subsidiaries in terms of up-streaming them to a whole co or Group?

A - Andrew Moss {BIO 3628034 <GO>}

Yes. Look, for the last three years, since the first leg of the financial crisis, there's been more pressure from local regulators on the ability to dividend. I think we've managed that well. We know exactly how to go about that. Any of our subsidiaries are still good dividend payers, backed up by good solvency levels and good operating profitability in the businesses. So I think, is there more pressure on than there was five years ago, the honest answer is yes. Are we able to manage that, the answer to that too is yes.

Q - Raghu Hariharan {BIO 15133573 <GO>}

Right. Thank you very much.

A - Andrew Moss {BIO 3628034 <GO>}

Thank you.

Operator

Our next question comes from the line of Toby Langley of Barclays. Please go ahead with your question, sir.

Q - Toby Langley {BIO 15924432 <GO>}

Good morning. It's Toby Langley from Barclays Capital. My first question is on the bulk provision. Can you -- I'm not sure if you mentioned this earlier. But can you give us the basis points loss assumptions that you're running on that at the moment?

Then, secondly, in the release you talk about weakness in your European markets affecting your ability to optimize business mix there. Can you expand a bit on that statement and suggest over what timeframe then you do now expect to optimize that portfolio?

A - Andrew Moss {BIO 3628034 <GO>}

Sure. Pat, do you want to talk on the C4 provision first?

A - Pat Regan {BIO 15131018 <GO>}

Yes. So I think on that one, Toby, we -- it's actually the same as we've talked about before. So it's in the 65 basis points kind of range, as a blended average across all of the corporate bonds and commercial mortgages.

A - Andrew Moss {BIO 3628034 <GO>}

Toby was talking just specifically about the UK annuity provisions, I think (multiple speakers).

A - Pat Regan {BIO 15131018 <GO>}

Yes. So that was -- sorry, that was the UK annuity provisions. If you measure it in terms of percentage of assets. So the provision as a percentage of the assets, that's about a 7.5%

level. So the first number was in terms of the spread measure. But as I say, provision divided by assets is about 7.5%.

A - Andrew Moss {BIO 3628034 <GO>}

And I think it's that latter measure, to be frank, Toby, which we'll -- as we go through into the year-end, we'll take a look at that, because from that perspective it seems to me that a review for the year-end is in order.

Igal, do you want to just comment on the mix point in Europe?

A - Igal Mayer {BIO 15440055 <GO>}

Yes. Toby, that's a specific comment on the Third Quarter. As you'd expect in markets like France, where unit-linked is a significant portion of our business, customers sit on the sideline when they see volatile markets. So while we'd like to drive more unit-linked business, that's the headwind we face. We've faced that before. We saw that same trend in late 2008 and early 2009, when markets began to stabilize, customers' appetites for those products grew. And obviously we benefit from that. So that's really what that comment is all about.

Q - Toby Langley {BIO 15924432 <GO>}

Thank you.

Operator

our next question comes from the line of Gordon Aitken of RBC. Please go ahead with your question.

Q - Gordon Aitken {BIO 3846728 <GO>}

Morning. Just a question on hedging. So Andrew, you mentioned that the hedging -- you don't actually hedge from GBP4 billion down to GBP3 billion on the IGD. But the hedging really kicks in at GBP3b. I just wondered if you could give us a bit more detail on your hedging program. The other companies have talked about having -- buying out-of-the-money put options, having rolling five-year programs. Is that the sort of thing you do? And also, just if you can talk a bit about how the hedging splits between the policyholder and the shareholder. Thank you.

A - Andrew Moss {BIO 3628034 <GO>}

Sure. Thanks, Gordon. Pat, do you want to just cover that?

A - Pat Regan {BIO 15131018 <GO>}

Yes, sure. Hi, Gordon. A couple of things on that, then. So obviously I did talk a little bit about the Delta Lloyd impact. And they always talk on their corporate as a large hedging program they've put in place themselves. So in addition to that, we've got a couple of things that are big macro level. We have a cap collar protection on the euro/sterling relationship of GBP2 billion notional. Then on the macro equity hedge, as you remember, we hold actually relatively small amounts of direct equity holdings. But we have a GBP3 billion notional put arrangement coming in at about a 10% decline in markets, as I say, over about a GBP3 billion of notional.

That's all covering direct shareholder. Within the policyholder funds, we have a -- as John, I think, talked about back in January when we did the presentation, we've got a dynamic hedging program in place there that's been very effective in terms of protection on movement in assets on that. So there's a whole series of hedges in place on the actual with-profit funds. But at the macro Group level we have the both equity and currency hedges in place.

Q - Gordon Aitken {BIO 3846728 <GO>}

Thank you.

A - Andrew Moss {BIO 3628034 <GO>}

Thanks, Gordon.

Operator

Our next question comes from the line of Tony Silverman of S&P. Please go ahead with your question, sir.

Q - Tony Silverman {BIO 2162363 <GO>}

This is Tony Silverman, S&P Equity Research. I was just wanting to -- it's on the IGD. And I was just wanting to ask where the spread movements have been. Was it primarily France? Because you mentioned before there was a helpful table on the UK bank debt securities. Is that market value -- the GBP3.3 billion at the bottom, is that market value at September 30? If so, how did that move over the quarter?

And another aspect to it might be what exactly was the impact of Delta Lloyd in the total. And generally what were the major items in the spread movement? Thank you.

A - Pat Regan {BIO 15131018 <GO>}

All right. Thanks, Tony. I'll take the (inaudible). The GBP3.3 billion on the bank debt is all mark-to-market. I don't have actually the number off the top of my head that that would have moved in the quarter. We can check that offline. In total, it would have been about GBP200 million in terms of the overall IGD movements.

The two places, actually, where we had impact of spread movements would have been France and the UK. UK we talked about, which was the increase in the -- or if you like, the formulaic increase in the provision based on the spread movements. But also in France as well, obviously, corporate bond movements moved quite profoundly in the Third Quarter in France, some of which actually would have come back since the end of the Third Quarter.

Q - Tony Silverman {BIO 2162363 <GO>}

Thanks very much.

A - Andrew Moss {BIO 3628034 <GO>}

Thanks, Tony.

Operator

Our next question comes from the line of Oliver Steel of Deutsche Bank. Please go ahead with your question.

Q - Oliver Steel {BIO 6068696 <GO>}

Good morning.

A - Andrew Moss {BIO 3628034 <GO>}

Hello, Oliver.

Q - Oliver Steel {BIO 6068696 <GO>}

Two questions. I think Raghu asked about the sensitivities of spreads from here and okay, I appreciate the answer. But are you able just to highlight in the bigger European countries how it works? Because in France I think you said that the level of unrealized gains is now -- or at least at the end of the Third Quarter it was somewhere close to zero. So I guess the sensitivity downwards now on that would be quite limited. So I'm just wondering if you could talk more widely about France and others. That's one question.

The second question is I seem to remember that you were looking to pay back more than just the GBP700 million of debt in November. And that there was a whole debt repayment plan for the next two or three years. And I'm just wondering if you can update us on that. And when the timing of that is due and how you're going to manage that.

A - Andrew Moss {BIO 3628034 <GO>}

Yes. Let me take the first -- the second one first. The plan was over three years, to pay about down half of the debt that was maturing. So frankly, implicit in that answer, Oliver, is the point on timing. It's when we reach the step up points on that particular debt. And at the moment, our intention is still to follow through on that. And the call on the hybrid this month is clearly part of that. So no real change there on that, I think.

On the sensitivity of the spreads going forward, actually, your summary on France was pretty much 100% accurate. Pat, I don't know if you want (multiple speakers).

A - Pat Regan {BIO 15131018 <GO>}

Yes. Your summary of France was good. The UK we talked about. It was a formulaic approach in the Third Quarter that built up that provision. So you couldn't -- obviously we'll look at that in the round in the Fourth Quarter. And the other big markets, Oliver, the Italy and Spain don't use mark-to-market movements. And as I mentioned earlier, neither does the US system. And hence we have a bit of a large unrealized gain not included in IGD. So none of those would actually impact sensitivity to credit spread movements included in the IGD number.

Q - Oliver Steel {BIO 6068696 <GO>}

Okay. Thank you.

A - Andrew Moss {BIO 3628034 <GO>}

Pleasure.

Operator

Our next question comes from the line of Greig Paterson of KBW. Please go ahead with your question, sir.

Q - Greig Paterson

Just a follow-up question. At the half-year, you showed sensitivity and you didn't cloak it. It was IGD sensitivity around interest rates or gilt yields. You did cloak it in the form of a higher interest rate; I think it was 100 basis points worth of -- minus 700. The implicit is that a reduction in 100 basis worth was worth plus 700. But I think over the quarter we saw lower interest rates in the US and in the UK, except in France and Italy it wasn't the case. But should there not have been a big positive kicker coming through? Basically, that sensitivity you provided in June was not very useful (inaudible).

A - Andrew Moss {BIO 3628034 <GO>}

Thank you, Greig.

Q - Greig Paterson

It didn't turn out to be the truth, is the right --

A - Andrew Moss {BIO 3628034 <GO>}

This is not an easy thing to model, because of the -- as Pat used the word earlier, the idiosyncrasies of the way IGD works in different places, mark-to-market movements and --

Q - Greig Paterson

Hello, you're very distant.

A - Andrew Moss {BIO 3628034 <GO>}

Mark-to-market movements count until they don't -- sorry, I was trying to express my sympathy for your difficulties in modeling the IGD.

Q - Greig Paterson

So you're testing my hearing.

A - Andrew Moss {BIO 3628034 <GO>}

I think as we go forward, we'll look to see if we can improve it. But it really is difficult, because different movements at different times in different countries have different effects on the IGD number. And that's something that we manage. It's a pretty technical area for us. But we've got a good track record of managing that over time and we're confident of our ability to do it. It is difficult to look into the Company and be able to model that accurately over time.

Q - Greig Paterson

Should I just ignore that sensitivity provided and just say, all right, it didn't turn up?

A - Pat Regan {BIO 15131018 <GO>}

I just want to say a little bit, Greig. The equity has worked pretty accurately. So the equity movements did follow what was in the table. On the interest rates, it does, I guess, depend on where they are. So as interest rates declined in the US, we did see an increase in the value of the fixed income in the US, which as I say increased our unrealized gains. But that doesn't count towards the IGD calculation because of the way it works. So it does -- in that sense there, we're depending on where interest rates move. Inevitably, as we put the table together, we assumed a flat movement across the piece. And that's not what happened.

Q - Greig Paterson

All right. I imagine you should -- I should rather drill down into detail.

A - Pat Regan {BIO 15131018 <GO>}

Inevitably, because the rules are -- do differ country by country, it is quite hard to apply a rule across the piece that gives you an overall sum of it.

Q - Greig Paterson

All right. Thank you.

A - Andrew Moss {BIO 3628034 <GO>}

Thanks.

Operator

Our next question comes from the line of Marcus Barnard of Oriel Securities. Please go ahead with your question.

Q - Marcus Barnard {BIO 2103471 <GO>}

Yes. Morning, guys. Could I just ask for a bit more explanation on the simplifying and accelerating the Quantum Leap, in order to deliver the benefits by the end of 2011? I take the point about Ireland that you've done. But I just wonder if you could pad out a bit on restructuring your European regional operations, obviously without wishing to steal any of the thunder from your forthcoming European Investor Day. Thanks.

A - Andrew Moss {BIO 3628034 <GO>}

Sure, Marcus. Let me hand over to Igal. And we'll update you.

A - Igal Mayer {BIO 15440055 <GO>}

Yes. Marcus, thanks for the question. Yes, I don't -- we will save most of the detail for the Investor Day. There's two things that I think you should be looking for. One is improvement in the cost base, as part of the GBP400 million cost challenge that we set ourselves. And a big part of Quantum is delivering that.

In terms of some of the more underlying benefits, those are well underway so I can talk to you about operational changes that we're making. You'd expect things such as linking together the operational capabilities of each of the different countries. So that's things like data centers and desktops. Some of the other stuff, I'm very pleased with the progress we're making; it's blending together our claims management capability. Those are real operational benefits that have sustained value. So extending out some of our bigger UK capability, whether it's around managing supply chain or bodily injury indemnity cost. Those programs are being spread out across the region.

And lastly, we are managing one balance sheet. And we're getting a hell of a lot better at doing that. And that's been a big part of Quantum to build that capability. So when we do the Investors Day, we'll show you both the financial benefit that will come through in terms of cost savings. But as importantly we'll show you those operational things that are coming.

Q - Marcus Barnard {BIO 2103471 <GO>}

Okay. Thanks very much.

A - Igal Mayer {BIO 15440055 <GO>}

All right.

Operator

Our next question comes from the line of Blair Stewart of Merrill Lynch. Please go ahead with your question.

Q - Blair Stewart {BIO 4191309 <GO>}

Thanks very much. A couple of questions left. The pickup in pensions business in the UK, to get back to the mundane, what's driving that? And what percentage of that business is coming on commission paying terms. And is it wise to be paying commission ahead of RDR?

Secondly, could you just clarify what is the Delta Lloyd effect on IGD, given it's not consolidated anymore? Just a bit confused about that.

And thirdly, from the sublime to the ridiculous, really, in terms of disaster planning, what would your thoughts be on the impact of your business operationally and in terms of asset allocation, etc., on a disorderly Greek default? Thanks.

A - Andrew Moss {BIO 3628034 <GO>}

Okay. Thank you. Let me take the third one first, Blair. Then I'll ask Pat to talk on the DL effects on the IGD. And then we'll come on to the pensions business.

Our base planning scenario, as you know, because I think I've said this on a platform with you at your recent conference, is for a Greek default. So whether in some respects, whether it's orderly or disorderly, it's still difficult, of course, to see the secondary knock-on effects. I think markets will react probably as we've seen in the last week to the prospect of a disorderly default in a slight more alarmist way.

So -- but what knock-on effect that will really have on other countries in Europe, it's hard to say. It might prove to be the catalyst for further action in Italy, for example, which I guess on reflection, when you look at the last week, whilst the action that was taken by the political leadership in Europe last week clearly was a major step in the right direction, any objective analysis has to say that the markets are looking for more in Italy. So difficult to predict. But that's the way I think I would be thinking about it.

Delta Lloyd effect on IGD?

A - Pat Regan {BIO 15131018 <GO>}

Yes. The way the IGD rules works, we still take a proportionate share to our proportionate ownership, 42%, until we fall below 20%. Okay?

A - Andrew Moss {BIO 3628034 <GO>}

Then the pensions business in the UK. We're doing really well in the Group personal pension space. Yes. We are paying commission. And we've done that for the last number of decades. That's, as always, something that is part of the distribution model there. It will change. Nevertheless, we think we're ready for those changes. And I'm really pleased to see the market share in that space going up as strongly as it is. We're very focused on that.

The management in the UK business I think has done very well in that regard. We have Trevor joining us in just a few weeks' time now. And I fully expect him to make sure what I think is a very important strategic issue for us is to -- in the auto enrolment era, for us to have a strong offering in that space.

Q - Blair Stewart {BIO 4191309 <GO>}

Just coming back on the pensions question, Andrew, that -- often get asked about the prospect of business being churned away from you, the business that's been put on the books on commission paying terms and almost by definition attracting higher charges for the customer, because it was put on at commission paying terms. The prospect of that being churned away from you in a post-RDR world, what's your thoughts on that?

A - Andrew Moss {BIO 3628034 <GO>}

I think we'll see, Blair. I think our (inaudible) relationships, our employee benefit, advisor relationships have really moved on in a very positive way over the course of the last year or so. And our capability -- all of this is about operational capability. And frankly it's about focus of the team on the particular business. They are focused on it and, as usual with Aviva, if we focus on it we tend to do very well on the businesses on which we're focused.

So frankly, I've got a great deal of confidence in the team and under Trevor's new leadership as well, which I think will only add impetus in that respect. So very happy to be judged on what actually happens as we move into RDR.

Q - Blair Stewart {BIO 4191309 <GO>}

Okay. Look forward to that. Thank you.

Operator

Our next question comes from the line of Andrew Crean of Autonomous. Please go ahead with your question.

Q - Andrew Crean {BIO 16513202 <GO>}

Just one quick follow-up. Did you change the liquidity premiums on the embedded value in the Third Quarter? I think they were 1.86% for UK, about 33 basis points in Europe and about 55 basis points in the States.

A - Pat Regan {BIO 15131018 <GO>}

Just only in line with the formulas that we set out for that stuff, Andrew.

Q - Andrew Crean {BIO 16513202 <GO>}

So could you give us the numbers, because I haven't got the formulas with me or the actual base numbers for the formulas?

A - Pat Regan {BIO 15131018 <GO>}

This one, if you remember, they're slightly different country by country. So I'll get David to follow up with you offline on that.

Q - Andrew Crean {BIO 16513202 <GO>}

That would be great. Thanks.

Operator

We have no further questions, gentlemen. No, sorry, that's a lie. Raghu Hariharan again. Please go ahead with your question.

Q - Raghu Hariharan {BIO 15133573 <GO>}

Hi, guys. Sorry for prolonging this call. But just two quick clarifications, actually. On the IFRS NAV, Pat, the movement in 3Q, does it include the RAC, which was I think about 20p, 25p?

And the second question was really on the increase in the surplus in the pension scheme. My sense was as bond yields fall your liability value will go up and asset values have gone down. So I would have thought the surplus actually comes down. So if you could help us with that, that would be great. Thank you.

A - Pat Regan {BIO 15131018 <GO>}

The answer to your first question is yes, it does include the benefit of the RAC.

In answer to your second question, there was a couple of things. As I say, we did proportionately a little better on the asset side, because we've significantly de-risked. And you've got to remember the discount rate is based off AA corporate bond yields of the equivalent duration.

Q - Raghu Hariharan {BIO 15133573 <GO>}

Okay. Thank you.

A - Andrew Moss {BIO 3628034 <GO>}

Thanks, Raghu.

Operator

We now have no further questions. So I hand the conference back to yourselves. Thank you.

A - Andrew Moss {BIO 3628034 <GO>}

Thanks very much. Look, thanks for making time to talk to us this morning. Our summary I think is clear, which is a strong operating performance, good momentum in general insurance, good profitability in life, more disciplined capital allocation and the benefits coming from that, on track to make our financial targets for the full year and of course, as we have to be, focused on maintaining the financial strength of the business in a tough external environment.

So that's what we'll be concentrating on over the next few months. Look forward to talking to you, of course, over the next weeks and months. Thanks so much.

Operator

Ladies and gentlemen, thank you all for your participation today. This concludes today's call. You may now disconnect your lines. Thank you.