Aviva PLC Q3 Interim Management Statement Conference Call

Company Participants

- David Barral, CEO Aviva UK Life
- David McMillan, Director, Group Transformation
- John Lister, Chief Risk & Capital Officer
- John McFarlane, Executive Chairman
- Pat Regan, CFO
- Robin Spencer, Chief Executive, UK & Ireland General Insurance

Other Participants

- Andrew Crean, Analyst
- Andy Hughes, Analyst
- Blair Stewart, Analyst
- Chris Esson, Analyst
- Greig Paterson, Analyst
- James Pearce, Analyst
- Jon Hocking, Analyst
- Nick Holmes, Analyst
- Oliver Steel, Analyst
- Unidentified Participant, Analyst

Presentation

Operator

Good day and welcome to the Aviva Q3 Interim Management Statement, nine months to September 30, 2012 conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. John McFarlane, Executive Chairman. Please go ahead.

John McFarlane {BIO 1509370 <GO>}

Good morning, everyone. And thanks for joining us. I've got Pat Regan our Financial Officer with me here. The purpose of this is essentially to give you an update on Q3 which is pretty much business as usual from my standpoint. So I will let Pat take you through that.

I think I've actually expanded the Q3 update just because I'm sure a lot of questions are on people's minds as to what progress are we making on the various initiatives. I think it's important to then stand back and say, what are we trying to do here.

But clearly over a number of years Aviva has got itself into a position where whilst there is some very attractive things and a very strong brand, we've actually systematically dragged down the value of the organization by having businesses that produce sub-economic returns. And by inefficiency inside the organization.

So it's become necessary to draw a line on that and then put in a program that will actually transform that. And essentially there were four major things that I put in the release that I was focusing on.

The first, of course, is to appoint a high quality CEO. Now part of the problem here is that everybody's expectation is at five past eleven today I'm going to make an announcement. Well I can assure you that isn't going to happen.

As of this week, we were still interviewing external and internal candidates. We have completed independent reports on them. And we're also doing checking, we're also doing consultation with regulators. So that process has to complete before we can make an announcement. But we are actually in good shape and on track and certainly in line with the timetable that we set out as a Board. So I'm very happy with where we're heading there.

The main objective financially was the concern over the company's capital level and volatility of the balance sheet. And obviously we're working on taking the risk down and building the capital up. Again we're making very good progress in that with our economic capital levels and IGD rising since the beginning of the year.

And in fact we've also put in the release something about the non-core disposals, highlighting the US. The important thing about that to understand is that it is a non-core business, it's not a business that we should continue with given the target returns that we're looking for. But actually the benefit to us is considerable from a capital standpoint which is our number one financial priority.

And in executing that, if we can at the levels we are currently working with, it will bring us out at or close to our minimum target capital; economic capital ratio. So it actually kills two birds with one stone.

As with respect to the other disposals, they tend to be individual markets. They are quite long in gestation. We will dispose of them all. They will be at prices which are perfectly acceptable and we estimate that on average we will be able to do that around book value and probably better.

Then finally, one of the problems that we have is that we're dealing with a very, very complex transformational program here. Given the entrenched nature of some of the culture and values that Aviva and also some of the analysis of our business has not given us the real signals as to what we should be doing. So we've put in this very comprehensive transformation program. I've given you a complete rundown on all the things we're working on just to give you a sense of this.

The one thing that's probably making the biggest difference is when we get to the sub-analysis of the individual business cells, we're finding at the micro level areas of strength. But we're also finding areas, even within good businesses where we're burning returns and producing negative returns.

So this analysis in and of itself will be self-correcting and will cause us either to improve revenues within the segment to reduce costs to manage losses more effectively or to withdraw capital. Or it may cause us, in fact to increase the investment in capital and expense in businesses with very high opportunity that actually we've been under-investing in.

So it's actually probably the most productive and sharp end nature of the program we're running. It's the bit that we're wrestling, to the ground quickly and of course we are actually building the result of that into our 2013 and 2014 plans as quite hard numbers. So that is going really quite well.

Now all of that said, getting to this hasn't been completely straightforward given the nature of the company that we're dealing with. Sometimes it's been a bit frustrating but actually as we work through it we're actually breaking it down and getting it to where we need to do.

I'm actually really quite happy with where we've reached. So on that note I'd like to pass you to Pat who will take you through the results.

Pat Regan {BIO 15131018 <GO>}

Thanks John. Good morning to everybody. On the Q3 results first, obviously the economic backdrop continues to be challenging. Both in terms of consumer demand but also obviously the low interest rate environment. Nonetheless, the operating profit trend is broadly in line with the one we saw at the half year.

Our capital generation, capital generation is GBP100 million better in the first nine months than at this time last year. And is over GBP200 million higher if you adjust for the disposals of the RAC and Delta Lloyd. Most of that improvement has come from a combination of continued lower capital usage, better capital allocation across the Life businesses and higher in force generation.

Particular progress has been made in UK Life, where again we've decreased capital usage, principally from writing lower bulk purchase annuities and lower guaranteed bond sales. And also increasing capital generation from the back book.

Italy has now returned to positive capital generation with the action was taken to reduce new business guarantees. And France and Canada continue to be reliable and good generators of capital.

As John noted, we continue to make good progress improving capital allocation, particularly between the 58 cells. But there's still more to do. What we are doing now is taking the capital allocation down to the next level with sub-cell analysis. So an individual cell, one of the 58 might have 10 or 11 sub-cells within it and we're differentiating our capital allocation within those sub-cells.

Now all of that means we're putting clearly value over volume particularly on the Life business. And when combined with market conditions, that means overall long-term saving cells around about 6% in the first nine months of the year to just over GBP22b.

Life new business profitability is ahead of our target with IRRs at just under 14%. The UK continues to perform well, protection sales are up 23%, individual annuities up 11% and Group personal pensions, important for auto enrollment, up 15%.

We've targeted a reduction in book purchase annuities and guaranteed bond sales and overall that meant that UK sales were level. And this deliberate shift in mix has seen the IRRs increase from 15% to 16% this year.

The UK Life business remains one of the key strengths of Aviva and we're confident that the continued growth in those targeted areas of annuities, protection and group pensions will provide a strong platform for the future.

Given our focus on capital allocation. And the subdued demand for savings products, we have seen a fall in new business in Mainland Europe. We've actively worked to increase prices and reduce guarantee levels in France, Italy and Ireland. And on the back of that with-profit sales in Italy are now 36% this year on the back of a 47% decrease last year.

Our focus also remains on the effective management of the in-force books in each of these markets. And maintaining retention levels to ensure that operating earnings remain resilient.

In the US we've re-priced annuity products a number of times this year. The lag impact of that you can now see on new business sales in the Third Quarter.

And in the emerging markets, overall it's flat with a 20% increase in Singapore offset by lower sales in Poland due to the regulatory changes there.

Turning onto General Insurance where premiums were steady at GBP6.7 billion and a combined ratio at 96.7%, slightly down on the half year due to higher weather claims in the Third Quarter.

The personal motor market is our strongest and most profitable area in both the UK and Canada. In the UK, personal motor sales were up 8% for the year, after adjusting for the

RAC impact and we now have over 250,000 new customers and over 2.5 million personal motor policies in the UK. Personal motor rating is slightly softer now. But obviously this follows big increases over the last two or three years. And the profitability of that book remains good.

Our UK commercial business, motor rates increased about 6%. But the other lines -- commercial lines is less positive and we have been more selective about the business we're writing there. A combination of good risk selection, rate increases and cost control means the UK combined ratio comes in at 97%.

In Canada, sales were up 5% to GBP1.6 billion and there's been a good increase improvement in the combined ratio to 93% this year from 96% last year. And again this is due to a range of actions on both retention, rating, underwriting and underlying growth in our customer base.

Finally onto the net asset value. The MCEV net asset value increased to GBP4.46, up GBP0.25 compared to the half year. Then the IFRS net asset value is GBP3.97 per share in line with the half year with the increase in operating profits offset by movements in the pension scheme due to a lower discount rate.

Just to talk briefly about strategic progress. Building our financial strength remains the single most important priority for the Group. To this end we've seen capital levels increase since the half year. At the end of October, our estimated economic capital surplus is GBP5.3b; it's a ratio of 146%, up GBP800 million since the half year. And up GBP1.7 billion since the last year end.

Similarly, the IGD solvency surplus is now GBP3.7 billion or a ratio of 167%, up GBP1.5 billion since the end of last year.

The increases were due to a combination of both improving market conditions. But also the actions we have taken through the year. In the Third Quarter we reduced our holding in Delta Lloyd, have done some further work to de-risk the pension funds and we've extended our equity hedging program as well.

We've also sold down roughly EUR1 billion more Italian sovereign debt in the Third Quarter, bringing the total we've sold down this year to nearly EUR3b. Now the sell-down has been offset partially by increases in market values. So our net shareholder exposure and this is now in pounds, GBP500 million direct shareholder exposure, down from GBP800 million at the start of the year. And participating exposure is GBP4.7b, down from GBP5.6 billion at the start of the year.

We've also confirmed today that we are in discussion with external parties to sell our US Life and Annuities business. Inevitably this disposal can only be made to a substantial discount to our IFRS book value; however, a sale would increase both the market consistent embedded value and significantly benefit our economic and capital surplus. We believe such a sale would be in the best interests of the Group.

Narrowing our focus is another key strategic priority along with the potential disposal of our US business, we continue to work on the 15 other red cells. In addition to Delta Lloyd, we've announced the sale of our Sri Lankan business. We're working closely with banks on eight other exits. And we're taking further radical action on the four remaining red cells. We expect to make further announcements on these in the first half 2013.

Our third strategic priority is to improve the performance of the Group. We set out today the nine programs to drive these forward. And within these programs we're working on well over 100 separate initiatives. And have set out details on some of these in the Release. I won't go through them now on the call. But will obviously be happy to take your questions later.

There is no doubt it did take initially more time and energy to build momentum across the programs than perhaps we expected. But we are now comfortable we are making good progress.

So to conclude, although the economic backdrop clearly continues to be challenging, our operating profit trend is broadly in line with the half year. We're making good progress on all of our strategic priorities to build the company's financial strength, narrow our focus and improve earnings performance.

We'd now be happy to take any questions you've got.

Questions And Answers

Operator

(Operator Instructions) We will now take our first question from Andy Hughes of Exane BNP Paribas. Please go ahead.

Q - Andy Hughes {BIO 15036395 <GO>}

Hi, guys, thanks very much. A couple of questions if I could on the General Insurance side to start. Just noticing the quarterly trend in general insurance premium income is down quite a bit, that's note eight. In fact it looks like it's down 10% over the quarter versus Q2 and down quite a bit versus last year. Maybe you could talk a bit about what's happening on the general insurance premium income side.

Also, could you give more detail on the weather impact that's impacted the combined ratio? Because I'm not getting the same message from anyone else that there was a significant amount of weather in Q3. So is it an Aviva specific thing?

The third thing is a request really. On terms of asbestos survival ratios, can you just confirm what they were at the end of the year and maybe if you've got an updated number that would be very helpful. Thank you.

A - Pat Regan {BIO 15131018 <GO>}

Thank you for the last question, Andy. On the GI premium terms, I've got Robin Spencer with me. So I'll let Robin talk to this. Essentially it's seasonality, the Third Quarter is seasonally a little bit lower than the second. You really need to compare Third Quarter this year with last year. But Robin, do you want to give it a little bit more color towards that?

A - Robin Spencer {BIO 16514830 <GO>}

Yes that's generally a trend that we always see in the Third Quarter. I think to add to that, Andy, if we cast our minds back a year we were at that stage we were still growing strongly into a hardening market with personal motor rates going up 18%, commercial motor rates going up 13%. Clearly we are in a different environment altogether at the moment.

I think that's the key reason for the different trend. I think the other thing I'd just pull out is that we are taking more action, given what's been said about cells and sub-cells, we're taking a lot more action to really focus on any of those segments of business where we can't write business profitably and we're not exiting any lines but we are clearly shrinking and taking action to reduce our overall exposure in those lines where we can't write profitably.

I drew out a few in the announcement that came out this morning. Such as bluewater hull, some agricultural segments, some leisure segments, pubs and restaurants and things we find it difficult to write those profitability both in the UK and in Ireland at the moment. So they'd be the key reasons why we're seeing some overall reduction in the pace of growth. But overall we're still year on year up about 2%.

Q - Andy Hughes {BIO 15036395 <GO>}

Just a quick follow on question to that if I could. I guess the point about rates -- that's one of the reasons why I didn't understand why it's come off. Because obviously the rate increases were going through the book in Q3 2011 and has the rate decline all gone through the book in Q3 2012? Presumably it works its way through the renewal book over time and that's why I guess I was surprised to see the decline this early on.

It begs a second question, is this rebalancing, how much more of the rebalancing is there to go in terms of premium volumes? Thanks.

A - Robin Spencer {BIO 16514830 <GO>}

I think in terms of rebalancing, one of the big advantages of our book, Andy, is the fact that we do have multi-channel multi-products which allows us to dial up and dial down where we're allocating our capital. So I wouldn't call it a one-off rebalancing, I think it's really how we manage the book on an ongoing basis is to decide which segments we can make money in because of our broad distribution that allows us to actually increase our overall penetration in those segments when it's good for us. So I wouldn't say it's an overall reshaping, it's part of a discipline that we have in running the overall book.

I think your observation is fair in terms of the overall earnings of it right through the book. You know that actually the full earning won't come through of some of those rate increases for 18 months. So we're seeing that roll off. But at the same time we were taking actions last year to exit some lines that were unprofitable and we're seeing some rate reduction. So I think at a press release class you can't see that necessarily in the numbers. But that's actually what's happening.

A - Pat Regan {BIO 15131018 <GO>}

Overall, Andy, I think if you look at the General Insurance, Canada is still growing that's been true for a while. GI overall in the UK where we're growing personal motor and happy to do so, on commercial lines you've just got to be a little bit more selective as the rating increases because the rate environment is a little bit softer.

On your weather point, taking it into context, there was slightly higher weather in Canada in the Third Quarter versus the first half of the year. There was actually quite good weather for the first half of the year. The combined for the discrete quarter overall for Aviva was a bit over 98%. So it was a nudge up rather than anything particularly to shout about.

Then on your asbestos question I don't know the answer off the top of my head. I'll have to come back to you on that.

Q - Andy Hughes {BIO 15036395 <GO>}

Okay. Great. Thanks.

Operator

We will now take our next question from Andrew Crean from Autonomous. Please go ahead.

Q - Andrew Crean {BIO 16513202 <GO>}

Good morning, all. It was just a couple of numbers questions I wanted to ask. Firstly, now that you're talking about the US sale, could you give us the figures for the US business in terms of what its contribution to economic capital available and economic capital requirement were. And also what its tangible IFRS NAV was. That was one question.

The second question was what was the pension fund surplus at the end of the Third Quarter? And what is the -- I know you've just done a triennial valuation, what is the current funded pension fund deficit?

A - Pat Regan {BIO 15131018 <GO>}

Thank you, Andrew. First question first. On the US book value, if you look at the half-year information you get the total enterprise value including everything on IFRS basis is GBP3.2 billion or the pure equity number is a bit over GBP2.4b.

Q - Andrew Crean {BIO 16513202 <GO>}

That's for tangible, the GBP2.4b?

A - Pat Regan {BIO 15131018 <GO>}

Both of them are the full IFRS numbers, including (inaudible).

Q - Andrew Crean {BIO 16513202 <GO>}

Right.

A - Pat Regan {BIO 15131018 <GO>}

The second bit that you can see there is that the full MCEV enterprise value is about just over GBP300m. We haven't given -- so that gives you, if you like the half of your answer to economic capital.

We haven't disclosed economic capital by business. What I would tell you that the risk charges for the US business if you like the required capital element is well over GBP1b.

A - John McFarlane {BIO 1509370 <GO>}

There's one other thing about the US is that because the business is growing and the nature of the product, we are adding a significant amount of capital each year. So were we to delay this, while you could argue that you might have different market circumstances, which we in fact doubt, nevertheless the maintenance of the business and its growth would add significant amounts of equity next year and the following year. And we do not believe that that additional equity would be released in sale at book value.

Q - Andrew Crean {BIO 16513202 <GO>}

Great, okay thank you. And on the pension?

A - Pat Regan {BIO 15131018 <GO>}

On the pension scheme, Andrew, the surplus, accounting surplus was GBP1.4 billion at the end of the Third Quarter.

Q - Andrew Crean {BIO 16513202 <GO>}

That's pre-tax isn't it?

A - Pat Regan {BIO 15131018 <GO>}

Yes. We haven't yet gotten to the (inaudible).

Q - Andrew Crean {BIO 16513202 <GO>}

But is that likely to be different from where it was at the end of last year?

A - Pat Regan {BIO 15131018 <GO>}

No. I've got John Lister with me now. John.

A - John Lister {BIO 15438517 <GO>}

No. It's not. It's fairly stable.

Q - Andrew Crean {BIO 16513202 <GO>}

Stable on 2011? Okay. Great, thank you.

Operator

We will now take our next question from James Pearce of UBS. Please go ahead.

Q - James Pearce {BIO 16758460 <GO>}

Morning, everybody. Couple of questions. You haven't been explicit about the dividends today. But given your comment about cash generation, economic capital and cost savings, is it reasonable for us to assume that the outlook on dividends is at least no worse than it was previously?

Second, could you put your (inaudible) personal UK motor into a bit more context, given that some of your peers are doing their best to shed business in UK personal motor and why the different approach at Aviva. Thank you very much.

A - John McFarlane {BIO 1509370 <GO>}

It's John. I'd say that nothing at all has changed on dividend. The statements that we made that we would try and hold the dividend but couldn't guarantee to commit to it, was in relationship to 2013 at the time we made it. Simply because when you think about what's happening here is that we're taking action to reduce earnings in a number of quarters because of the economic nature of the business.

We are disposing of non-core assets. We will be writing down the book value of the organization. The earnings will drop and at the same time we've got this other program which is trying to replace those earnings.

Of course, superficially, notionally if you take 2011 and take 2014 we're trying to make sure that the earnings that are lost through disposals are recovered through the transformation program. And if you remember 2011 was not a clean year, we've had a lot of restructuring costs and other charges below the line. Where we are genuinely trying to make 2014 a clean year. Which would mean if we achieve all of that, it would mean that 2014 is a much better year than 2011.

Now, of course, the problem with all of that is in maintaining a fixed dividend level when you actually are adding earnings and cash flows decline. It does place more stress on that in 2013. Essentially what we are doing is modeling on a month-by-month basis what the cash flows and earnings are, because obviously if you think about the US for example, that cash would not be released to the group center until the middle of next year or whatever. It's going to be down there somewhere.

So we need to pace all of this, just to make sure. We are not more uncomfortable with this at all. In fact we are broadly where we thought we were going to be. Therefore there's really nothing different here but that might just throw a bit of color on why we've said, look, we're going to try and do it but we can't commit to it until we actually see how some of this execution plays out and how the pacing of it all plays out. But our intent to try and hold the dividend is genuine.

A - Pat Regan {BIO 15131018 <GO>}

Hi, James. On the personal motor. And again I've got Robin with me here as well. My reflections on the personal motor market over a number of years is that to be successful in that market you need a combination of obviously brand, scale, cost efficiency and really good underwriting techniques.

I think over the last two to three years we've taken some really good steps forward on each of those. You will have seen this year we launched Quote me Happy, that's obviously an internet only very low cost, targeted at certain segments. That's actually been quite a big part of the roads and policy count this year.

So a combination of all of those means that we can both grow policy count but also with a good profitability. That wasn't always true for us. But over the last couple of years we've made big strides in each of those areas.

Robin, is there anything you would like to add?

A - Robin Spencer {BIO 16514830 <GO>}

Yes, probably a couple of things just to add to that, Pat. Our expense ratio is probably the lowest it's been since the year 2000 at the moment. So we're really building on the scale point as Pat's just said.

We are growing Quote me Happy, we've probably got a higher proportion of our let's say, preferred segments, than in any other part of our book because we are able to more discretely price for those segments we really want to compete in and really want to have on our books.

Another competitive advantage I think we've got is the fact that actually it might not be very obvious but 53% of our total personal motor book still comes through brokers. And actually we don't see that as price sensitive as some of the other segments. I'm sure you all know that we've seen big fall offs in the motor rates that we're achieving. But I think we've seen -- certainly we haven't seen as big a decline in the broker segments as we have in the direct segments.

The last thing I'd just add to that is, as it relates to our growth. Whilst we have seen 8% growth this year, I would anticipate that growth slowing and our ability, given that rates have come off, our ability to write new business profitably that adds economic value over the life time value of that policy obviously declines. So I'd expect the growth to probably fall off a little bit as we go through the rest of this year and into next.

Q - James Pearce {BIO 16758460 <GO>}

Okay. Thank you very much.

A - Pat Regan {BIO 15131018 <GO>}

Thanks, James.

Operator

We will now take our next question from Blair Stewart of Merrill Lynch. Please go ahead.

Q - Blair Stewart {BIO 4191309 <GO>}

Thanks very much. Good morning, everyone. Three quick questions from me. Firstly, could you comment please on how your net flows have developed across the Life business?

Secondly, there was a big pick up in investment sales, up 70% year-on-year. Just wondered if there is any one-off special effects in there or what we should think about going forwards.

Thirdly, just on the US disposal or potential disposal. You're saying that that disposal will take you into the target economic capital range. I think you've said in the past that if you assume US equivalents, it would take you to broadly about 165% on an economic capital basis. So I'm just wondering if a disposal will take you towards your top end of your target range or otherwise. Thanks.

A - Pat Regan {BIO 15131018 <GO>}

Hello, Blair, thanks for those. I'll take them in reverse order. On the US, no. I think it's safer to assume it will get us around the economic capital range. But in the bottom end of it and not the top end of it. It's still important though getting into our economic capital range is an important step forward for us.

On the net flows, the trends are broadly similar to the ones we saw at the half year. So you see in the UK the new products if you like, demonstrating positive flows and then a run off of the old endowment style with-profit products. Some good retention in Continental Europe but lower new business sales. So a moderate, very moderate decline in Continental Europe and very much a similar trend in the Third Quarter.

I think the main thing in investment sales actually isn't so much in the UK business, it's more in Aviva Investors and again they had GBP2 billion of net funded external sales. Again that was just some new client mandates that they won.

Q - Blair Stewart {BIO 4191309 <GO>}

Okay. Thank you. Just on the US point there. Should we take it to mean that a US disposal would be less favorable than US equivalence, judging by your comments?

A - Pat Regan {BIO 15131018 <GO>}

I'm not going to be drawn too much more specifically than that. I think other than to say obviously we're at 146% today and you can assume it gets us close to the bottom end of the range, Blair.

A - John McFarlane {BIO 1509370 <GO>}

Retention of the US is less attractive than selling it.

Operator

We will now take our next question from Oliver Steel of Deutsche Bank. Please go ahead.

Q - Oliver Steel {BIO 6068696 <GO>}

Good morning, everyone. Two questions from me. The first is about the economic capital requirement. I know these things are slightly vague. But it appears to have gone from GBP11.3 billion at the interim to GBP11.8 billion as at end of October, backtracking from the ratios you've given us. So I was wondering why that was because it seems quite a big uplift.

Then the second thing is the IRRs on new business. You were achieving 14.4% I think at the half year. You're now saying 13.8% at the nine month stage. I guess I've got two questions on that. One is why has that happened. And then secondly, it slightly worries me more generally that you're seeing quite a sharp deterioration between half year and nine months in the combined ratio. You're seeing quite a sharp deterioration in the IRR. Is there anything going on here that perhaps is not just down to exceptional weather and things like that?

A - Pat Regan {BIO 15131018 <GO>}

Thank you, Oliver. On the economic capital, the biggest movements on that on both the available and the required is generally for us, credit spread movement. So as credit spreads come in, you get an increase in both your available and your required. Your net number goes up and the ratio goes up but you do see both of them move. So that would be the principal reason why the required increase from the half year.

On the IRRs I think we were 13.6%, David, at the half year.

A - David Barral {BIO 17035123 <GO>}

That's right.

A - Pat Regan {BIO 15131018 <GO>}

With each individual discrete quarter this year has gone marginally up, not seismically. But marginally up on the IRRs. So I think we're actually moderately up, nothing greatly to shout about but moderately up from where we were.

On the general insurance as I mentioned earlier, the discrete quarter combined was a little over 98%. So still okay. We were good in the UK, we're about 97% discrete for the UK. Canada had slightly higher weather in the Third Quarter versus the first half. Had a 98% discrete for the quarter and 93% year to date. A very strong result.

Candidly, where we're working a bit harder is we've got a couple of smaller businesses, in places like Turkey where we need to do more work and we need to bring some of the skills to Turkey and to a certain extent Italy, though we had Canada and the UK to bear in those markets. So UK and Canada still performing very strongly.

Q - Oliver Steel {BIO 6068696 <GO>}

Okay. Thank you.

Operator

We will now take our next question from Greig Paterson from KBW. Please go ahead.

Q - Greig Paterson

Morning, everyone, three questions. I wonder if you -- actually three and the first one has two parts. I wonder if you could just give us a feeling in terms of written business, what your new rate increases in September you had on UK motor and also what your claims inflation as a percentage was year on year in the Third Quarter.

Also you've done a lot of re-pricing of product on the Life side. I was wondering to what extent that is through the system. Ignoring the slowdown in European economic activity, I was wondering should we be penciling some further declines in volumes in the Fourth Quarter into the First Quarter next year? Or is the structural decline already in the system now?

Then just in terms of individual annuities and protection products in the UK. I was wondering do you have further plans to gain market share? I wonder if you can talk about your market share and your product development there, what your plans are. Thanks.

A - Pat Regan {BIO 15131018 <GO>}

All right. Thanks, Greig, nice to hear from you. I'll let David come in, David Barral come in on number three.

On UK motor right now, as Robin alluded to earlier, it's small declines in direct pricing on new business and pretty flat in the broker channel is what we're seeing. Claims inflation trends I think 4%-ish. So broadly similar to what we've seen before on that. But you'll remember we've talked about quite a bit before, some of the risk selection stuff we've done over the last two or three years has meant our bodily injury frequency has definitely been lower than the market. We haven't seen the upticks that others have seen on that.

To the re-pricing trend --

Q - Greig Paterson

Sorry, Pat, those are year on year, Third Quarter this year versus Third Quarter last year in terms of your (inaudible) lines and direct and flat in broker?

A - Pat Regan {BIO 15131018 <GO>}

Yes. That's right, Greig.

Q - Greig Paterson

And on a written or an earned basis?

A - Pat Regan {BIO 15131018 <GO>}

That in effect would be on a written basis.

The re-pricing ones differ a little bit country by country. The US certainly there's a little bit of a lag effect so I think you could expect to see, continue to see a downward trend in terms of volumes.

Italy is probably similar we've taken a number of actions there in terms of how we write new business and guarantee levels on new business.

In France, it partly depends on the overall market and that's probably a bigger factor there where there's been a subdued demand overall for consumer savings products. We are broadly in line with the overall market trend.

David, on individual annuities and protection.

A - David Barral {BIO 17035123 <GO>}

Yes. So if I take protection first, Greig. We've built our market share in the IFA market consistently over the last three years or so. We tend to fight it out with L&G on a month-to-month basis, who is number one in the IFA market.

Most of our growth though now is coming from strategic partnership. So you will be aware that we've been focused now on people at the Post Office, Santander we launched last year which is now coming on quite well. Barclays already in training, in fact recently just in September launching a new exclusive five year deal with Tesco Bank which is still to come through. So that's where our focus is in terms of continuing to grow that business which is very profitable for us.

In terms of annuities we had built a very strong position. We are sitting with well over 20% market share. As part of the strategic review that John and Pat talked about. We looked at that very carefully, decided that we would operate within a stricter capital budget on annuity. That's allowed us to take a number of price actions. So that's sitting -- actually (inaudible) quite well as well. So it's now sitting even more profitable than it was before. Indeed recently we've been writing up business with zero capital strain.

So that remains focused, we've got a full suite of annuity products in there. I think unrivaled in the market quite frankly. Standard, enhanced, we've got fixed term products there as well, all the way to draw down and equity release. So this is a market, part of the franchise we're absolutely owning and winning on at the moment and we continue to do that profitably going forward.

A - John McFarlane {BIO 1509370 <GO>}

I might make a comment on that annuity question, it's John. This is demonstrating the kind of tradeoffs we're having to make in the organization at the moment. Given that we prioritize capital first and then return second and then, in a sense, earnings third, the fact that annuities are capital hungry causes us a problem when our capital ratios are below our target level.

So for that reason we placed some constraint on the ability of the annuity to grow. Coincidentally the re-pricing of annuities has actually brought them to incredibly good returns. So the rational thing for us to do is actually to add more capital to the annuity book now because of the returns that we can get. But given that we've prioritized capital over return we're actually slowing it down notwithstanding that.

That shows you when you get into this circumstances, if you're capital strong, you can take advantage. And in an unlimited way of market opportunities when they arrive. But when you actually are nudging under your capital levels you actually need to make tradeoffs and this is a sort of trade off.

Now that said there would be a point at which where there would be some limit on the proportion of our book that we'd have in annuities. Now we're probably short of that but nevertheless I think there is a boundary condition at some point where you want to have a bit more diversification other than that. But it just illustrates the kind of thinking that's going on here. And in fact in other circumstances, we'd be putting our foot on the gas here. But at the present time until such time as we get our capital ratios up, we'll probably continue to walk this fine line.

Q - Greig Paterson

Sorry, does that mean since you've done the re-pricing given your new capital constraint in this line, do you think you've lost market share or flat? Just to give an idea where the market is going, whether the market is doing the same thing as you?

A - David Barral {BIO 17035123 <GO>}

We haven't seen the Q3 figures yet, we'll have it shortly. But I expect that we will have held or maybe dropped slightly. But certainly in relation.

A - John McFarlane {BIO 1509370 <GO>}

The market's come with us.

A - David Barral {BIO 17035123 <GO>}

The market has come with us quite a bit. Certainly as John's just pointed out the profitability of it has gone up. So our net position we've won out of the action we've taken.

Q - Greig Paterson

All right excellent, thank you.

A - Pat Regan {BIO 15131018 <GO>}

Thanks, Greig.

Operator

We will now take our next question from Chris Esson of Credit Suisse. Please go ahead.

Q - Chris Esson {BIO 6194371 <GO>}

Hi good morning, two questions. Firstly of the increase in economic capital during the quarter, I wondered if you could outline how much of that came from the US versus other regions.

Secondly, also on the economic capital. And MCEV, to what extent will some of these cost saves that you've achieved flow through to VIF and if or into perhaps some of the softer forms of economic capital. Has that been reflected yet? Will it be reflected and to what extent will that affect your ratios?

A - Pat Regan {BIO 15131018 <GO>}

Great, I haven't got the specific number the US to hand, Chris. It certainly did go up slightly in the quarter, something in the region of GBP100 million or GBP200 million I think is broadly the order of magnitude.

Yes. Absolutely on your second; and that was; sorry I'm finishing off the question on the US. The net obviously mainly due to narrowing credit spreads in the quarter. All things being equal, the US actually declined, order of magnitude around GBP300 million a year just because of the profile of the new business.

In terms of cost save absolutely, yes. We talked a little bit before that there's a number of levers of putting up our economic capital ratios. One of those is as you reduce your expenses it improves your MCEV embedded value and hence your economic capital ratios as well.

We're not seeing that today. We're literally taking the actions or benefits in the future on that. So over time as we get into 2013 and certainly 2014 you'll start to see that captured in the MCEV embedded value and the economic capital ratios.

Q - Chris Esson {BIO 6194371 <GO>}

Can you provide indication of what percentage of the cost save targets are likely to fall within the Life business?

A - Pat Regan {BIO 15131018 <GO>}

Not today, Chris. But we will try and give you a bit more color on that as we go forward.

Q - Chris Esson {BIO 6194371 <GO>}

Okay. Thanks.

A - Pat Regan {BIO 15131018 <GO>}

Thanks.

Operator

We will now take our next question from Nick Holmes of Nomura. Please go ahead.

Q - Nick Holmes {BIO 3387435 <GO>}

Hi there. Thank you very much. Just a couple of question. First one is on the US. I wanted to ask about the rational for the US disposal. Isn't there an argument that you're selling US Life at a cyclical low, whereas you could for example be selling Canadian P&C at a cyclical high? Basically the problem in the States is obviously low interest rates. If these rise then presumably the impact on your economic solvency will be just as good as if you sold the operation. So I wondered if you could just take us through that.

Then secondly, with your French Life business, just wondered obviously the French banks are a very big threat seeing massive outflows. Where do you see this all going in France? Thank you very much.

A - Pat Regan {BIO 15131018 <GO>}

Hi there, Nick. When we did the strategy in July there were a couple of things we said. First priority is raise economic capital and you look at the most intelligent way to do that. The second is we want to be in the right sort of businesses and the right sort of businesses are the ones with really good market conditions and either they currently produce good economic returns or they've got a realistic plan to do so.

The combination of all of that analysis led us to the view that the US wasn't the right fit in our portfolio. It just delivers an okay return on local stat capital. But as you remember was about a 3.8% return on economic capital. So a combination of that. We did not see any realistic scenarios where that would get to our target levels.

Secondly, the difference between local stats, the US view of the world and economic means you can generate a significant economic capital positive with that type of transaction.

I guess we could debate timing and whether conditions will improve in the future and whether that would flow through to valuations of US Life businesses; I have a slightly different view to you. I don't think there's a clear path where that's going to happen.

A - John McFarlane {BIO 1509370 <GO>}

I was just going to say a couple of things. We look at the businesses across the cycle. So across the cycle the US business, because it's well short of our economic -- well, it's actually destroying value on an economic basis systematically. But it actually looks reasonable on a local books basis. So for that reason you can't sell it intelligently but you can't hold it intelligently. I think that's the problem that we have here and it's making that trade off.

It doesn't diversify very well either inside. So the collateral benefits to the Group actually are negligible. So the other part of that is given that we're looking at businesses across the cycle, yes, it's absolutely true, we could sell our Polish business when the economic growth in Poland if 5%. We can sell our Canadian business now which probably is at a slightly cyclical high. So I would agree with that.

On the other hand, through the cycle this is a very attractive business for us and yes, we do not need to make that decision for capital reasons. In fact, that business diversifies very well for us and actually should Solvency II come in, it will actually be a very attractive for us in a Solvency II world.

So there are lots of reasons, not just through the cycle value but actually from other collateral benefit reasons why the Canadian business is more attractive to us than the US business.

Q - Nick Holmes {BIO 3387435 <GO>}

So could I say the bottom line is that you are taking a call on interest rates. You're assuming that US interest rates are going to remain low for a year or two and that makes the US Life business fundamentally unattractive in the medium term.

A - John McFarlane {BIO 1509370 <GO>}

Look, that may or may not be the case. We are not making a call on interest rates. We are making a call on the stress scenarios in the United States which are incredibly unattractive for us.

Q - Nick Holmes {BIO 3387435 <GO>}

Clear, thank you.

A - Pat Regan {BIO 15131018 <GO>}

We're making a call on which businesses we want to be part of.

A - John McFarlane {BIO 1509370 <GO>}

We're making a risk call here as well that adding sequentially incremental capital every year in this area will not produce value for us and will take our risk to a level that we would not regard as sensible.

Q - Nick Holmes {BIO 3387435 <GO>}

No. That's clear. Thank you. The French question.

A - Pat Regan {BIO 15131018 <GO>}

The French question, this is on the role of French banks in insurance.

Q - Nick Holmes {BIO 3387435 <GO>}

Yes, just your feel of where the market is going. Do you think the French banks are going to let up a little bit or is this going to remain? How worried are you basically?

A - Pat Regan {BIO 15131018 <GO>}

At the moment I think, the main trend we're seeing as I said earlier, is the overall reduction in demand for savings products. I think that's the predominant one. We're not expecting any great change in the tax laws which is good. So there had been some discussion of that and how the tax laws around French insurance products.

In terms of the banking part of that, we're not actually seeing any enormous change on that at the moment. So I don't think we are any more aware of that. As you know most of the French banks do in house manufacturing of insurance and again our expectation is that won't change.

A - John McFarlane {BIO 1509370 <GO>}

I might say something, that just occurred to me about the US. If we were in a rich capital position, would we sell the US? The answer is yes, we'd still sell it. So to me that's the key decision here.

Then the next question is would we be better waiting, even if we were full capital, would we be better doing that now or adding more capital and doing it later? We still believe we should do it now.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay that's very clear. Thanks very much.

A - Pat Regan {BIO 15131018 <GO>}

Thank you, Nick.

Operator

We will now take our next question from Jon Hocking of Morgan Stanley. Please go ahead.

Q - Jon Hocking {BIO 2163183 <GO>}

Morning, everybody. I've got three questions please. Firstly, just to come back on the dividend. John, I think you mentioned that 2014 is intended to be the clean year. I just wondered in terms of the dividend going forward, are we going to get a resolution of this at prelims or is there an argument for waiting and seeing how '13 turns out and what the underlying run rate is before you go forward on dividend policy. That's the first question.

Second question, in terms of the sub-cell analysis work, how far along the path are you on that. When are you likely to get to a point where you are implementing any initiatives that come out of that? That's the second question.

Then the third question is just interested in the comments in the Release and that were made at the front of the call in terms of the difficulties in getting traction for restructuring. Is that communication, is that organizational structure? What do you think the issues are there and how are you going to overcome them? Thank you.

A - John McFarlane {BIO 1509370 <GO>}

I'll deal with the first and then we'll maybe get David McMillan to maybe come in on the sub-cell analysis and then I'll come back to culture at the end.

The dividend is not under active discussion here. It's not a matter that we've raised with the Board. So we have a genuine intention of trying to hold the dividend. So it's not as if it's permanently under active consideration.

But obviously one of the things that we need to do once the 2013 and 2014 plans are sharpened up and we're still work in progress there. We just need to make sure that the cash flows up into the center and the level of cash at the center gives us prudent cover. That's all we really need to do. If we were to sell the United States then obviously the cash at the center would increase very substantially anyway now. So were that to have been today, we wouldn't even be discussing this event. It would be a non-issue.

So it's actually just making sure if we achieve what we want to in 2014, the cover is perfectly respectable I've no issues in respect of that. The cash flow should be adequate and so forth.

It's just is there some (inaudible) tightness in 2013 that we need to just make sure. Because we want to be in a position that where there's decent cover there. All other things being equal, it's not -- from a management standpoint, we've been relatively comfortable with where we are with it.

But the trouble is, there's a lot of execution assumptions built in to what we've said. And that's why we've said, look, we're genuinely trying to hold it. But you know, there are circumstances where we just would be unable to; they're not a likely scenario. But they're possible scenarios. I think that's the thing we're trying to do. We've actually managed to hold it so far. But remember, 2013 is that sweet spot where it just becomes tougher and we don't know the answer but we think we know what the answer is. I think that's where we are.

Q - Jon Hocking {BIO 2163183 <GO>}

Thank you. In the past you've highlighted you're not a big fan of the scrip. How does that fit into the decision making? Is it possible you make a decision on the scrip later or is everything going to happen?

A - John McFarlane {BIO 1509370 <GO>}

It's a tomorrow decision. The question will be when things normalize are we able to substitute a cash dividend for the script\ or not? That's the question and that's not a today question at all, that's a down the road question. Make no bones about it, the reason for the scrip when you look backwards at Aviva it's actually been necessary to bolster capital levels. So we just want to get off that basically and then make rational decisions as what's in shareholders' interests.

Now we're still in the process of building capital so we've retained the scrip. But it has no place long term in normal circumstances and it's just how intelligently can we get to normal circumstances and can we? So I think we've pushed that into the future rather than a present consideration.

Q - Jon Hocking {BIO 2163183 <GO>}

Okay so just to make sure I fully understand what you're saying. Effectively '13 could be a tight cash year. You intend to hold the dividend but it's possible you hold the dividend with the scrip policy intact and then at some point when things look better you could actually eliminate the scrip. Is that fair?

A - John McFarlane {BIO 1509370 <GO>}

That's an ideal scenario. All other things being equal. But I'm not committing to any of that but that would be a rational aim for us.

Q - Jon Hocking {BIO 2163183 <GO>}

Okay. Thank you.

A - David McMillan {BIO 17298829 <GO>}

Yes, John. Good morning, David McMillan here. Just on the sub-cells, I think we are viewing the forensic approach to the sub-cells of the business as a massive opportunity for us going into 2013. We've been taking action in 2012 right across the board.

So some of the examples we've talked about in the press release on the GI side, accident[ph], on leisure in the UK, Canada and Ireland. Agriculture in the UK, water partnerships in France. And on the life side of the business David talked earlier about bulk purchase annuities in the UK and we've also launched in Italy and across some of our other Continental European businesses a whole suite of lower guaranteed products.

So we're taking action as we speak. The intent in 2013 is to continue that and we've got comprehensive plans right across our major businesses. So on the GI side, for example, we're looking for every sub-cell, the sub makes 7% core to have a corrective action plan against it.

Q - Jon Hocking {BIO 2163183 <GO>}

Okay. Thank you.

A - John McFarlane {BIO 1509370 <GO>}

On the culture, what I was trying to allude to here is that in the businesses right at the sharp end of the customer part, you tend to get more rapid decision making and things happen reasonably quickly.

In some of the stuff that we're trying to engineer across the company, it's actually a little bit more difficult and slow. I'll give you an example, it's not -- so therefore in general it's not the sort of thing where you press the button and something happens. It's that you press the button and then you wonder what's happened. It does take a while.

There was a little cultural thing that was quite interesting where the decision was seen the first step in a new negotiation. Again so getting through a decision is actually a decision and you have to do it rather than discuss whether we should implement it or not.

So things like that. It's just little symptoms of it. A good example is the de-layering program. Firstly, if you've got over 30,000 people -- how many people have we got now? Okay, 40,000 people how many management levels is sensible for an organization like that? The answer is if you exclude the CEO and the people at the bottom of the organization, you're talking about four or five. But we have nine.

So the first question is how could you possibly build nine in the first place and think it was any way constructive or sensible? Because you kind of had one person -- two people reporting to one person and then two people reporting to one person and so forth. So you have costs in all that and also the sluggishness, the pacing of things was way slowed down in the process.

So it's difficult to understand how you could actually get to that point. You've then got the point of how do you take it out. In fact, in order to do it we've had to put in massive amounts of process in order to make sure it happens here. Because all the way down there was just negotiations and discussions as to why it didn't apply to me and so forth. So things do take time to work through the system here. But obviously that's quite a major one because once we get that down to five levels and we're there now, at least we've taken that element of sluggishness out.

There's been a bit of a quality element to that too. In that we've made sure that the best managers are retained rather than the weakest managers and so forth. So we've upgraded our management in the process.

I think David McMillan would probably admit it's been tough getting consensus on some of these programs. I don't know, David, if you want to.

A - David McMillan {BIO 17298829 <GO>}

Yes, I think we've achieved a lot this year but certainly as John says, one of the things about my role is to really up the cadence of delivery in the organization and push the pace a hell of a lot harder. That's what we are trying to do.

A - John McFarlane {BIO 1509370 <GO>}

I'm absolutely certain that going back a couple of months that David McMillan thought why did you take me out of that really good job I used to have and given me this thing to do.

A - David McMillan {BIO 17298829 <GO>}

(inaudible).

A - John McFarlane {BIO 1509370 <GO>}

But he seems to have come around and he's starting to get traction there. I'm just trying to illustrate we're making quite a big change in what is a relatively bureaucratic culture. It just takes time to get traction. But as long as you don't take no for an answer you can get there.

Q - Jon Hocking {BIO 2163183 <GO>}

Great thank you.

Operator

We will now take our next question from Paul (inaudible) of RBC. Please go ahead.

Q - Unidentified Participant

Yes, hi there, just a couple of questions please. Firstly, you talk about in the release spending over GBP800 million a year on IT costs. I was just wondering where you think you can get that number to and also whether reductions in those costs are included in the GBP400 million cost save target.

Then second question was just on auto enrolment. You've seen good growth in group personal pensions in the UK so far. But what do you see the pipeline on that. How many large schemes have you got signed up and when do you think your existing book will be starting to auto enroll?

A - John McFarlane {BIO 1509370 <GO>}

I'll just say something about IT, it's John. The program for IT is over a longer period than the GBP400 million promised. So obviously some of it is in there. You're dealing with an apple and a pear here. We've not actually put on the table yet what the savings number is. But it is significant. But remember it's a much longer program than the end of 2013. So there's bits of it in the GBP400 million number but there's a good chunk of it actually later as well.

A - David McMillan {BIO 17298829 <GO>}

Paul, just building on the point about the GBP400 million savings that we committed to. We're ahead of our plans in terms of delivering on those savings. So we go into 2013 with quite strong confidence that we are going to certainly hit that number. I think some of the opportunities that we see in our technology estate and the simplification of that just give us further confidence that that number is eminently achievable.

A - John McFarlane {BIO 1509370 <GO>}

David, do you want to talk about auto enrollment?

A - David Barral {BIO 17035123 <GO>}

Yes, Paul, on group personal pensions the pipeline remains strong. We've already auto enrolled our first scheme actually which went absolutely fine. But the bulk of auto enrollment for us won't kick in until 2014 actually because the vast majority of our book is in the small to medium size. It's only more recently been moving up into the bigger schemes.

So because of that the auto enrollment works from a legislative point of view it means we actually see the tide shifting up in 2014. But we're already started.

A - Pat Regan {BIO 15131018 <GO>}

Thanks, David.

Q - Unidentified Participant

Okay. Great. Thanks.

Operator

We will now take our next question from Andy Hughes of Exane BNP Paribas, please go ahead.

Q - Andy Hughes {BIO 15036395 <GO>}

Hi guys, I can actually start with an answer because one of the benefits of being a pensioner is I do get the funding update. So I think the funding deficit was GBP1.9 billion at the end of March on the funding basis. That sounds right.

The question I've got. And I've got three questions. The first one is on the reinvestment rate. Can you just give me the GI reinvestment rate for assets at the moment and how that's moved since the half year?

The second question is Ogden and how you are reserving for that at the moment. Is it at 2.5 and what's the sensitivity?

The third question is kind of overview strategy one. Because I think, John, you said it all basically when you said, we're sacrificing earnings for economic capital. I'm just not sure I understand why economic capital's important. From a personal perspective Solvency II comes in maybe five years' time, maybe longer. But the biggest problem the Group seems to face. And possibly the reason why it was downgraded is the fact the leverage is quite high and the IFRS earnings, if you go through all the trends that you've described in terms of net flows, are very negative.

So the danger is that you impact the leverage position by having negative net flows, poor results from the GI business and that's what causes the problem, not actually capital. That's just an intuitive point as to why the strategy is the way it is. Thank you.

A - Pat Regan {BIO 15131018 <GO>}

The reinvestment rate has not changed a lot since the half year, Andy. And it's about 2.5% on net new money.

On Ogden, we've reserved for some increase. We haven't reserved for all the potential outcomes on that. So there are some outcomes where you could perceive more than we've increased. But we have reserved for some of the potential outcomes on that.

John, income and capital.

A - John McFarlane {BIO 1509370 <GO>}

Yes. Actually I'll just take a bit of a distraction here before I answer that. I've just been thinking that one of the things that surprised me as a banker coming into an insurance company was how little focus we give to the asset side of the balance sheet. Which is why I've added the program to David McMillan's program, which is the asset side and actually having a better return on risk on the asset side.

Of course Aviva Investors strategy fits into that. So we need to up our game in both of those. But if this was a bank, we would be incredibly focused on the asset side and lots of discussions, lots of analysis, lots of Board discussions on assets. So that's been a curious entry point for me. I still believe that there is more opportunity that we haven't even scratched the surface there, on the asset side. So I think that's been interesting.

On the economic capital, Solvency II isn't relevant. That's a regulatory matter. You can't make an argument that you should produce sub-economic returns and therefore that's rational under any circumstances.

So what we're saying is that any business that produces a negative economic return and cannot be turned into one that produces a neutral deposit for returns should be eliminated. It's as simple as that. So Solvency II just happens to be consistent with that in that the assumptions underpinning Solvency II are based on economic capital. But if you just run the organization on EVAR you'd get the same answer. It's the same.

Now just thinking about the tradeoffs for the moment, I don't think you're right in that the reason the stock price was down. I think it was multi-faceted. I think the first thing was the level of risk -- here's a simple symbolic two sets of numbers.

Somewhere at the lower edges we had something like GBP3 billion of economic capital surplus at the bottom. About GBP3 billion or GBP2.9 something. And we had GBP10 billion of south European euros of sovereign debt. Again I'm not analyzing that, I'm just saying symbolically.

So you're the shareholder looking in from the outside and you've got a very uncertain and depressed market in Europe. You're sitting on GBP10 billion of that stuff and you've got GBP3 billion or less economic capital at the center. I tell you what, that just (inaudible) this company is running too much risk. And we don't have enough capital under stress scenarios to sustain it.

So I think that is the greatest impact on the stock price. The level of risk and rise in the cost of equity associated with the risk. So what we're trying to do is lower the cost of equity and build the capital resources, such that in stress circumstances the company is secure and is producing reasonable returns. So I think that to me is the dominant thought as to why capital levels need to be built.

Now when I say making tradeoffs, the better answer to that is if you think of the value of the company it's the book value, plus the present value of future excess returns. So that's the equation that you need to manage.

Now in thinking about that equation, it's perfectly obvious if we're having to write down book values, then according to market circumstances our book value is overstated. So that's the first issue that we need to deal with, given that we were in the process of putting an asset for sale and will have to write it down. That's the -- if we've written the goodwill down already. So that's the first issue that we had, which means therefore the capital levels in general -- not on an economic basis but just on a book basis, are overstated given that.

So then you say, what is that present value future excess returns. Essentially it's an area under the curve as such that you've got your future earnings rising, as time goes out then they get discounted at a higher level because of long term returns. Risk rises at square root of time.

So basically you get a shape of a curve that goes up and then up and then attenuates. At the same time the excess returns always get completed to the norm, depending on your competitive advantage. So there's a fade element in your excess returns.

You've got a growth element in your excess returns. You've got a return element and then you've got a fade element but you've also got a risk element that deflates the curve. So you get a curve that has a shape that's curved up and down. And essentially you're trying to maximize the area under that curve. That curve is essentially a function of the level of return, the risk of those returns, the fade of the returns and the growth of those returns. Therefore you are making tradeoffs all the time on that equation.

But simplistically what we've done is said, look, there's no question in our minds therefore that the biggest priority here is to make the company safe. Because that's the thing when we talk to the larger shareholders, they say it's the number one thing we want you to fix.

So what that means in order to fix that, as I said in UK annuities for example we are having to make a trade off that we are actually going to forgo pretty solid returns instead of building our capital bases. Or at least not making the capital erosion worse.

Now once we get to a level -- let's say we got to any of the -- I'm not using these numbers scientifically. But let's say we got GBP7 billion of economic capital and a lower risk balance sheet. That is a much better situation than the GBP3 billion economic capital and a risky balance sheet. Much, much safer. (multiple speakers) you can start to make tradeoffs and say, well hold on a second, let's be much more normal about the way we manage the organization. Let's invest a little bit more in future returns. Let's actually put more money into UK annuities. Let's not worry too much about the capital levels, let's actually manage the company on EVAR and/or a return. So you're looking for more earnings growth in that scenario.

So all we're really saying is that we genuinely believe and we're told quite categorically by shareholders, eliminating the level of risk and building the capital base was their number one priority.

Now we won't take that to the extent where we say we've got to be well above our target ranges and keep the tradeoffs running. Once we get to sensible levels you can start to say well let's run the place normally. That's all that's happening.

Q - Andy Hughes {BIO 15036395 <GO>}

I think what I was trying to say, John, was that even if you build your economic capital surplus up, you still can't de-lever the Group, which is the key challenge. For me the key risk is the leverage not -- (multiple speakers)

A - John McFarlane {BIO 1509370 <GO>}

You have reduced your lev -- if your debt remains constant and your economic capital has risen you have de-leveraged the group.

Q - Andy Hughes {BIO 15036395 <GO>}

Not if your earnings have fallen significantly and your fixed charge coverage is significantly lower than 6 times.

A - John McFarlane {BIO 1509370 <GO>}

From a pure leverage ratio basis, our total assets over economic capital your assets will come down somewhat, your capital levels will have gone up substantially. Remember, capital levels will have gone up 2.5 times or more in that scenario. But your assets won't have fallen by half.

A - Pat Regan {BIO 15131018 <GO>}

The other thing, Andy, as we talked about, was the third priority being the performance improvement. All about replacing the lost earnings of the disposals with new earning streams. That's what the nine programs are about. Therefore, net-net, once you've done that; and especially as we've talked about a couple of times, our plan is sequentially over time that we will pay down some debt. It's not the first priority it comes later in the sequencing. But you replace the earnings for your earning streams in 2014 are compensated. New earning streams replacing the things that are under disposal.

A - John McFarlane {BIO 1509370 <GO>}

Remember we can't pay down debt unless we raise surplus -- unless we have surplus cash. So there's a pacing to that.

The other thing is, if you're thinking about this equation we can't do much in the short run about our earnings. Because even if we cut costs it's got a one year or just under one year payback. Therefore we are actually improving the end of next year's earnings, not the current year's earnings. Now that works on a present value basis.

So the thing that we can deal with quickest is the capital because it's actually mainly to do with disposals and not putting more capital in to stop it destroying value. So that's dead easy. You're actually not sacrificing; you're not making tradeoffs here.

There are marginal tradeoffs, for example that we're slowing down in annuities business. But they're not significant. You then can say, well okay, the next thing that we can fix is return because it will take us a while because we actually have to either improve the sales or take capital away and so forth.

Then you've got the earnings growth basis, which is largely cost reduction rather than revenue growth, although hopefully there is some revenue growth and loss reduction.

So this is just a practical reality to this. It's not really making tradeoffs, it's first things first.

Q - Andy Hughes {BIO 15036395 <GO>}

Okay. Thanks very much.

A - Pat Regan {BIO 15131018 <GO>}

Thanks, Andy.

Operator

We will now take our next question from Greig Paterson of KBW. Please go ahead.

Q - Greig Paterson

I'll just be very brief. In terms of just clarification. The comments you made, there was something contradictory. Did you say the US at its current run rate is generating economic surplus capital or destroying economic surplus capital? One comment seemed to imply it was one way and the other implied the other one.

The second question is just the US debt -- sorry, the US if you sell it, do you expect that debt to go with the transaction and hence improve your debt ratios?

A - Pat Regan {BIO 15131018 <GO>}

The comments we made were a couple of things. One was, has the US economic capital profile improved in the quarter and the answer was yes. That's purely to do with public credit spreads have come in.

Second is, in just even market circumstances what would happen. You'd have a negative to the extent of around GBP300 million each year because of the negative profile of new business.

A - John McFarlane {BIO 1509370 <GO>}

Burning capital.

A - Pat Regan {BIO 15131018 <GO>}

So it uses economic capital all other things being equal.

A - John McFarlane {BIO 1509370 <GO>}

It doesn't produce an economic return on that new economic capital.

Q - Greig Paterson

Is that sterling or dollars?

A - Pat Regan {BIO 15131018 <GO>}

That's in sterling.

Q - Greig Paterson

Then if you sold you sell it with the debt?

A - Pat Regan {BIO 15131018 <GO>}

Yes. Well we obviously haven't been specific about what any transactional structure would look like. But I think it's fair to assume that what we'd like to do is sell the entire enterprise.

Q - Greig Paterson

So that will improve -- (inaudible) improve your gearing ratio.

A - Pat Regan {BIO 15131018 <GO>}

Yes in a way, it obviously depends on the method of how you calculate the gearing ratio. But yes, you would sell the entire enterprise to the equity and debt value of the business.

Q - Greig Paterson

All right. Thanks.

A - John McFarlane {BIO 1509370 <GO>}

By the way on the last question, we're actually trying to do it all. We just have to do it in sequence.

Q - Greig Paterson

We're supportive at least at KBW.

A - Pat Regan {BIO 15131018 <GO>}

Thank you, Greig. Any other questions? All right, well thank you everybody. Good dialogue, good set of questions.

Obviously we'll update with even more detail when we get to the interims and we look forward to speaking to you all then.

Operator

That will conclude today's conference call, ladies and gentlemen. Thank you for your participation. You may now disconnect.