

Q1 2015 Earnings Call

Company Participants

- Alexander Rijn Wynaendts, CEO, Chairman-Executive & Management Board
- Darryl D. Button, Chief Financial Officer
- Willem van den Berg, Head-Investor Relations

Other Participants

- Ashik Musaddi, Analyst
- David T. Andrich, Analyst
- Farooq Hanif, Analyst
- Farquhar C. Murray, Analyst
- Gordon Aitken, Analyst
- Nick Holmes, Analyst
- Steven A. Haywood, Analyst
- William H. Elderkin, Analyst
- William Hawkins, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, and welcome to the Aegon Q1 Results Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Willem van den Berg. Please go ahead, sir.

Willem van den Berg {BIO 15203834 <GO>}

Thank you. Good morning, and thank you for joining this conference call on Aegon's first quarter 2015 results. As always, we will focus on the key items to keep today's presentation short, leaving plenty of time to address your questions. We would appreciate it if you take a moment to review our disclaimer on forward-looking statements, which is at the back of this presentation.

Our CEO, Alex Wynaendts, will now provide an overview of this quarter's performance and will answer your questions together with our CFO, Darryl Button.

And with that, I'll hand it over to Alex.

Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Thank you, Willem, and good morning, everyone. Again, also, thank you for joining us today. So our results this quarter were clearly mixed with disappointing underlying earnings contrasting with very strong life sales and deposits. In this call, we would like to provide you with some more color on the key drivers behind these results, before addressing where we stand today on Solvency II.

As you can see on slide three, the biggest item impacting our underlying earnings this quarter is adverse claims experience in our U.S. business. The main element of this adverse experience is adverse mortality of \$63 million. While we usually see seasonal effects on mortality in the first quarter, this time, the seasonal effect was more severe, driven by both frequency and severity of claims.

Over the last few years, we've recaptured a number of reinsurance treaties on all the blocks of business. Our mortality results have, therefore, become more volatile, which became apparent this quarter. At the same time, in the U.S. accident and health business, we also saw adverse claims experience, amounting to \$27 million. This was a result of seasonality in our supplemental health business and higher long-term care claims.

And let me reiterate that we're clearly disappointed by these higher claims as they overshadow the very strong growth of our business as we'll cover on the next two slides.

In the first quarter, our sales grew by 32%. There were three main drivers for this growth. First, record deposits both on a gross and net basis, which I'll come back to in a moment. Second, new life sales, which were especially strong in the U.S. and in Asia. And third, higher accident and health sales supported by the U.S.

While it's clear from these numbers that our customers continue to value the products and services that we provide, these sales also contribute to the creation of long-term shareholder value. The value generated by new business this quarter was €140 million. And although this number has come down from the previous quarter, we are pleased with this result considering the very low interest rate environment in which we operate.

Let me turn to slide five, and share some more details on this quarter's record deposits. In the U.S., the production of variable annuities continues to be strong. This despite product changes to improve profitability in the low interest rate environment. Our U.S. retirement business is also performing very well, with deposits up 12% to over \$9 billion and with 80% of the quarter's growth coming from recurring deposits. This growth is the result of the success we've had in better connecting with plan participants. Through outreach programs and digital tools such as mobile apps and customized websites, we've been able to help plan participants better understand their retirement needs leading to higher recurring deposits.

If you now take a brief look beyond the Americas, in the Netherlands, we saw deposits increase to €1 billion at our unique online retail bank, Knab. Aegon Asset Management had strong third-party deposits, up 24% driven by absolute return fund in UK and Dutch

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mortgage fund. And our platform in the UK, we've had £1 billion of inflows for the first time in any quarter, driven in part by the success of our customer upgrade program.

I would also like to highlight here that the new business trend as a percentage of sales further improved this quarter, a clear evidence that we're executing on a strategy to become more capital efficient. And on that note, let's move to capital management on slide six.

Our gross financial leverage ratio is now well within our target range of 26% to 30%. The result of a significant deleveraging we've implemented over the last three years. Being within our target range, together with excess capital at the holding of €1.4 billion, creates greater financial flexibility. And furthermore, during the second quarter, we will upstream an increased interim dividend of \$700 million from our U.S. business as U.S. with \$1.5 billion of excess capital is now well over its buffer level as per capital policy.

Now turning to slide seven, let me now give you a short update in Solvency II. As you know, implementing this new capital framework is a significant undertaking for us and for the entire industry here in Europe. Many of our colleagues, at Aegon, across the various businesses are working very hard to ensure we are ready by January 1, 2016. And as the implementation date approaches, we're gaining greater insights in implementation process of Solvency II. Number of key items do, however, remain uncertain and will need to be resolved over the course of this year.

Particular, we will be submitting our internal models for regulatory approval for our Dutch and UK businesses, and we will do this before the end of the second quarter. For our U.S. business, we assume equivalence while conversion of the life insurance companies' RBC ratio is still under discussion with a Dutch regulator. Taking into account not only these uncertainties, but also the progress we've made so far, I can, today, reaffirm that we expect our group Solvency II ratio to be within the range of 150% to 200%.

One last point on Solvency II that I'd like to make here is that there has been significant attention on where group ratios in industry will land. Our view, however, is that the local ratios will be more important because it's these ratios that will ultimately drive cash flows to the holding and ultimately to our shareholders.

So in summary, while I recognize that this was a difficult quarter from an underlying earnings perspective, I'm pleased that despite the challenging low interest rate environment in which we operate, our customer focus is allowing us to grow profitably. And by taking the right steps to ensure that the company is well capitalized, we're confident that we can operate effectively on Solvency II and continue to help ever more customers secure their financial futures.

Darryl and I are now happy to take your questions.

Q&A

Operator

Thank you. We will take our first question now from David Andrich from Morgan Stanley. Please go ahead.

Q - David T. Andrich {BIO 15414075 <GO>}

Hi. Good morning. Thank you for taking my questions on my side. First of all, I was just wondering, in terms of the increase in operating free cash flow in the quarter, I'm just wondering if you could give a bit more detail on the one-off impacts coming through.

Second of all, on slide 22, I couldn't help but notice that you dropped the indication lines for target level and buffer levels of capital in the Netherlands and the UK. And I was just wondering if there was anything that we could or anything that we should read from that.

And then finally, I was just wondering if you could give any indication or affirmation whether the UK and the Netherlands are also within the 150% to 200% Solvency II range. Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Hey, David. It's Darryl. Let me hit those questions. The first one on operating free cash flow. Yeah. The onetime items was really tax-related as it related to the U.S. And actually, we did some recapture of some of our captives that we had in Bermuda. And in doing that, we were able to actually utilize net operating losses that existed down there from our variable annuity hedging program. So we were able to crystallize that and turn that into capital benefits in the U.S. And that was the bulk of the onetime items.

You're correct in noting that we did drop the kind of the target buffer lines off the Netherlands and the UK this quarter. And we did that because we really are transitioning over to Solvency II. So, what we're finding is on the local ratios that the IGD I ratios and the Pillar I ratios are really drifting into the background as not our most relevant conversation that we're having with the regulators. So we know that that's a bit of a hole. And we have to follow up, and we will follow up in January with a new capital policy that's all linked to Solvency II. So that basically represents where we are with the information gap that we have with Solvency II out there right now.

And the third question, I need a little help remembering what that was, sorry.

Q - David T. Andrich {BIO 15414075 <GO>}

Just wondering if you could give any indication of whether the Netherlands and the UK are within the 150% to 200% Solvency II range that you set it for, for the group number.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. So, we're not actually giving any guidance on the country units on this quarter. I actually hope that on Q2 that actually that would be - so August might be the right time to

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start to give you some guidance on where we are in the country units. A lot of that has to do with, there's still so many of open items on the internal model approval process.

Alex mentioned in his opening remarks, we're going to be filing that in June. And we should have a much better indication at the end of June, at least where we sit. We'll have some open regulatory approvals still in August, but I think we'll be in a much better position to tell you where the country units are coming in.

Q - David T. Andrich {BIO 15414075 <GO>}

Okay. Thank you very much.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah.

Operator

Our next question comes from Farooq Hanif from Citigroup. Please go ahead.

Q - Farooq Hanif {BIO 4780978 <GO>}

Hi, there. Thanks for taking my questions. Firstly, on the 150% to 200% range, you've reiterated that obviously stuff has changed. I mean maybe I can ask it this way. In that 150% at the bottom end of the range, are you allowing for, kind of, adverse development on all of those uncertainties that you've listed on your slide? That's question one.

Secondly, long-term care has obviously gone up as an issue in the U.S. You obviously have payers that have also had poor experience. What comfort can you give us that we're not going to see this repeat going forward, particularly given lower kind of reassurance, but also just given low yields? And the last thing is, there's kind of been a change in message, it appears to me, on the group ratio. So the last time I think we spoke, you were worried about the group ratio being the driver of dividend policy. But now, you're saying, well, actually, it's the local regulators and how they interpret Solvency II driving internal dividends. But at the hold co, what we've got is what we've got. Can you just explain why you changed that message? Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah, Farooq. It's Darryl. Actually, let me deal with the last question first. I don't think that that's a change in message at all, actually. I think I've been fairly clear in delivering the message, I think, from the beginning which is the most important part of Solvency II will be the local ratios because that will drive cash across the organization. It's true that there is group supervision underneath Solvency II, and that we will have a group ratio. And we'll have to have our dialogs with the Dutch Central Bank on exactly what that means from managing group capital position. But by far, the most important part of cash movement across the organization will be driven by the solo ratios.

Q - Farooq Hanif {BIO 4780978 <GO>}

Can I just come back to that, quickly? Yes, so, obviously the solo ratio drive cash movements in the group, but you seem to be suggesting that in terms of your overall dividend policy, is that what you're saying? Your overall dividend policy is not really going to be determined by that. Is that correct or not?

A - Darryl D. Button {BIO 7089946 <GO>}

Well, I think we have to get into that conversation. We will have some group target as part of our overall capital policy. I think that's fair to say. We have a group ratio today. We have it under our group IGD 1 ratio, which is we used in dialog with the Dutch Central Bank on capitalization across the group. It's more of an indicator on where aggregate capital sits across the group.

I think it's fair to say, if the group ratio is troubled or under pressure, it's going to be because there is underlying solo issue somewhere. So I still think it comes down to the solos. The group ratio is impacted by things like the debt in the holding and things like that. And there will be opportunity over time to further reduce senior debt and replace that with Tier 2 over time, and that will impact the capital ratio as well. So those are the kinds of things that we have to take into account when we think about a group ratio dialog.

On your first question, you asked about our range. Does the range cover sort of negative outcomes across the different threats? Yes, that's the purpose of the range. So we've tried to put out there what we think is a realistic range given the uncertainties that still remain. And we still think that that's an appropriate range, but we do think we can start tightening that in when we get into the second half of the year. And obviously, by the time we get into Q3, Q4, we'll know exactly where we're coming out.

We'll look to try to maybe tighten that down, maybe even already in August, as I mentioned before, depending on how our final outcomes in the next month or two go. But it does cover some uncertainties both within Europe, and largely related to the internal model process, if you will. And also in the U.S., as we continue our dialog, we have a working assumption of the 200% conversion rate on the RBC, but that's very much a working assumption and we're in the middle of the dialog with the Dutch Central Bank on that right now.

Second question, your middle question, I think was on long-term care. Yeah. All I can say there is, it was a bit of an unlucky quarter for us, quite frankly. We had a lot of the claims story out of the U.S. kind of all went in the wrong direction and long-term care happened to be one of those. We had some accident and health underperformance in the quarter. About half of that was long-term care, and the other half was our supplemental health business in the U.S., both experiencing negative results. I don't have anything to suggest that it isn't just a fluctuation at this point. I think on the medical supplement products, it's more of a seasonal impact and I think the long-term care is more of a fluctuation.

Q - Farooq Hanif {BIO 4780978 <GO>}

Okay. Thank you very much. Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah.

Operator

We will take our next question now from Farquhar Murray from Autonomous. Please go ahead.

Q - Farquhar C. Murray {BIO 15345435 <GO>}

Good morning, gentlemen. Just two questions, if I may, both around capital. Firstly, when Aegon originally introduced the buffering target thresholds for the S&P level, kind of the intention was to upstream anything above the buffer level. Yeah. If we look at the upstream of \$700 million in the second quarter, that would still leave you running somewhat above the buffer level. And I'm just wondering what's the rationale for that.

And then secondly, on Solvency II, where are we with regards to the discussions around the RBC conversion ratio? I think the Solvency II projection for 1/1/2016 of 150% to 200% assumes a 200% conversion factor, but always seem to be a possibility that it could be somewhat higher than that. I'm just wondering where the debate is possibly heading on that. Thanks.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. Farquhar, it's Darryl. I'll take those. Yeah. I think on the S&P, you're absolutely right. We have been running on the high end of the capital range in the U.S., and we've been capital generative in the U.S. And in fact, we are going to be upstreaming, increasing the normal half-year dividend because of that fact. So I think we are kind of living to the policy, if you will.

I think your broader question is, but why are we operating towards the higher end? I think in this interest rate environment, we feel fairly comfortable actually running towards the higher end of our stated range. I think where interest rates and volatilities are in the market would not be the right time to bring capital ratios in the U.S. to the bottom end of the range. So I think you can continue to look for us to run towards the upper end of our stated ranges, but managing within our capital policy.

On the RBC conversion, really, well, all I can say is, we're in the middle of the dialog. We have used 200%. It's what we use in our Solvency I framework. So it was the natural placeholder. We think that's actually a good number. But quite frankly, we're in the middle of the dialog with the Dutch Central Bank on that. I know the Dutch Central Bank is having some discussion with EIOPA and that there does appear to be some inconsistencies on what some of the other companies are using. So we're just going to have to sit back and wait for that dialog to play through to see if there's an attempt to try and bring some consistency to play. I actually hope by August that we'll actually have that discussion finalized, and I'll be able to tell you where we land. We've allowed for some slippage in that ratio in the range that we've given, so the base number is 200%. We've allowed for some slippage, but quite frankly, I can't say anymore than that at this point.

Q - Farquhar C. Murray {BIO 15345435 <GO>}

Okay. Thanks very much.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah.

Operator

We will take our next question now from Ashik Musaddi from JPMorgan. Please go ahead.

Q - Ashik Musaddi {BIO 15847584 <GO>}

Hi. Thank you, and good morning everyone. Just few questions. First of all on leverage, it looks like you're indicating you can re-lever the balance sheet a bit. Can you give us some indication as to how much would that mean? So for example, 1 percentage point, you mentioned is €400 million cash at the holding company. What would that mean from Solvency II number perspective? And is 30% a max number that you would look to go to? And what will be the main driver of that? Basically, is it like covering for solvency or doing M&A, et cetera? That's the first one.

Secondly, you're talking about fungibility under Solvency II. So, I guess, you mentioned it earlier as well, Darryl, but I just want some color. Is fungibility totally dependent on local ratios or there is more to that? So for example, when we need to think about fungibility from U.S., is it purely dependent on RBC, and your buffer level target or is it anything else determining that as well?

And thirdly is, what is the right number for the holding company cash flow? Because you're currently running at €1.4 billion, you're getting a good decent cash from U.S. in second quarter. And hopefully, if you can do it in line numbers for next three quarters in U.S., you'll be getting a chunky dividend again from U.S. So that means by the end of the year, we will end up at around €2.7 billion, €2.8 billion of cash at the holding company. So what are we missing on that? What sort of level are you planning to run that? Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Okay. Ashik, a number of questions there. Let me try to take those in order. Leverage ratio, yeah, we try to highlight that really, when you look at our excess capital position in the holding, you also have to bring in the fact that there's leverage capacity, and that was the purpose for putting the 1%, €400 million sensitivity out. That's the same number, really, we think under Solvency II.

And specifically to your question, yeah, 30%. I've said all along, I'm comfortable anywhere in the 26% to 30% range. So I think as long as we're inside that range, I look at it as flexibility to optimize and manage the cap structure. It's an attractive market out there right now in Tier 2 space. So it's possible that we would actually entertain tapping the Tier 2 and in terms of what exactly we would deploy that for. We would make final calls when we get into the fourth quarter when we know the final Solvency II outcome, but there's a

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number of things that we can do in terms of refinancing some of the perpetuals that we have. We have our ambition for the €400 million share buyback that we talked about before. So we have a number of things that we'd like to do with the cap structure. So tapping the Tier 2 market in these attractive terms is probably something that's on our radar screen.

You mentioned fungibility in the U.S. Really, we're just flagging it because we're still having the conversations on the equivalence issue in the U.S. It's really about RBC ratios and conversion. But there is some language in Solvency II that requires us to look through to the fungibility of that capital of whatever we include in the group ratio. And so, we have to go through the work and have the dialog with the regulator to get comfortable that whatever excess capital we do count in the group ratio from the U.S. is in fact we can demonstrate its fungible over time. So that's just a constraint that's part of the dialog and the reason we listed on the page for transparency.

The €1.4 billion you were rolling forward excess capital for the U.S., I'm certainly not going to give a forecast of excess capital for the end of the year. But the only thing I would adjust, maybe, in your thinking is, on the U.S., we're obviously looking to upsize the half-year dividend because of where we sit relative to the group policy. But I don't think I would take that and normalize that as the new sort of standard annual dividend from the U.S. I think you need to kind of get back to the operating free cash flows for the U.S., which are running around \$300 million a quarter. So I would just temper a little bit a notion of doubling the \$700 million and calling that the dividend for the year.

Q - Ashik Musaddi {BIO 15847584 <GO>}

Yeah. But, I get your point on this point, but just a bit of clarification. So, I think you mentioned you'll be trying to run at the top end of the range, which is around \$700 million. And you just mentioned \$300 million is around the normal cash flow. So you get around \$900 million in next three quarters. So that means, I mean, still even if you upstream that \$900 million, it's still a big number. I'm not saying you'll do that, but still it looks like, if you want to retain at around \$700 million capital in U.S., there is a lot of flexibility in that.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. And the only thing I would maybe add to my comments earlier on Farquhar's question is that, yes, in the low-interest rate environment, we want to be at the upper end. But the other comment I made, I think, last quarter and I'll repeat again is that as interest rates have fallen, we've had some abnormal capital benefits in the U.S., which is a little bit of the nuance in the capital ratios in the U.S. are not fully economic base. So some of our interest rate hedge programs have been kicking us some additional capital accretion. And as rates rise, I expect that to reverse itself. So since our managing expectation is for rates to rise in the U.S., we're looking more right on that in the last couple of days. But I do expect the capital to come down a little bit from that perspective as well. And I think you have to bake that in to what you're looking at.

Q - Ashik Musaddi {BIO 15847584 <GO>}

Okay. That's very clear. Thank you.

Operator

We will take our next question now from William Hawkins from KBW. Please go ahead.

Q - William Hawkins {BIO 1822411 <GO>}

Hi. Thank you very much. Can you just talk a bit more about the U.S. mortality losses, and where you have confidence that we're seeing one-off bad luck and where you don't have that confidence? So maybe a bit more detail about the contracts that are affected the type of the origin. I mean, specifically in the context the fact that you just changed a lot of mortality assumptions six months ago.

And I suppose, finally on that point, can you also talk a bit about what you're seeing gross versus net in your experience? Because again, you flagged your changes in reinsurance experience. And if your gross experience isn't changing and this is just a change in net, then, to me, that would be very clearly a trend rather than one-off. So more color on that would be helpful.

And then secondly, in the UK, it looks like you have seen, as expected, a good spike in conversion on to your platform in the first quarter after the FCA approval. Can you just comment generally, does that mean that we're now seeing conversion rates that are more in line with your expectations? And given that we're looking at about £900 million for the first quarter, how could that look in the next few quarters, because I think you have indicated that that could be lumpy this year. Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. Let me take the first one on mortality. Actually, let me deal with the second part of your question first, because I think it is part of the story. We have recaptured some reinsurance treaties over the last couple years. What that means is that we have less reinsurance coverage than we've had in the past. We have been analyzing those books that we have recaptured, and the performance this quarter on those books was poor, but not anymore poor than the rest of our books, so it was very spread across our book.

But with less reinsurance coverage, what it means is when we enter into a negative quarter like we just had in Q1, we have less dampening effect. And we saw €30 million less reinsurance recoveries than we did in the same quarter prior year, last year. So already, €30 million of our €63 million adverse results, in fact, are the result of having less reinsurance in place.

From a gross perspective, what are we seeing in terms of trends? As I said, it's fairly spread across the book. It's a combination of both frequency and severity. We certainly had an uptick in larger claims, and that definitely played a factor. We're seeing our universal life book impacted more than our term book. That does mean that it is a little more concentrated in the older ages.

And as I mentioned before, we're used to seeing a Q1 adverse impact to the seasonality, and we would normally put that at €25 million to €30 million. So at €60 million, we were

definitely larger than what we expected, but I would say closer to a two standard deviation event for us. But I absolutely expect that to come back in the next couple of quarters. So we'll basically be monitoring it very closely to make sure that there isn't a trend developing there that we weren't otherwise aware of.

Q - William Hawkins {BIO 1822411 <GO>}

So, Darryl, have you already launched the review of assumptions in the context of these figures?

A - Darryl D. Button {BIO 7089946 <GO>}

No. I think in any one quarter, one quarter of fluctuation is not enough to move an assumption. And it's a statistical business at the end of the day. It's a lot large numbers business. So it takes several quarters of data, and as I mentioned, doing the analysis to look at whether these are random fluctuations or whether there's a need to change the mean.

As I mentioned, we would put this quarter at closer to a two standard deviation event. That can happen from time-to-time. And it's not unusual when you consider the Q1 seasonality that we normally see. So when you factor in the seasonality, it would come back away from a two standard deviation event more probable. So I think it's a case where we just need to continue to watch couple more quarters of experience and make sure that a lot of this is seasonality, and we'll be watching closely to see to make sure there isn't a trend.

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Let me take your question on the UK and the upgrade of the platform. And yes, in the first quarter, we upgraded around 25,000 customers. And the assets that we upgraded with the 25,000 amounted around €500 million, which is roughly half of the increase you've seen on the platform.

What's been very positive is that the opt-out rate has been very low. As you know, this is a process for which we needed approval and support of the SGA, that's taken somewhat longer. But the upgrade was successful with the low opt-out rate, but we've also seen and that's particularly relevant is that these are customers that are also more and more consolidating assets from other places towards our platform. So the objective is to upgrade those customers where we expect that we only hold a small portion of the assets. To give you an idea, we actually believe that we probably hold on average only 15% of their pension assets. We upgrade them on our platform with the intention to attract the assets which are with other providers.

So the first batch was 20,000 to 25,000 customers, and we expect to be able to upgrade another 70,000 customers in the second quarter with assets of around £1 billion assets. And again here, we expect also to see more consolidation which is going to drive further growth, and is also offsetting the fact that the margins and the fees we're charging on the platform are lower than what they used to be charged on the older environment.

Q - William Hawkins {BIO 1822411 <GO>}

Great. So for now, that upgrade is on track with your expectations?

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

That is certainly on track with our expectations, not only from a customer point of view in numbers and assets, but also very importantly from an operational point of view. We've been able to upgrade them in a very efficient way, with, as I said, very limited opt-out, very limited manual involvement and that's exactly what we were trying to achieve with this platform.

Q - William Hawkins {BIO 1822411 <GO>}

Cool. Thank you.

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

But we still have a way to go, William.

Operator

Our next question comes from William Elderkin from Goldman Sachs. Please go ahead.

Q - William H. Elderkin {BIO 3349136 <GO>}

Thank you, and good morning, everyone. Couple of questions, please. Just back on the U.S. and the onetime effects. I mean, my understanding of your answer to the previous question was really none of the adverse movements we've seen in the first quarter should be structurally recurring in terms of the kind of earnings model guidance you provided, but could you just clarify that?

Secondly, back on the UK. I know you have very positive inflows that you just discussed. I see your press release has some quite cautious statements related to the UK as well. Can you give us a sense of what the lapse experience has been on the back book over the second quarter so far?

Secondly, has the UK business in terms of its cost structure really reached your target level or other further cost improvements that we should expect to come through?

Then thirdly, in terms of the effect of the DWP pricing cap, I guess, that comes through in on revenues in the second quarter. But I think you've also warned that the commission payments are likely to continue through the 2016. And I was wondering, I think €20 million to €25 million annual earnings impact you've given in relation to DWP still hold for this year given that you get, I guess, the revenue hit, but no offsetting commission effect? If you could just clarify that.

And then finally, completely separately, you seem to be making fairly positive noises on capital and capital generation. Is it still reasonable to expect sort of a so-called capital

return in relation to the preference share transaction, I think, beginning of last year and in this calendar year? Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Okay, William. Well, that was a lot of questions. I think we've jotted them all down here. So we're going to try and take them in order. On the mortality run rate, really not much else I can add. I really think that the Q1 was an aberration, and we saw a deeper seasonal effect than we normally see. But all I can repeat as before, it's something that we're going to watch very closely going forward to make sure that there isn't a change to the mean that we weren't otherwise anticipating, but it's not my expectation at this point.

On the UK lapse rate, on the actual specific lapse rate for the quarter, I'm going to have to have Willem follow up with you. I actually don't have that available.

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

We've seen, actually, an improvement on the corporate side while the lapse on the individual side has not been very much changed.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. Directionally, I can say it's probably a little slower than what we had been expecting and that there's a lot of activity, but not a lot of movements. I think a lot of people that are making phone calls and our call centers and our quotes are through the roof. But there isn't a lot of money in motion yet as kind of my directional. But I'll have Willem give you some statistics on that.

UK cost structure, all I can say is on that one, costs have to come down as we progress into the new platform environment. It's a transition that we're moving from the old business into the new business, and that's part of our strategic plans in terms of the forward direction of the business. And so that's something that we continue to focus on and work towards, particularly as we upgrade customers and move over into a full platform environment. And that is a lower cost, lower revenue environment, as you pointed out.

On the pricing caps, the only thing I would add there is that because a lot of customers have decided to wait until 2016 in terms of reducing the commission, some of the effect is going to drag in. It's going to leak in over time effectively. So we'll start to see some small impacts on that now, and we'll work our way up to that over the next four quarters, five quarters or so.

Share buyback.

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Yeah. As you said, Darryl, earlier, it is very clearly our intention to execute on returning capital. And obviously, we will do that once we get clarity around Solvency II. So that's been very clear.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. I think we've been consistent. That'll be a fourth quarter decision for us once we have the final clarity we need on Solvency II.

Q - William H. Elderkin {BIO 3349136 <GO>}

Great. Thank you.

A - Darryl D. Button {BIO 7089946 <GO>}

Yes.

Operator

...comes from Nick Holmes from Société Générale. Please go ahead.

Q - Nick Holmes {BIO 3387435 <GO>}

Hi, guys. Thank you very much. Just wanted to follow up. Sorry, sort of pressing you a bit further on the mortality issue. Can we infer from what you're saying that on balance, you think that the likelihood of another big mortality reserve review which would trigger another big hit this year is really pretty remote? That's the first question.

Second question is looking at your ROE target of 10% to 12%, what would you say about that at this stage of the year? What guidance would you give on that?

And then just last question, looking at variable annuities, you said that there was some product adjustments you've made in the last couple of quarters. Just wondered if you could take us through those and how they could affect sales this year. Thanks very much.

A - Darryl D. Button {BIO 7089946 <GO>}

Okay, Nick. Let's see on Q3, yeah, sorry if it sounds like I'm kind of beating a dead horse. Really, at this point, I look at Q3 as a seasonal aberration. I actually think that my expectation is the mortality results will come back already starting next quarter. I can't promise that there won't be an impact on the Q3 assumptions because that'll very much depend on how the results play out in the next couple quarters and our comfort zone, if you will, to make sure that there isn't a new trend line. So it's really based on the data that's going to continue to emerge on the books. But what I can do is repeat what I said before. Any one quarter's experience is not enough data to move a trend line. And I think that's probably the strongest statement that I can make on that.

And the terms of the 10% to 12% ROE guidance, well, we're not going to make that for this year. I think that we had been making good progress on moving towards that number. I think this first quarter now has set us back. I think if you kind of remove the first quarter, we're continuing to trend in a trajectory, if you will, to get there. But we are going to come short of the 10% to 12% for this year. I think that's clear.

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On the VA, on product...

A - Alexander Rijn Wynaendts {BIO 1821092 <GO>}

Yeah. On the product, what we have done is taken into account the fact that interest rates have come down. And as such, we've had to make some adjustments in product to reflect that and to maintain profitability. We see mostly that impact in the fourth quarter, well, actually, in the first quarter, what you see is that we've had pretty strong sales in a market that has not been growing. So, effectively, we are clearly maintaining our position in a market, variable annuities, and we want to make sure that we continue to sell our products profitably, and that's why we adjusted our sales. But fortunately, we see that more adjustments are being made in the market. And as such, we are able to maintain our position.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay. Thank you for that. Can I, sorry, just come back very quickly on the ROE target 10% to 12%. If you were to take out the one-offs, mortality, other things, would you sort of be confident that the underlying ROE will be in the region of 10%? Is that what you're sort of realistically hoping for?

A - Darryl D. Button {BIO 7089946 <GO>}

No. Nick, I think honestly if we hadn't taken this mortality impact out of this quarter, we were still going to track a little short of that 10% to 12%, and a lot of that had to do with the persisting low interest rates that we've been experiencing. We're a little delayed on getting the Canada sale executed, which was going to help that number for this year. So there's a number of items that were just providing us some headwinds to getting to that 10% to 12% on a normalized basis. So when you step back and look at the bigger picture, we were getting closer, but I think we were on trajectory to fall a little short and then, unfortunately this first quarter then sets us further back.

Q - Nick Holmes {BIO 3387435 <GO>}

Okay. Thank you very much.

Operator

Our next question now comes from Gordon Aitken from RBC. Please go ahead.

Q - Gordon Aitken {BIO 3846728 <GO>}

Thanks. Morning. Couple questions please. Firstly on Solvency II transitionals, with several UK companies said last week they would be using transitionals. So the question is, will you be applying for a transitional deduction from your technical provisions? And if so, in respect to which legal entities and if you could just talk a bit, will it limit dividends from those legal entities?

And the second question is, you said you'll upstream the \$700 million from the U.S. business. When do you expect to next pay a dividend or upstream a dividend from the

Dutch subsidiary and the UK subsidiary, please? Thanks.

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. Hi, Gordon. Let me see. On the Solvency II, no, the transitionals is not really a material part of our Solvency II story. Really in the UK, we've been managing on a Pillar II economic basis for a while anyway. So transitioning over to Solvency II is somewhat similar to the Pillar II framework. And we've also been on a fair value framework here in the Netherlands as well. So we're not really using transitionals as it relates to the biggest one being the yield curve transition. We're going right to a swap curve plus either matching adjustment or volatility adjuster. Will it limit dividends? I guess that comes in to your next question.

On the U.S., because of the size of magnitude of the U.S. business and the relevance and importance in the group, we tend to pay an interim dividend in the second quarter and then we'll true up a final dividend in the fourth quarter, and that's been our historical practice. And I see that continuing this year.

In the UK, we've not been paying a dividend for quite a while. And as I mentioned before, I expect it to be - we really need to get in to Solvency II and see at least one, if not, two years of experience under Solvency II before we can upstream a dividend out of the UK. And so that's, I would push that off till 2017 earliest.

And the Netherlands is really just a situation where we're really kind of basically waiting to assess the final Solvency II position. We did not pay a dividend last year because of the uncertainty around Solvency II. And I think, as I mentioned earlier in the call, I think August would be a good time for us to try to start to narrow in on where we think the country unit capital ranges or these ranges are coming in subject to regulatory approvals.

Q - Gordon Aitken {BIO 3846728 <GO>}

So it could be this year from the Netherlands?

A - Darryl D. Button {BIO 7089946 <GO>}

Yeah. Well, again, it very much depends on the final Solvency II outcome. Yeah.

Q - Gordon Aitken {BIO 3846728 <GO>}

Okay. Thank you.

Operator

Our next question now comes from Steven Haywood from HSBC. Please go ahead.

Q - Steven A. Haywood {BIO 15743259 <GO>}

Hi. Good morning. I see that the U.S. value of new business dropped dramatically in the first quarter this year obviously because of the low yield impact. And you've done quite a

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lot of product changes here as well. So do you think that due to these product changes, this impact will reverse throughout the rest of this year or is there more product changes that will be required or has the yield also changed again since the first quarter, and therefore the product changes need to be impacted further?

And then also, just a sort of a random question on your fair value items. Now, for once, they were kind of in line with what consensus is going for. But do you ever see the absolute size of these reducing anytime in the future?

A - Darryl D. Button {BIO 7089946 <GO>}

Hi, Steven. On the first question, I would say that in terms of product changes, yeah, the U.S. maybe came down substantially. I would say there's two products I would call out. The variable annuities which had actually I would say for the better part of the last 18 months had very wide margins particularly going back earlier last year when interest rates were higher. And so we've seen those margins come down to the point where really we got down to more of our marginal cost of capital, which shrinks the VNB from excess margin down to about zero. And that's really where we got to in the first quarter.

Now, we made a couple of product changes to try and put positive excess margin back into the product and that will produce some positive MCVNBs. And then, just in the last few days, interest rates have come back up, and of course, that will help as well. So I do think that the variable annuity margins will come back up, but the product is still very viable and growing.

The other product, I would say, is that we actually had on our universal life secondary guarantee, which is a more interest rate sensitive product actually drifted down into negative territory, negative MCVNB. So we were getting below our cost of capital. So there, the impact was more profound. So we actually had no choice but to pull the product and we did that back in February. And that, of course, will improve the MCVNBs by removing the negatives that started to come in. We are shifting our life production over into a less interest rate sensitive product in terms of IUL and some of the term business. So both of those are the product changes that will improve the VNB numbers going forward.

Your second question was on fair value. Yeah. The fair value line will continue to be volatile. I think that, by definition, we have a number of accounting mismatch items that are down in there that don't necessarily always follow the economics of the business every quarter. So we try to call those out and speak to those. In this particular quarter, I would highlight that, a good example is, we have a hedge that we hedge some of our perpetuals, which are issued on the Dutch government bond and we swap them to EURIBOR and because they're perpetuals, they go directly to equity, but the derivative that does the hedging goes through that fair value income line. It creates some volatility quarter-to-quarter, but this quarter was, I would say, extraordinary because interest rate volatilities spiked fourfold in Europe, fivefold. And so we took some P&L losses related to that.

There was a bit of an offset in the Dutch guarantee business for the same issue on the other side. So we still see lots of volatility that goes down through there, but it's something that we do monitor and we do look to see if there's a way to bring that volatility down over time.

Q - Steven A. Haywood {BIO 15743259 <GO>}

Okay. Thank you.

A - Willem van den Berg {BIO 15203834 <GO>}

Yeah. Thank you for participating in this call. I hope we've been able to answer your questions. And we still have few questions available for the press and the journalists.

Operator

As there are no further questions in the phone queue, that will conclude today's Q&A session. I would now like to turn the call back to the speakers for any additional remarks.

A - Willem van den Berg {BIO 15203834 <GO>}

Thank you very much, and have a great day. Thank you for listening into it. Bye-bye.

Operator

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

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