PHOENIX GROUP

2014 Q3 Interim Management Statement

Thursday 23 October 2014

Clive Bannister, Group Chief Executive Officer

Good morning everybody, thank you for attending today's call. I am Clive Bannister, Chief Executive of the Phoenix Group, and I welcome you to our Third Quarter Interim Management Statement call.

I am joined here today by my colleagues: Jim McConville, our Group Finance Director, Simon True, our Group Chief Actuary, and Sam Perowne, Head of Investor Relations. We will be happy to answer your questions in a few minutes, but first I would like to take you through the highlights of our Third Quarter Announcement which we released this morning.

First, cash generation. In the nine months to the 30th September, we distributed a total of £438 million of cash from the operating businesses to the holding companies, which does not include the £390 million of proceeds from the Ignis divestment.

We now expect that cash generation for the full year will be towards the top end of our target range of £500 - £550 million. And after our normal cash outflows and the debt repayments that we made in July, we still had £957 million of cash at the holding companies, as of the 30th September.

Now turning to capital. We report our Group solvency position on two bases: the IGD and the PLHL ICA. Our IGD surplus and IGD headroom, which is the excess over the IGD capital policy, have both remained stable since the half-year at £1.1 billion and £0.4 billion respectively.

And our PLHL ICA surplus and headroom also remained stable over the period since June, at £0.7 billion and £0.6 billion respectively, as of the 30th September, with the negative impact of lower yields being offset by management actions that we have undertaken in the third quarter.

And from an individual life company perspective, we report the Phoenix Life free surplus. The position was £297 million as of the 30th September, with a decline from the half-year position, principally due to the remittance of cash from the life companies and the negative impact of decreasing yields during the quarter, which were partially offset by additional management actions.

And finally, from a Solvency II perspective. We continue to work towards our Internal Model Application, but there remain a number of specific details in relation to the implementation of Solvency II, upon which we are awaiting clarity. The Group is working towards a capital position that is aligned with our PLHL ICA surplus, but this clearly remains subject to regulatory approvals.

So, to conclude, I am delighted by the progress we have made so far this year and look set to finish the year in a good financial position.

At this this point I'd like to finish, and if we may, Seb, can we move on to the Q&A session, and thank you very much.

<u>Q&A session</u>

<u>Question 1</u>

Torcail Stewart, Baillie Gifford

The Phoenix Life free surplus, now that's reduced over time from about £530 million and then to £380 million, and now it's down to £300 million. How low can this go and what is the regulatory minimum and how close to it are you now with Phoenix Life?

Clive Bannister

Torcail, thank you for your question, I'm going to hand it over to Jim.

Jim McConville, Group Finance Director

Thank you, Torcail. The free surplus represents a surplus over and above the minimum, so in theory it could go to, I guess, £1 million or lower than that. In practice, as we've said in previous calls, we always take a view on the surplus in light of the ongoing economic circumstances and so on, and therefore we would not expect it to go to the absolute minimum, and the level of the surplus can fluctuate depending on the timing of management actions and the timing of dividend payments out to the Group. So if you go back in time, you will see that it has gone lower than the current amount, and, indeed, higher, as you observed.

Torcail Stewart

And how would that compare with peers running an equivalent business, how low would they go?

Jim McConville

I think you would have to ask peers that question. I don't believe that's one for me to answer.

<u>Question 2</u>

Ming Zhu, Canaccord

Thank you, good morning. Could you give us some more clarity of the exact management actions that you actually have done in Q3 in terms of offsetting the falling yields, please?

And just a follow up on that, the yield has dropped much further since Q3, and so has the equity market, and is there any guidance you could give us around that and whether you can do more management actions, please?

And I've got another question on M&A. Is there anything you could tell us in terms of the outlook in the consolidation space, please? Thank you.

Clive Bannister

Ming, thanks for your question. I'll do M&A at the end, and Jim, you have the first two questions.

Jim McConville

Okay, thank you Ming. On management actions, one of the main ones we did in the quarter was further equity hedging, which has given us a benefit in terms of a capital release, and therefore, if you recall again from previous meetings, that we had a very substantial proportion of our equities hedged, around 80%, and that has now increased to around 90%.

We have seen, given the movement in yields, a small decrease as a result of the yield movement since September, but we have in train further management actions in due course, and so we're not concerned about that.

Clive Bannister

And, Ming, with regards to your question to M&A, we never comment specifically. We have advertised our interest in looking at opportunities; we think we are an extremely eligible counterparty in terms of going forward with a huge consolidation opportunity in the UK market. I mentioned at the first half results I thought there might be a period of hiatus with the market awaiting Solvency II, and also the outcome of the FCA legacy review, which we think will finish in June next year, and that is what I would repeat. We can see reasons why there may be transactions sooner, and we can see reasons why they may be further away. So I go back to my original phrasing, a period of hiatus whilst the market thinks about things.

Ming Zhu

Thank you. Just as you mentioned on Solvency II, could I just have a follow-up on Solvency II please? Is there a timeline you could provide us in terms of when you will get your Internal Model approved and what's outstanding please? Thank you.

Jim McConville

I think along with the rest of the industry, Ming, we are expecting our Internal Model Application to go through the process in the first half of next year, with approval expected by the half-year.

Question 3

Alan Devlin, Barclays

A couple of questions. First of all, I wondered if you could update us on the progress on potentially achieving an investment grade rating, and how important is this in doing any M&A?

And then secondly, I just want your view on given where your stock is trading at discount to embedded value, your view on doing buy backs versus M&A? If you can buy your own stock at 60-odd% of embedded value, is that not a potentially attractive use of your cash and capital?

Jim McConville

Progress on investment grade, what we said at the half year was we would spend the second half of this year preparing to engage with the agencies with a view to entering the formal process around the turn of the year/beginning of next year, and if all went well, and that is an if, we would expect to get something by the half year, and we're on track with that timetable that we set out.

In terms of its importance in M&A, the benefit to us of getting investment grade, one of the key benefits is clearly an immediate reduction in our debt financing costs, because our bank debt in particular contains a clause which allows us to realise lower interest costs the minute we get investment grade. Secondly, it clearly opens up our ability to access a wider investment pool within the debt markets, and therefore thinking of our future debt strategy it gives us more options in that regard, which in turn could play through to assisting in M&A depending on the nature of financing for any particular transaction.

Clive Bannister

Alan, with regards to your second question, thank you for drawing my attention to the discount at which we trade. No I don't think it's acceptable. Do I then answer that exam question by going to a buy back? This is a matter that the Board regularly reviews, but the current view is not. Why do we reach that conclusion and why does the Board reach that conclusion? I think there are three parts to that answer.

First of all, I want to retain the strategic flexibility that comes with having our own cash resources. In the event that there is an M&A opportunity to pursue I think that is a useful flexibility to have.

The second reason is, if I buy back my own EV I've already done quite a lot of management actions so there's less scope whereas if I spend my cash on buying somebody else's EV, then there's the opportunity to get additional management actions and add value to shareholders that way.

The third reason, which I think is the softest of the three, is I think it slightly undermines the confidence that we have in our underlying business model, that the cash flows are delivered, cash is delivered by this machine over a long-term basis. That is what we've done for the last five years and will continue to do. And there's an aspect of running out of ideas to do a buy back. As I've said, that's the softest of the three reasons. I would assert the first two reasons, but at the moment, we "never say never", but the Board is not inclined to do a buy back at this moment in time.

<u>Question 4</u>

Marcus Barnard, Oriel Securities

You said previously that you thought the FCA review on back books might cause participants for M&A to wait until there's more clarity. Do you think that's still the case, or do you think there's some more clarity emerged over the last few months that might bring forward M&A transactions as we're sort of seeing that there'll be perhaps be less of a review than we thought?

Clive Bannister

Marcus, thank you for your question. If we take a slight step back, we believe the output of this review will still be June next year, so the end of the first half of next year. That is what we've been led to understand by the FCA. Obviously that may be attenuated or may be shortened but we're working on that timeframe. We are one of a group of companies participating in this thematic review, I'd call that standard operating procedure. There are three avenues of enquiry which are being looked at, one of which is the quality of the communication which we as an industry have with our policyholders. Obviously that's enormously important, but we don't think it pertains to shareholder value.

The second is looking at a strategic way in which business is managed between open and closed life. You could call it a degree of cross-subsidisation between those two businesses. That is a factor for some players, but not for us self-evidently because all we do is run a closed life business. And the third and final area of investigation is looking at the cost to policyholders – let me put it crudely – to get their hands on their money, access to their pensions prematurely, and we said at the first half that when we've looked at our unit linked book, and it's specifically applied to the unit linked business which is about 20% of our overall book, £11bn, the average cost for our clients to exit is around 1%, which is around £200. So those are the avenues which are being investigated and reviewed. We are participating in that. We have interviews with the FCA in the first week of December.

At the heart of your question is whether I think because of the nature of the work, whether that is going to affect the environment for doing M&A. And I said that this may be one factor which puts things into abeyance or creates a hiatus. There are other reasons for saying that, at the outcome of this work more people will look at their book of businesses and decide that some will be eligible for closing in a way they might not have done beforehand. So I see reasons why the FCA review slows things down but may actually create more opportunities for the Phoenix Group. So at this moment in time I don't think that the current work being done is going to specifically accelerate the M&A opportunities.

Question 5

Oliver Steel, Deutsche Bank

I think you mentioned something about trying to get the IGD surplus up towards the PLHL ICA surplus level, because that still is your binding constraint I'm assuming, and I'm just wondering what progress you're making towards doing that?

Clive Bannister

Oliver, I'm furrowing my brow and as this is such a tricky question I'll hand it over to Jim. But just so we remind ourselves of the maths, the IGD headroom is currently £400m, and that is the biting constraint correctly, and what we're working towards in parallel is that PLHL ICA, which we believe is where Solvency II is heading, and so that's the target that we're working towards. I don't see that we were trying to do what you originally suggested, but I may have misunderstood your question. Jim?

Jim McConville

I don't recall ever having said that, and therefore I don't think to answer your question is valid in that sense. We've obviously got both pillars that we need to view against. The IGD surplus is very insensitive, as you will have seen, and ICA surplus, although relatively insensitive is less so. As Clive said, we are working towards a Solvency II position aligned with the ICA surplus, but I don't think we've ever said we'd try and get the IGD in-line with the ICA surplus.

Oliver Steel

Okay, perhaps I'll ask the question another way. When Solvency II comes in, does the IGD constraint disappear, and therefore we can look to the ICA surplus as being the real sort of free capital or excess surplus capital that you have available?

Clive Bannister

I'm going to ask Simon True, our Group Chief Actuary, to reply to that.

Simon True, Group Chief Actuary

Yes, I think that is our understanding, that the IGD constraint will fall away and that we will be looking at the Solvency II balance sheet as being the sole measure of our capital requirements. As Clive and Jim have both said, it's very much in our interests to manage that in such a way that it's consistent with our current PLHL Group ICA surplus, and which is why that is increasingly our focus for the next 14 months until Solvency II goes live.

Closing Remarks

Clive Bannister

Gentlemen and ladies, thank you very much indeed for taking the time today. As I've said, I'm delighted with the progress we've made so far this year. As we've said a few minutes ago, we think that we will be towards the top end of our target range of £500-550m and therefore finish the year in a good financial position. Thank you very much indeed for your time.