PHOENIX GROUP

Phoenix Group Holdings

2015 Full Year Results

Wednesday, 23rd March 2016

Henry Staunton, Chairman

Good morning ladies and gentlemen and welcome to our 2015 Results Presentation.

I am joined at the podium by faces familiar to most of you, Clive Bannister, our CEO, Jim McConville, our CFO, and Andy Moss, who is CEO of the Life Company.

And by way of introduction, I took over from Howard Davis last September. One of the reasons I was interested in the role was that following Solvency II, I thought that some competitors would review their business models and consolidation opportunities could arise. So I look forward to Phoenix taking advantage of that and growing its business further.

Looking to the future, Phoenix is starting from a solid base and is well placed for that future. Our resilient long-term cash flows and robust Solvency II capital position are a testament to the Group's business model. Thirdly, the achievement of an investment grade rating in 2015 confirmed the rehabilitation of the Group's balance sheet. The Group continues to demonstrate its capabilities in managing closed funds efficiently and effectively for the benefit of customers and shareholders.

As we announced today, the Board is recommending a dividend of 26.7p, in line with the 2014 final dividend and consistent with our stable and sustainable dividend policy.

I'll now pass over to Clive and the team to take you through the results in more detail.

Clive Bannister, Group Chief Executive

Thank you, Henry, and good morning to everybody.

2015 was a year of major achievements for Phoenix. First, despite economic and regulatory uncertainties, we delivered both our cash generation and our MCEV management actions targets. Second, our Solvency II Internal Model was approved by the PRA last December and we start the new Solvency II regime with a robust and resilient capital position.

And finally, as Henry has already noted, we achieved an investment grade credit rating from Fitch. This improves our access to capital markets and has facilitated a revised bank facility, lowering our cost of debt and positioning the group well for the future.

In spite of the uncertainties that faced the Group at the start of last year with regards to Solvency II, Phoenix delivered cash of £225m and is well on track for the longer term 2014-2019 cash target.

In addition, Phoenix Life continues to execute value-added management actions. £205m of additional MCEV was created through management actions in 2015 and this has meant that the Group has exceeded its £400m target one year ahead of schedule.

The introduction of Solvency II was a major focus for the Group in 2015. This culminated in the PRA approving the use of our full Internal Model in December, one of nine life companies.

The opening surplus of £1.3bn is, as we guided last year, well in excess of the existing PLHL ICA surplus and we report today a shareholder capital coverage ratio of 154%. More importantly, the surplus is resilient to market volatility; and as of 4th March 2016, the surplus remains constant at £1.3bn.

It should be stressed that the new Solvency II regime does not impact the underlying financial framework that underpins Phoenix's business model. Our stable and sustainable dividend policy is unchanged and we will continue to seek to optimise our Solvency II position through further management actions.

As signalled this time last year, the 2015 cash generation was impacted by the transition to the new Solvency II regime, with the Phoenix Life companies retaining capital during the year to ensure a successful Internal Model application process. The capital position of the life companies is now clearer, and today we have announced a cash generation target of £350m to £450m for 2016; put another way, normal service is now resumed.

In addition, we have set a new five-year cash generation target of £2bn between 2016 and 2020, aligned with the maturity of our new bank facility. Cash generation remains the key focus for the Group and we will therefore continue to seek ways to maximise the cash generation from the Group. The Group's long-term cash profile not only supports our investment grade and our dividend policy, but provides the Group with greater flexibility in growing the business through acquisitions.

I will now pass you to Jim, who will take you through our financial results in greater detail.

Jim McConville, Group Finance Officer

Thank you, Clive, and good morning everyone.

I'll take you through each of the key metrics in more detail shortly, but let me set out the summary of the key results:

Cash generation of £225m, in line with our stated target range for 2015. IFRS operating profit of £324m. MCEV of £2.5bn with a strong contribution from management actions. A robust Group capital position with a Solvency II surplus of £1.3bn and a Shareholder Capital coverage ratio of 154%. Our PLHL ICA surplus was £0.6bn and our IGD surplus was £1.5bn. This is the last time we will report these two metrics. And finally, total 2015 dividends of 53.4p per share included a recommended final dividend in respect of 2015 of 26.7p per share.

As we described last year, the 2015 cash generation was impacted by the transition to Solvency II with the life companies retaining capital during the year rather than releasing it up to the holding companies. Of the £225m of cash generation during the year, management actions accounted for £20m.

The operating expenses of the Group have reduced through continued strong cost management. The payments to the Group pension schemes have also reduced by £33m over the year, reflecting the contribution schedules agreed with the trustees.

Non-recurring costs were lower this year due to the cost of the Ignis disposal and debt restructuring incurred in 2014.

Debt interest payments increased during the period as a result of the Tier 1 bond exchange, which meant paying both the Tier 1 coupon in January and the coupon on the new subordinated bonds in December. However, we have reduced debt during the year through our repayment of £190m, which will lower interest costs in the future. This demonstrates the Group's confidence in its capital position and also helps facilitate the new revolving credit facility we announced today.

The Group's operating profit was £324m for the year, which includes £58m from management actions. The impact of management actions on IFRS profits can be lumpy and were lower than the previous year. This has impacted the headline number but it is still an excellent performance overall.

2014 included a one-off benefit from the Ignis disposal, and in 2015, there was a further positive non-recurring item from the restructure of Opal Re, the Group's captive Bermudan reinsurance company. This transaction involved recapturing the annuity liabilities and then agreeing a new reinsurance agreement with an external third party. Andy will go into further detail on this management action shortly.

We incurred £99m of finance costs, which included a £27m impact from the accrual of the coupon of the new subordinated debt issued in January. The coupon on the previous Tier I bond was accounted for within equity, and therefore would not have been included in the analysis on this slide.

And finally, after tax we generated a profit of £249m. The tax credit in 2015 derives from the settlement of a number of historic tax issues.

Now turning to look at MCEV. We set out here the material movements in MCEV over the year. For clarity, we have shown the value generated from management actions separately.

So moving from left to right: we generated post-tax operating earnings of £135m, excluding management actions, which reflects expected returns on the life company embedded value at the long-term risk-free rate, plus assumptions of real world returns.

We delivered £205m of incremental value through a number of management actions, which Andy will discuss in a moment.

Below the line, economic variances, non-recurring and other items totalled a negative £114m, primarily reflecting the differences between the short and long-term rate assumptions and the negative market movements over the year. In particular, widening credit spreads had a significant impact on MCEV in 2015.

We also had a negative impact to MCEV from certain actions we've taken to optimise the Solvency II balance sheet during 2015. These mainly resulted from the restructuring of various credit portfolios, which reduced the amount of liquidity premium within the MCEV.

The increase in market value of the Group's listed bonds during the year has reduced MCEV by £26m and re-incurred financed costs, including the Tier 1 coupon, of £91m.

Both the Group's pension schemes are in surplus under IFRS, but these surpluses are not included within the Group MCEV. Therefore, pension contributions are deducted from MCEV and the post-tax contributions of £44m made during the year are shown here.

Finally, we paid dividends of £120m during the year. And at the end of December, the Group MCEV was just over £2.5bn, representing MCEV per share of £11.15.

We will not report MCEV in future. We will continue to focus on meeting our cash generation targets and increasing future cash flows through management actions. And we will be providing further details on Solvency II in future financial reporting at an analyst session in May.

Fitch Ratings assigned investment grade ratings to both our senior and subordinated debt in August last year. The investment grade rating provides broader access to the capital markets in the future, with a wider potential investor universe the Group now has greater flexibility in future debt issuance, including the approved ability to issue regulatory compliant subordinated debt.

We have also recently renegotiated our senior debt bank facility, putting in place a £650m revolving credit facility at a reduced interest cost. This revised facility has no mandatory or target amortisation payments and offers the Group greater flexibility to make acquisitions.

In terms of the future, we continue to examine options with regards to replacing our bank debt with a longer-term financing structure. Given the progress we have made over the past two years, we are well placed to access the markets at an appropriate time.

Moving on to our regulatory capital position, this is the last time I will be reporting the Group's IGD and PLHL ICA position. The only further point I will mention is that as part of our preparation for the introduction of Solvency II, we simplified the Group's structure and this has had a positive impact on IGD over the course of the year.

This slide sets out our Solvency II position at the end of 2015, representing the results of our full internal model calculated at PLHL level. We have eligible own funds of £5.8bn with 87% of Group own funds being Tier I capital. The Group SCR is £4.5bn, giving a surplus of £1.3bn. As we have done with IGD and PLHL ICA in the past we will continue to focus on the overall surplus number and its resilience. As a closed fund business we do not need to hold additional capital to fund new business growth.

Phoenix has a number of strong with profit funds with surplus estates, together with the Group pension schemes that are in surplus, however these surpluses are excluded from the Group eligible own funds of £5.8bn. There is an additional £0.4bn of surplus in the strong with-profits funds and £0.1bn in the Group's pension schemes. Although these amounts are excluded from the Group's eligible own funds and hence the surplus of £1.3bn they are still available to absorb economic shocks. This means that the headline surplus is extremely resilient to economic stress.

We have therefore split out the strong with-profits funds on the Group pension schemes from the calculation. This is similar to the approach taken by some of our peers and provides a shareholder capital coverage ratio of 154%.

Our unsupported with-profits funds are managed on an individual basis to ensure they maintain a surplus above their capital management policies, whilst aiming to accelerate the distribution of the estate to our policyholders over time.

There remain a number of specific management actions we can take to improve our Solvency II position, including optimising our matching adjustment portfolio and further hedging of market and longevity risk. As I mentioned, we will be providing a greater level of detail on Solvency II in May.

The surplus and its resilience will remain the focus of our Group capital reporting. As you can see, the surplus is highly insensitive to market movements, with the key sensitivity being to increased longevity. This insensitivity is partly due to the additional surpluses within the with-profits funds and the Group pension schemes that I have just talked about. This is further reinforced by the risk management actions we take within each fund to allow for a smooth and stable run off.

This resilience is demonstrated by the surplus calculated as at 4th March which remained at £1.3bn. Market movements have reduced the surplus by £0.1bn over the first part of this year but this has been offset by management actions, including additional hedging of interest rate risk.

We have today set a new annual target of between £350m and £450m for 2016 and a new longer term cash generation target of £2bn between 2016 and 2020. We expect that around 25% of the £2bn target will come from management actions. In future we will report the split of management actions between those that increase Solvency II own funds and those that reduce capital requirements.

Beyond 2020 we anticipate a further £3.2bn of cash generation, demonstrating that the long-term cash flow file of the Group remains a key strength. However it is important to remember that the amounts shown here after 2020 do not include any benefit from management actions. As Andy will demonstrate shortly the key strength of the Group is to continuously find ways to add value to shareholders and policyholders, and this will continue into the future.

We have set out here an updated version of what is probably a fairly familiar slide showing the illustrative sources and uses of cash over the period to the end of 2020, based on the new £2bn cash target. We begin with our cash at the holding companies of £0.7bn as at 31st December 2015. The green bar to the right of this of £2bn represents the cash generation expected to emerge over the period, and continuing to the right, we can show the various uses of that cash over the period to 2020.

As can be seen we have assumed that the new bank facility is fully repaid by 2020 through payments made during the period. There is £0.6bn to fund an illustrative stable level of dividends at the current cost of £120m per annum over the next five years. And after these uses of cash we are left with an illustrative £0.8bn of cash at the holding companies; and this demonstrates our confidence in a stable and sustainable dividend well into the future.

Here we provide further information on cash generation expectations and the uses of that cash from 2021 onwards. We expect there to be around £3.2bn released as cash to the holding companies after 2020 as represented by the green bar. As I mentioned earlier this does not assume any further management actions. Known uses of this cash include the remaining pension scheme contributions and outstanding debt, and this leaves an estimated £3bn of cash at the holding companies available to fund interest costs, expenses and dividends. I will now pass you to Andy who will talk you through recent developments at Phoenix Life.

Andy Moss, Chief Executive Phoenix Life

Thank you, Jim, and good morning everyone. In 2015 there was an enormous amount of work carried out on the Solvency II transition, despite this we continued to enhance the Phoenix Way, our approach to delivering shareholder and policyholder value. We restructured Opal Re, the Group's captive Bermudan reinsurance company at the end of the year; this involved the recapture of £1.4bn of reinsured annuities from Opal Re and a new reinsurance agreement with an external reinsurer which covers the bulk of the recaptured liabilities. This is more efficient from a Solvency II perspective.

We also completed the fund merger of National Provident Life into Phoenix Life Assurance in the first half of this year, leaving only two remaining UK life companies; a reduction from nine life companies in 2009. Furthermore, we sold our small Irish subsidiary, SMI, which only had around 3,000 policyholders and therefore lacked the scale to operate efficiently.

The key event on the customer side was the new pensions freedoms which I will cover shortly, and we've also continued to increase the distributable estate within our with profit funds to enhance future policyholder returns. We have now increased the distributable estate by £817m over the past three years.

As Clive mentioned earlier we set ourselves a target of achieving £400m of incremental MCEV over the three year period from 2014 to 2016. I'm delighted that in 2015 we have achieved a total of £205m of incremental value, meeting the target a year early. Specific management actions achieved include the acquisition of a portfolio of equity release mortgages and further benefits from the full implementation of the MG-ALFA system. In total we'd have added £1.4bn of MCEV over the past seven years.

As can be seen in the right hand chart we also have a long track record of accelerating cash flows, on top of those that flow from the organic run off of the Group's life policies. Over the past seven years Phoenix has generated a total of £1.6bn of cash from management actions. There are further management actions planned to optimise the Group's Solvency II position and therefore help to increase the cash flow over the coming years. As Jim mentioned, we expect around 25% of the new £2bn long-term target to be generated from management actions.

One of the big challenges for closed book consolidators is to have an operating model that is scalable both upwards and downwards. This slide helps to demonstrate Phoenix's track record in this regard. The table shows that we've continued to be successful in being able to run down our cost base in line with our policy run off; this is underpinned by the variable cost nature of our outsource relationships. The policy run off can change from year to year but you can see from the cumulative position that we have consistently managed costs down faster than policies have declined. All this demonstrates cost efficiency and the development of our operating model means that it is also scalable upwards, allowing us to on-board further closed life funds in an efficient manner.

As we have discussed in the past there is a great deal of regulatory activity and we have set out here just some of the key bodies involved in the UK life industry. This activity has been particularly marked from a conduct and customer perspective, and as we have said many times before having a strong customer proposition is vital to succeed in the closed life fund consolidation market. The FCA released its report on the treatment of legacy customers earlier this month, the report for consultation has set out a number of best practice ideas which we'll be actively reviewing to see how we can further enhance our customer's experience and outcomes.

With regards to the FCA consultation on cap in exit charges our experience is that these charges are not significantly influencing our customers' behaviour. However, should a cap be introduced we would not expect the impact to be material, given around 80% of our customers have no exit charge. Assuming the cap is set at say 5% for those over 55 the impact on cash flow would be in the order of £6m.

2016 will see changes to complaint reporting for the industry which we welcome in terms of transparency for customers. We believe we are well positioned to not only deliver the new reporting, but to drive improvement in this key area. This regulatory focus will certainly continue in the future and therefore it is essential to have in place an operational model that can demonstrably add value to customers.

As I mentioned earlier, the introduction of the new pensions freedoms have been the main customer event of the year. There was a significant initial surge in customer calls in April and we have seen, along with our peers, an increase in full encashment for smaller pension pots. During 2015 we have seen 43,000 customers requesting full encashment at an average pot size of £13,000; although we have seen limited interest from our customers in alternative drawdown products.

We have taken steps to offer a full range of products to our customer base to meet either investment needs or long-term income needs, this includes an extended partnership with Just Retirement that allows customers to access options such as simplified financial advice, drawdown products and enhanced annuities.

In 2015 we wrote £485m of annuities, compared to £545m in 2014. 71% of these annuities had guaranteed rates, these policies provide attractive rates for customers and we continue to believe that our assumptions with regards to take up rates remain appropriate.

Non-guaranteed annuity values written were down slightly by 8% compared to 2014. We still see annuities being an attractive option for many and we aim to provide competitive rates to our customers, benchmarking against the top five open market providers.

We continue to ensure delivery of the promises made to customers in their products and to provide high levels of security and service. We also look for possible ways to engage with customers and help them understand their policy benefits. During 2015 we instigated new or amended mailings to around one million customers with the aim of improving engagement with our products. We've also continued our actions to prevent pensions fraud and have prevented a further £10m of potentially fraudulent transfers in 2015.

The right hand side of the slide sets out some of the key customer metrics and indicators that we track against. I'm glad to say that we have met or exceeded all of the stated targets. These take into account benchmarks that we see externally and we will continue to seek ways to improve and ensure that these levels are maintained.

I will now pass you back to Clive to wrap up.

Clive Bannister

Thank you, Andy. Today we have set a new target of between £350m and £450m for 2016 and a new longer term cash generation target of £2bn between 2016 and 2020. Beyond 2020 we anticipate a further £3.2bn of cash generation, as Jim indicated, demonstrating that the long-term cash flow profile of the Group remains a key strength. The £3.2bn shown here after 2020 does not include any benefit from future management actions. The strength of the Group is its ability to continue to find ways to add value to shareholders and policyholders alike, and this we will continue to do well into the future.

The regulatory landscape is evolving and we believe it is therefore essential to have an operational model that is specifically designed for the management of closed life funds. Phoenix is well positioned to benefit from the capital changes that are taking place in the open business models and that are impacting the industry across the UK. The actions we have taken from a financial and operational standpoint put Phoenix in a strong position to play a leading role in future consolidation, and I am certain, more certain than ever, that there is a significant opportunity for Phoenix to generate further value from mergers and acquisitions.

To end, 2015 was a busy year for the Group and our achievements have positioned us well for future growth. We will continue to focus on delivering value to customers and shareholders alike. There remain a long list of management actions to deliver, including optimising the Solvency II balance sheet and further simplification of the Group structure. Phoenix is active in industry discussions with regards to the future of our entire industry, and we expect that in the coming years there will be a number of opportunities for the Group to acquire and manage additional closed life portfolios. We look forward to the future with confidence.

That, ladies and gentlemen, brings to the end the formal part of our session. Thank you very much for your engagement. Let’s move on to questions and answers.

Q&A SESSION

Question 1

Ben Cohen, Canaccord Genuity

I have two questions on the outlook post-Solvency II. The first was, if you could give any more details about in the Solvency II world the different type of approach you might have to take with regard to management actions.

Then also that question with regards to your view of M&A. Now that you’ve worked through Solvency II, has your view as to the attractiveness of different types of books that might be out there, how has that changed in a kind of post-Solvency II environment?

Jim McConville

If I deal certainly with the first question, Ben. I think in the immediate future we will continue to work on optimising our Solvency II position. During 2015 we did quite a significant amount of work, first of all as we mentioned the recapture of the internal reinsurance agreement with our Bermudan reinsurer and replacing that with an external reinsurance deal. But we also did quite a lot of work in terms of optimising the credit position within the with-profits funds and moving from gilts to swaps and so on. So that was a lot done in 2015.

What you will see going forward into this year, there's further work to optimise our Matching Adjustment portfolio. We basically took hopefully a low risk approach to the Matching Adjustment application in 2015, and there is further work we can do to maximise the Matching Adjustment position this year, and we will continue on the journey of improving our strategic asset allocation to access some higher yielding funds. And of course hedging continues to be managed on a dynamic basis.

Henry Staunton

Just to recap, Solvency II is the prime driver of cash flows, that's why MCEV is a much less useful indicator, and as Jim has indicated we took actions during the year which were positive for Solvency II and actually therefore some of them turned to be negative for MCEV, so that's why we're dropping MCEV and focusing on Solvency II. In terms of M&A, do you want to comment on the different products?

Clive Bannister

Two parts of M&A. There's a sort of big structural environmental consequence of Solvency II, Ben, and then I think your question is more focused on does it change our appetite or push us in one direction or another? So let me deal with the micro, and we may get back to the macro question later on today.

At one of end of the spectrum you have annuities and the cost of longevity and credit, at the other end unit linked, pensions somewhere in the middle. We're agnostic. We have a great predisposition and ability to deal with with-profits, and as you know we were involved in a transaction last year which was substantially in the annuities environment. Andy said that we're proud of the £485m worth of annuities that we wrote. It's the only part of our new business, it's the only new business we do, it's vesting, so we think that annuities have a role to play going forward. They have to be properly priced. That has to be done in the context of a capital charge from Solvency II on longevity, and then also what we can get on the other side of the balance sheet in terms of a sensible asset strategy. As you know, the shareholder funds in our Group are very cautiously invested, 77% plus are in single A or above.

And on the other side, we look for acquisitions that principally give us the maximum scope to demonstrate our ability to do more management actions, either the enhancement of old MCEV, as the Chairman has correctly said, and also the acceleration and release of cash. So, I end where I began, which is we're agnostic to the underlying business, we're capable and competent and happy to take on any, but obviously pricing has to reflect the new regulatory environment and the capital charges therein.

Henry Staunton

And of course we're partly driven by what competitors decide to do. And of course it could be that they're more interested in asset management and therefore less interested in particular products, it could be closed with-profits policies or whatever. So it'll be not only what we want to do as well as to what fits in with their strategy.

<u>Question 2</u>

Ashik Musaddi, JP Morgan Cazenove

Just a couple of questions. One, can you give us some sense about your appetite for M&A in terms of what sort of size should we expect, or what sort of size are you comfortable with?

And secondly, you mention that you're not particularly prone to one sort of business be it annuities, unit linked or with profit, but is there any preference that you have? Clearly, you're open to more or less everything because your management actions have been pretty strong, but is there any preference?

Henry Staunton

Well obviously before I had over to Clive, I'd say we looked at Guardian which was a £1.5bn or so acquisition, so we'll clearly not be frightened by something of that sphere. But I think if it was below £100m or so these deals are complicated so why would we necessarily get involved in something that small? So there's a range, and below a certain amount it just wouldn't be worth the hassle.

In terms of products, I think we've partly covered it already.

Clive Bannister

Actually, I can very happily comment. We want to do deals that have three characteristics. The first is, they have to be accretive to our shareholders, that's why we get of bed, we are stewards of other people's capital. The second is, we are determined to defend the investment grade and position ourselves, because that is a very important benchmark which was achieved by Jim and his colleagues and so we're going to protect that. And then finally, the dividend is an important signal. That is what we believe is at the heart of our business model, the ability to deliver cash, benefit our policyholders and take care of shareholders. So deals that fall within those three criteria: accretive; dividend protecting; and ensuring that our investment grade rating is protected, those are the key drivers.

I go back, I'm agnostic on the business type. The type of opportunity we're seeking is one where we can demonstrate to the maximum our scope, and on average we have delivered £1bn too in the last four years of additional cash flow delivery; and I think you heard from Andy, we set ourselves a target to deliver £400m of MCEV over four years, we actually delivered £466m of incremental MCEV and we did it in three years. So if we get hold of the right asset what we've been doing to ourselves in the bringing together of five life companies in the last seven years, what we've been doing to ourselves we will do to a target if we're given the opportunity.

<u>Question 3</u>

Oliver Steel, Deutsche Bank

Three questions. The first is, you used to give us the sort of headroom over your targets for Solvency, so do you have a headroom figure for Solvency II?

Secondly, obviously what happened in 2015 is that you were forced to hold cash back in the life companies, and yet you only give a sensitivity at the totality level. Can you give us some sort of idea as to how close you are to the minimum you need to hold down in the life companies out of that Solvency regime. Because actually out of the surplus less than half of it is actually in the life companies. So any guidance you can give you that would be useful.

Third question is on the £650m revolving credit line. You say this gives you flexibility for acquisitions, but equally you say on acquisitions that you don't want to increase the debt to a level where you might see a rating deterioration. How long would you expect your debt to increase by if you were to use that £650m?

Jim McConville

Previously under the Solvency I regime, Oliver, we did disclose the headroom as they were imposed on us by the PRA and therefore we were advised to disclose that. The Boards of the Life Company and at Group level have internal capital management policies agreed, but we haven't chosen to disclose these as I think it's not normal practice that these are disclosed, but they are prudent capital management policies designed to obviously protect the position in times of stress.

In terms of your question on the new debt arrangements, let me deal with that first, and you discuss the further flexibility. What the new arrangement does, first of all it's a revolving credit facility for the full £650m, and it has no mandatory or target payments associated with it. What it does have is lighter restrictions in relation to the approvals we would need from the banks to engage in acquisitions, so there's more freedom to do acquisitions without the need for bank consent. Plus, there is also a facility attached to the deal which is – if you like the phrase – a supersized facility, to increase the amount of debt to support an acquisition up to a certain amount. So that gives us much greater flexibility in terms of thinking of our funding requirements associated with an acquisition.

But if you stand back and look at how we would approach an acquisition, one of the criteria we have always said is that on an acquisition we would expect leverage to fall, and therefore the mix of equity, debt and cash resources, and the debt structure of the acquired company, would have to be taken into account to make sure we come up with a cocktail of financing that delivers that lower leverage.

I've completely forgotten your second question, I apologise!

Clive Bannister

Solvency and life company versus the £650m.

Jim McConville

I think Andy has covered that. It's dealt with by the capital management policy within the life company.

Henry Staunton

Is there anything you'd add on the debt, Clive?

Clive Bannister

All I was going to say is Jim has been naturally modest, it's been an extraordinary journey. Five years ago when we had the two Impala, the two silos, it was a cat's cradle of covenants. I thank the key stakeholders, our banks, who have shown us enormous support on that journey. In 2011 we paid £122m of interest cost, last year if you take out the Tier 1 cost it was £71m. It's that sort of delta, and this new facility at 175bps versus two years ago at 475bps, shows the journey that the company has taken, and Jim has already referred to how it will help us when we do M&A.

Henry Staunton

I just would add that Fitch are clearly aware of our plans because they're out in the open to actually make acquisitions, so in terms of the credit ratings Jim has mentioned it wouldn't just be all for debt if we didn't do a deal with £1.5bn etc. But they're aware of our plans so it's built into their credit rating.

Oliver Steel

Can I quickly just come back to you on the debt? You say you want the debt leverage ratio to come down, are you prepared to give yourself some time to do that? If, for instance, you're expecting management actions to deliver value within, say, 12 months are you happy for the debt leverage to go up for 12 months in the knowledge that it will come down thereafter?

Jim McConville

No, I don't think we expect to see leverage increasing.

Clive Bannister

We are going to avoid any downgrades because we think an investment grade gives so much stability and additional resilience to this organisation.

<u>Question 4</u>

Andy Sinclair, Bank of America Merrill Lynch

Three questions please. Firstly, equity release mortgages, you mentioned that your bonds portfolio – I think I missed the number – but could you just let us know what size was that portfolio and did you get matching adjustment for that portfolio?

Secondly, you mentioned the impact of a 5% cap on exit penalties; I just wonder if you can give us an idea on what a lower cap would be and actually how much income you get in total from exit penalties at the moment.

And thirdly on M&A, it seems that most of the things that have been stopping M&A are now out of the way, be that the backbook review, Solvency II, investment grades weighting. What's stopping us now? Is it just competitive environments? Can you comment on that, thanks.

Jim McConville

On the equity release mortgages, Andy, we acquired a portfolio of £300m last year, and at the tail end of last year we also entered into an arrangement which increases our portfolio by £15m to £20m per month. Neither of these were included in our original matching adjustment application and will be part of our next application as we refine our Solvency II position.

Andy Moss

On the exit penalties, just to give you an idea of the range then, if that exit penalty was actually set at zero we anticipate the cost for the over-55 population would be about £22m. Obviously the exit penalties only arise for those that exit.

I think in terms of exit charges, so I think I referred to the fact that only about 80% of them have no exit charges. Of the remaining 20% the average sort of exit charge that we see is about 1%.

Clive Bannister

This is where I get the opportunity to wave my hands around. Andy, it's a very good question. I'm going to step back a bit and then dive into detail.

If I step back, let's look at the broader industry. There are three great big trends which are going to drive our industry forward, one of which is increased consumer flexibility. So A-day was an immensely big change for our industry, giving people the freedom, appropriately, entirely appropriately. So there's a consumer dynamic here.

The second is the regulatory change over the capital in our industry. We noted in January that our friends at the Prudential said that they thought that longevity risk was more expensive after Solvency II, and that drives a cost of capital which is critical against various risk types. And then finally we have the background of continued long-term interest rate declines.

Those are the three major systemic drivers which are going to force, we believe, and we wrote a thought piece with Cass Business School called the 'Meaning of Life' where we said the old vertical stack of an old insurance company was going to be severely challenged. So the old model which combines savings with some form of protection with investment we think is going to be challenged. And the industry is driving itself into two directions: there's one direction which is capital light and a savings model, which has tax advantages; and the other which is a more protection, capital-heavy business. And these are priced differently by the market – I'm looking at our investors here, they're managed differently by companies and they're certainly looked at differently by consumers who now have increasing choice.

And therefore we believe, fundamentally, that this industry is going to evolve. There will be further consolidation and that there is a completely different business model for those of us who run a closed life business: different types of actuaries; we don't worry about products; we don't write the new business; we don't have the capital strain; we look after policyholder outcomes in a different way such as accelerated estate distribution. This is a different model from our colleagues who very actively pursue an open model.

And therefore against that backdrop your question is well posed. We think future consolidation is inevitable. And your question is: well, what's holding it back? So I'm going to draw your attention to that slide which is page 33. We think there's a big market out there, it's a big swimming pool. You can choose a number between £250bn and £300bn. Those businesses are owned by three types of owners: closed life businesses, 17% in the hand of the banks, 35% in UK life companies, and then foreign insurance companies.

In the middle category we describe the vendor motivation. That slide has not changed in two years. When I first put it up I said the big hiatus and there would be a period of hiatus, was awaiting the outcome of Solvency II so that vendors were more certain about what they had for sale, and acquirers would understand the capital implications, the in-boarding and in our case harmonising on Solvency II.

And I think that Andy you are right to say that the game is changing. Those tectonic plates are moving, and we wish to be actively involved in future discussions.

What are the breaks – those are the accelerants for why change should take place – is that for the owners of these companies it's quite an interesting trade off between the dependency upon the stable cash flows from an old business versus building a new capital-like business which is more dependent upon, shall we say, asset management fees. You need a very big business in the new world compared to the business you were running in the old world. And that transition for many firms will take several years and it requires a series of actions which are not, as you can imagine, trivial when a firm shifts from being a capital-heavy protection model to something that is different. So I think that change is underway.

<u>Question 5</u>

Fulin Liang, Morgan Stanley

I have two questions please. First of all you provided the sensitivity results for the shareholder part of the surplus. I'm just wondering, do you have similar sensitivity results for the Group pension schemes?

And second question is I noticed that actually you reported negative IFRS operating profit for your unit linked business with a result of a significant drop in the assets. I'm just wondering what is causing that.

Jim McConville

The sensitivities that we have shown are based on the overall position taking into account the pension scheme surplus and with-profits funds. But if you go back to the slide that I showed where the surpluses within those funds are sufficient to be able to absorb the shocks in those funds themselves, so where they are taking into account the overall position they do have the effect of dampening down that shock because they are in a strong surplus position.

Andy Moss

On the unit linked business what we did during the year we harmonised our expense mechanism charging on unit linked business, so we moved it all to a per policy fee away from some of the business which was charged on assets under management fee. That meant in terms of IFRS reserving that we had to increase the reserves in the short term. When we look at it over the lifetimes of the policies the actual value increases slightly because overall the charges were reduced. So it's a one-off reduction in the operating profit this year which will come back over time.

Henry Staunton

Just whilst that slide is up Andy do you want to touch on anything on slide 39 that is worthwhile, in case any other questions arise over the IFRS figures?

Andy Moss

I think overall the profit is reasonably stable when you look at the margins which are being generated. So our profits are reasonably predictable on the with-profits side. The internally supported funds, again we're seeing similar sort of margins coming through.

Obviously what we do see in the operating profit line is any assumption changes coming through or any one-offs. And as Jim referred to earlier sometimes they can be a little bit lumpy.

On the annuities side we were slightly lower this year because there was a squeeze in terms of pricing and to maintain our competitive position, to ensure we were providing good value to customers and then pricing was squeezed slightly. But other than that it is a reasonably stable position.

Question 6

Eamonn Flanagan, Shore Capital

Clive, can I bring it back to your three criteria for M&A? You talked about accretive for investors. By what measure should we look in terms of your focus, in terms of accretion: is it net asset value accretion? Earnings accretion? You're dropping MCEV; is it for NAV etc?

And then the second point about the dividend, forgive my ignorance here, have you changed the focus slightly from enhancing the dividend to protecting the dividend?

Clive Bannister

Eamonn, thank you, good questions. Accretion in the old days used to be easy to show because you'd pay something for MCEV and there would be either a positive or a negative delta against where you're actually trading. We think MCEV is in the rear-view mirror, for the reasons that Jim has described, so we are not thinking about accretions in terms of MCEV. Nor would we be doing it against anything published in the NAV space, which is not a relevant criteria.

That goes to the heart of what we're focusing on, which we've always focused on, is cash flows and the ability that any acquisition will do to enhance. And enhancing in two ways: there is a volume and an extension. So there are two ways that were we doing an acquisition we'd like to be able to advertise that we had better coverage because of enhanced cash flows, and they are attenuated, they go out further years. That's why it was important for us to take that last five-year target and extend it out beyond 2019 to 2020.

That's on how we're thinking about accretion. And then the other two criteria we want to protect our investment grade rating and we want to make sure that the dividend – and then it goes into your second question about dividend.

We've always said that we want to have a stable and sustainable dividend. That is the phrase used by the Board for the last three years. We changed the dividend in 2013 when we raised it by 20% plus to its current level. And we've always thought it would be curious to do anything to our dividend other than in a situation when there's been a transactional, material change in the business, which would allow us to move from stable and sustainable. So I'm saying that we are stable and sustainable.

You used the words, 'are we protecting the dividend?' No. I'm saying that in an M&A situation it might allow us to move from being stable and sustainable, where we are today, because we have a greater confidence about future cash flows, which would give the Board the flexibility to look at our dividend policy then.

Henry Staunton

On the back of a not unreasonable current yield.

<u>Question 7</u>

Ashok Gupta, Private Investor

A couple of questions probably more for Jim. The first is on the pension scheme. You seem to be paying an awful lot of money into a pension scheme with a surplus. Is it possible to give some flavour as to your plans for managing this? For example, buying it out or whatever, if that's the intention.

Secondly, when you do your May MCEV presentation, the final piece, it would be very helpful to see some sort of reconciliation between own funds and MCEV.

Clive Bannister

Reconciliation – sorry, help me?

Ashok Gupta

Between own funds, Solvency II own funds and MCEV, just to understand how the switch over compares.

Jim McConville

The contribution schedules that you see going through accounts are based on agreements that we've reached with the trustees of the two schemes some time ago. And these are contribution schedules which allow for payments over the next few years and do reduce over time.

We're obviously just in the process of completing the next triennial valuation. We do not anticipate any major change really to those contributions as a result of that valuation.

We do however work with the trustees of the pension schemes to work with them in terms of the way they look at their risk profile and so on, and in how we can improve the efficiency of the scheme and the surplus position. And we take action with other pension exchanges and so on as appropriate. And we do from time to time look at whether wider actions, such as buying out part of the pension scheme, may be the right thing to do.

So that is not something that is currently planned, but certainly is something that we would look at from time to time.

In terms of the Investor Day we will be providing a lot more information about the Solvency II position, own funds, and going back to Eamonn's point of what replaces MCEV accretion. And I'm sure we'll be talking about MCEV and the transition into Solvency II in more detail.

Clive Bannister

I note that we inherited pension funds which needed strengthening. Both funds are now in terms of IFRS in surplus. The reduction in payment, we paid £88m last year; it's £55m, so '14, and it's a £55m contribution. And in the slide Jim showed going forward, so the monies post-2020 there's no further contribution to those pension funds. So that is something that we had to worry about and we don't worry about anymore.

Henry Staunton

But you don't want any detailed questions on IAS 19?

Clive Bannister

No. We'd be shoved in that direction terribly quickly.

<u>Question 8</u>

Kailesh Mistry, HSBC

In the report you mentioned one of your priorities in 2016 is to, I think it said something like broaden your funding sources further. Could you just elaborate on what that means? Is it getting rid of the bank facility and issuing?

Clive Bannister

Did you say getting rid of the banks? You know where you're sitting right now so I'd be very careful what you say!

Jim McConville

I think it's consistent with what we said last year, Kailesh that at the moment clearly a substantial portion of our funding is in the form of bank debt, although that is reducing. We've made very good progress in terms of restructuring that bank debt and lowering the interest cost of that bank debt, as we've described a number of times over the past few years. However we have an ambition to reduce the proportion of bank debt further, and that would involve probably the issue of capital qualifying tier 2 debt into the future.

Now, the important point is we've no immediate refinancing requirement. Our arrangements go out to 2020, so there is no pressure for us to do anything on that front in the immediate term. Clearly the debt markets are not in great shape at the present time and the cost of that debt would be quite high. But it's something we monitor on a regular basis, and as and when we saw a sensible opportunity we may well take advantage of that.

<u>Question 9</u>

Oliver Steel, Deutsche Bank

Just one more question on the back of that pension scheme question. You said that you were stripping them out of your solvency calculation. But if you're still contributing to them that seems a little odd that you can strip them out of your solvency whilst still contributing, because clearly by implication you have an economic deficit.

Jim McConville

Well, what we're not recognising in the £1.3bn surplus is the surplus in the pension schemes, because that gets taken back down to zero is the way it works.

Oliver Steel

Your 154% are you stripping out both pension schemes from that?

Jim McConville

Yes.

Oliver Steel

And what is the SCR for the two pension schemes so that we can adjust back if we want to?

Jim McConville

The adjustment is, the surplus was £0.1bn. I think one of the slides shows the adjustments that we've stripped out.

Oliver Steel

Yes. What about the SCR?

Jim McConville

I'll get you that question offline. I don't have it to hand.

Concluding comments: Henry Staunton

Thank you very much for coming and look forward to seeing you in May.