Legal and General Q1 2014 IMS Results

Wednesday 7 May 2014

Mark Gregory: Group Chief Financial Officer

Good morning everyone and thanks for joining the call. I'm joined in the room today by various members of the management team, including John Pollock, CEO of LGAS, Mark Zinkula, CEO of LGIM, Kerrigan Procter, Managing Director of Legal & General Retirement and Paul Stanworth, Managing Director of Legal & General Capital.

Once I've given an opening statement we'll take any questions that you have. Today we've announced another quarter of record results in which we delivered strong growth in cash generation as well as in sales and asset flows, once again benefiting from our responses to the underlying global macro trends of aging populations, homogenous asset markets, welfare reform, digital lifestyles and bank retrenchment.

Before I give an overview of the Q1 results I'm going to cover the recent industry developments following the budget in March and the subsequent auto enrolment default fund charge cap announcement. Whilst the timing and the precise nature of these changes was not known to us the direction of travel towards greater customer choice and fairness has been clear for some time. We positioned our strategy and our business model to benefit from these trends over the longer term and so we welcome the changes as they accelerate the evolution of the market.

We expect to replace reductions in individual annuity volumes by bulk purchase annuity business, so the total amount of annuity business we plan to write over coming years has remained unchanged, pre and post the Budget.

The total size of DB pension schemes in the UK private sector is huge, with £1.8 trillion of liabilities on a buyout basis. We therefore expect demand for BPA to increase over time. We're agnostic on the outcome of the consultation on individual transfers from DB to DC as we believe none of the five outcomes being consulted on is likely to materially affect the BPA market. We support the freedom of choice that allowing such transfers would give, as long as they're subject to appropriate customer protection and fairness safeguards. And in the event that a snippet of transfers do occur DB schemes are likely to find de-risking solutions more affordable.

For individual pension savers we plan to provide a simple drawdown facility for customers backed by a range of LGIM funds appropriate for savers approaching, at and in retirement. We refer to this as account-based drawdown, given its simplicity and similarity, to a bank account. For customers concerned about outliving their finances we're committed to providing a full range of annuities, from standard to impaired and level in payment to investment need.

On corporate pensions we welcome the government's announcement of a pension charge cap for auto enrolment default funds which will focus consumers on our value for money products. We're already operating our pricing no higher than 50 basis points, so would have supported an even lower cap than the 75 basis points announced by the Pensions Minister.

The auto enrolment charge cap, together with the higher annual ISA limits will encourage further retail and pension savings and we will benefit from our market leading workplace savings business and our ownership of the UK's largest retail savings platform in Cofunds. These developments validate our strategic positioning and we're excited about our future prospects in all of these markets.

Turning now to an overview of our business performance. In our Legal & General Retirement Division annuity premiums total £3.3bn, which is four times higher than the same quarter last year and included the largest ever UK bulk annuity contract covering £3bn of the ICI pension funds liabilities. We continue to see strong quote pipeline for bulk annuities as pension scheme Trustees and their sponsoring employers are increasingly seeing the economic environment as a more favourable one in which to transact. Our leadership in investment management and longevity means we're well positioned to capitalise on rising demand for liability driven investing, longevity insurance buy in and buy out.

We expect the individual annuity market to contract by around 50% in 2014, and by around a further half in 2015 as a result of the Budget changes.

One thing which will remain unchanged in the annuity and longevity market is our pricing discipline, we are very focused in delivering our target return on economic capital.

LGIM now manages £463bn of assets, up £13bn from the year-end, with total flows for the quarter of £3.8bn and an improved persistency of 93%, up two percentage points from Q1 2013. LGIM's international expansion continues with £2.6bn of net flows from international clients and LGIM's bolt on acquisition of US based Global Index Advisers announced in February is on track to complete this month and will provide LGIM with scale and distribution in the $6 trillion US defined contribution market.

In addition we continue to build our international presence outside the US, particularly in the Gulf, Europe and Asia.

In LGAS our market leading UK retail protection business delivered new sales at £42m, 56% up on the prior year and a new record for quarter one business. The total amount of retail protection premiums we receive over a 12 month period now exceeds £1bn.

Our savings business have net flows of £1.6bn boosted by the addition of Cofunds net flows and the continued success of our workplace savings platform which now has £9.1bn of assets under administration.

Legal & General America delivered another strong quarter of growth with 12% increase in sales up to $38m. We accelerated the rate of progress in Legal & General Capital where Paul Stanworth and his team completed £1bn of new direct investments in the quarter. We make direct investments to deliver a risk-adjusted yield enhancement which in turn supports a wider group such as the £3m ICI Bulk Purchase Annuity deal and to enhance the return on our shareholder funds.

Those were the trading highlights for the quarter. In addition our net cash generation was up 21% on last year at £301m with operational cash growing 6% year on year and a small positive new business cash surplus driven by the volumes of annuities and retail protection business we wrote in the quarter.

Looking ahead, we're confident that our diversified portfolio businesses mean that we're well placed to take advantage of the opportunities that are arising from our five identified macro growth trends and that recent industry announcements will accelerate these trends. We look forward to continuing to deliver value to our customers and for our shareholders.

I'll now open up the call to questions.

Question and Answer Session

<u>Question 1</u>

Andrew Sinclair – Bank of America Merrill Lynch

Morning all. I've got three questions please. Firstly on the pipeline for bulk annuities and longevity insurance transactions can you just tell us how much visibility do you have on future deals and whether you're seeing any increased competition in these markets?

Secondly, I think Cofunds has historically been overweight ISAs relative to the other major platforms. Given the increases in the ISA allowances and other changes in the Budget can you tell us how much this changes the prospects for Cofunds?

And thirdly, could you tell us your thoughts at this early stage on how the transition from accumulation to decumulation is likely to work in the new retirement landscape, and what role you think the free guidance process will play in this? Thanks.

Mark Gregory

Thanks for that, Andy. So Kerrigan, if you take the one on bulk and longevity pipeline visibility, John can do the co-fund one and I'll say a few words on the whole guidance process and how that might play out.

Kerrigan Procter

Just on the bulk annuity pipeline you talked about visibility and in terms of timeframe for that it's probably between three months for the smaller deals to nine months for the larger deals, so things are in the pipeline in terms of larger deals, we get an idea of what's coming through the market probably over the next nine months or so and that obviously shapes our thinking.

In terms of increased competition in the market, your question about that, the answer is no really we haven't seen that yet. I think we talked about this earlier in the year that really our area of focus was most probably at the larger end of that market and that, as we mentioned several times before, the skill sets required to be successful in that market, let's say hard won, it's quite a barrier to entry for other people to enter that part of the market, so certainly no signs of increased competition in there, so it still looks a favourable market for us.

John Pollock

Hi Andrew. Yes, I'm fairly optimistic about the prospects, and it's not just driven by the NISA, although it is much nicer I have to say. I think a number of things that have happened in the market are actually pro savings, we've seen quite a strong government trend towards encouraging savings and I think that's clearly going to continue and clearly what that means for us with the Cofunds capability backing a lot of our savings businesses going forward I'm quite optimistic. You'll see it more in the close for savings rather than purely in Cofunds which remains the branded IFA fund supermarket but utilising that capability in a broader sphere means I'm pretty optimistic about on-platform savings growth.

Mark Gregory

Okay, just picking up the last general question on kind of accumulation and decumulation, Andy, I guess on accumulation building on what John said there I think we do take the view now sitting with the liberalisation of annuitisation etc. we do think that DC based pension savings will become more attractive going forward so we do expect there to be a further stimulus to the accumulation side, aside from just the ISA in the increases.

In terms of the whole kind of guidance I mean clearly the Chancellor announced at the Budget that there is going to be this guidance for every person at retirement and we're quite engaged in that whole process, clearly there's a lot of people speculating what it might look like and no one knows for sure, and in house view is that we do want it to be a genuinely impartial independent body that gives that guidance, not a product provider and hence we think people like the Money Advice Service or The Pensions Advisory Service, TPAS, are the very best placed to give that, and indeed we are actually working on an active live trial with TPAS as we speak to think about how that might work in practice. Clearly it's a lot of work to do, and clearly it's not going to come in till this time next year, but nevertheless we are very keen to make sure that works for consumers in the UK and make sure they make the right decision for what will be a critical decision for them.

<u>Question 2</u>

Farooq Hanif – CitiGroup

Firstly I just wanted to ask about your predictions for the individual annuity market, it still seems a little bit optimistic to me given the changes and I was wondering whether, I mean obviously Q1 was not a fully developed quarter, you've had some cancellations and you've had the breathing period but could you tell us what are your experiences in Q2 so far and whether that's kind of playing out, you know, the 50% drop in individual annuity volumes? So that's question one.

Question two is you talk about kind of thinking about the savings business as a savings business and in a way going forward kind of separating in our minds the workplace and Cofunds, and also what you're implying is that you're going to use the architecture of Cofunds to back the whole business going forward, and I was wondering, when will we start to see more concrete steps? Will it be a big cost to do that and do you think the margin benefits are going to be attractive? Thanks very much.

Mark Gregory

Thanks Farooq. Well, I think Kerrigan for the first one again, and John for the second one again.

Kerrigan Procter

Hi Farooq. Just on the individual annuity predictions, so far the experience has been almost exactly in line with what we expected so we talked about 50% volumes, that's what we're seeing post Budget, so that seems in line, gives us some confidence that we're assessing the market appropriately. We still do expect let's say a further 50% fall by the end of 2015, as full changes work through post April 2015.

Certainly surveys we've seen back that up and I think one of the important points that we get is that when we talk to individuals and when we talk to IFAs who talk to individuals that they are still really concerned about outliving their finances and really concerned about meeting their bills, so it's the culture of annuity buying and the whole process through which people buy annuities is well embedded in this country, that may be less true in the US and Australia. So we are confident in those figures.

I think the other point I'd bring out is that even though we're talking about a lower percentage take-up rate of annuities, be reminded please the growth in the DC market, we talk about £250bn growing to £3 trillion in 2030, so it's a very important market in terms of overall savings. And John just said, as I'm sure we all agree around the table, that there will be even more flows into those savings, given the changes; and a lower take-up rate on a much bigger figure – obviously there's a pretty supportive market in the long term for individual annuities.

John Pollock

That's a great question Farooq. I absolutely see Cofunds at the core of the savings business architecture. And we already to some extent utilise that through our IPS capability, which we deploy in our banks and building societies. So, as we see a transition towards higher customer-centricity away from sort of product administration, so I expect the Cofunds' capability to be sitting behind it. And what that really means is the investment for Cofunds is more BAU investment as we change our focus on investing in our IT platforms for the product administration, so we will be transferring that to the Cofunds and the broader architecture of a savings business.

At this stage I don't really see it playing a huge part in the workplace savings business; that remains focused on corporate customers rather than retail customers. But who knows; in the fullness of time it may have some part to play.

So, no fundamental step change in the investment profile on IT.

<u>Question 3</u>

Gordon Aitken – Royal Bank of Canada

Three questions please on the bulk market: First on margins: what happens to margins on individuals and bulks going forward? You've always said in the past that margins are the same on both; do you think that continues?

Second question on competition: You've got people like some of the consultants like Towers Watson saying it's expecting new entrants into the bulk market. You say in your release today that bulks are very different from the individual market, requiring a strong and sustained track record. How do you square that with the fact that in 2013 the two biggest writers of bulks were Pensions Insurance Corporation and Royalty Life, both relatively new entrants into this market, and I think you were number three? So that's the second question.

And the third on bulks: You didn't tell us exactly what you wrote ex the ICI scheme in the first quarter. It seemed to be quite a bit down on last year. Was that because you chose not to write bulks because you knew the ICI deal was obviously coming, or because just fewer schemes were brokered around the market?

Kerrigan Proctor

First question on margins, you talked about individuals and bulk being the same. We talk about similar. It varies from year to year depending on the precise nature of the market: sometimes higher, sometimes lower; no consistent pattern over those over the past few years. Yes, we still that as true going forward. Probably the emphasis I wanted to make is when we talk about margins for individual annuities we're really talking about margins for external market. Now, we price the same external and internal, others may have a different experience depending on their internal pricing but given the external competition that we're always facing on the individual annuity market we see the balance between bulk and individual swinging backwards and forwards, but not being substantially different over time.

Talk about competition and what's different in that market. I think one of the significant differences between the bulk market and the individual market is the individual market was substantially bought on price; and in the bulk market the Trustees' first duty is for security for the accrued benefits of pensioners. I'm not suggesting that the pricing isn't a significant consideration but it is a slightly different dynamic in that market. So, it is true that people think about, particularly when you look at buyout, they look at name, track record on the market, credibility, credit worthiness, capital, and they really do consider those things. I think it's a fair point that there are three main people participating in that market currently, perhaps four. But we really don't see that significantly changing, particularly at the larger end of the market. There could be a bit of disruption at the small end of the market temporarily.

And then on the ICI deal in terms of volumes written in Q1: Yes, you're correct in that we wrote a limited amount of bulk business beyond the ICI deal. That really was predominantly a matter of pricing discipline. The ICI deal was attractive to us, attractive for the client and so that's what we really focused on for the quarter.

Question 4

Greig Paterson – KBW

I'm interested in – I don't know how would one think about it – but the new business strain on your individual annuities versus the bulk annuities. And also within the individual annuities it appears to me you say pricing is similar on the individual versus the bulk in terms of the open market, but your internal investing stuff must have a higher margin, and that is probably the stuff you're going to lose. So I wonder if you could speak about new business strain bulks versus individual open market versus individual internally? That's what I'm most interested in.

Kerrigan Proctor

You'll see this on some of the press commentary, I'm sure, Greig. On new business strain, on new business surplus, we talk a lot about the investment strategy and our direct investments supporting that new business strain or new business surplus, and while we'll continue to be able to secure those investments, it's a positive environment for that strain. And because we run our overall annuity book backed by one investment strategy co-mingled effectively, then I wouldn't particularly distinguish the potential for strain or surplus between individual and bulk. That's not really the way we consider and look at that internally.

Then moving on to your point about within individual annuities – I'll come back to the margins point on it – but actually we've talked before about more like a 75/25 split external to internal. Actually we've seen that shift slightly towards internal; not a big shift and early days to work out if there's a pattern, but actually a slight shift towards internal. So, probably contrary to what you may have been thinking. I think the point was about margins there.

Greig Paterson

On the bulks you're not answering my question. I want to know, you wrote a big bulk and the strain was lower than before, so clearly this bulk had a different profile to the other bulk in terms of strain. If there's going to be a secular shift from individual to bulks what is the difference? Could you tell us in the first quarter what the individual strain number was versus the bulk strain? It's clearly a material factor.

Mark Gregory

We don't disclose that, Greig so it's your assumption that the strain was better or worse than it had been in prior quarters. Clearly we haven't disclosed that; we've only given the total net new business surplus in the first quarter of this year. Again, back to Kerrigan's point, overall we write this business primarily on a kind of a co-mingled basis so you shouldn't see it as being a different kind of financial characteristic comparing individual to bulks.

Greig Paterson

It's jumping around like a yoyo your new business strain and those are the key factors, the mix between individual and bulks, and you don't feel that's material.

Mark Gregory

As I say we haven't actually given the breakdown and even the surplus. Clearly at the half-year we will give more detail.

Grieg Paterson

Can I recommend that in the half-year you separate the two so we can improve our forecasting? Thanks.

Question 5

Farhad Changazi – Nomura

Let me just follow on Greig's question then on new business surplus. In 2012 there was an even mix of individual premiums versus bulk; and in 2013 there was more shift towards bulks and new business surplus increased, well it actually doubled. Is there something underlying in terms of 2012 to 2013 we should be aware of? Or can we extrapolate that bulks do give you better new business surplus?

I appreciate you're seeing the experience of 50% drop in annuities sales, that's probably I suspect from here on, but in terms of the grand bigger picture we see the 75% drop in 2015 for the market versus 2013. Where do you see your individual annuities sales going in that respect, all else equal?

And notwithstanding that, if you had to choose would you rather deploy capital in bulks versus individual annuities?

And just finally, could you also provide some insight into the potential new products, income drawdown products you mentioned, which are a proportion potentially of guaranteed income as well?

Mark Gregory

Just on the point around new business surplus being higher in 2013 on annuities compared to 2012: fundamentally that's a volume point. We wrote a lot more business in 2013 than we did in 2012. So, our total premiums last year were £4.1bn; whereas in 2012 they were £2.3bn.

So, the primary reason the surplus was higher in 2013 was purely because we wrote more business. Again, it's not about the mix between bulk and individual fundamentally; it's actually about fundamentally writing more annuity business on the right terms, keeping our pricing discipline that we achieved.

That's why we achieved a better surplus last year than in 2012.

Kerrigan Proctor

Just on the second point on the drop in annuity volumes in the market that we predicted and others predicted. And then how well our sales look in individual, and at that time would we rather deploy capital in bulks. Addressing that last point first, would we rather deploy our capital in bulks? I think we talked about our unique strength, which is we can choose at any time what's the most attractive market to deploy our capital in or deploy our risk appetite in, I should say. And if at the time, as is now, we emphasise bulks then we will continue to write more in bulks.

We do still plan to remain a significant participant in the individual annuity market. And as I was pointing out, there is a reduction in sales. But in the longer term, of course, the bigger volumes going into that market with a lower percentage take-up rate still makes it an attractive market. And it particularly makes it an attractive market for those people with digital capacity, which we have, and pricing capability.

And I would make the last point in particular: as it shifts from an age 65 purchase to an age 75 purchase in the annuity market, as we expect, then those with significant experience on mortality, particularly at older ages, which of course we have given our 27 years' experience in the market, will really benefit from having the pricing capability in that market. So, we would expect ourselves to have an ongoing competitive strength in that market and to write our fair share, subject of course, as ever, to the catch phrase pricing discipline.

Then there were the income drawdown products. I'll say a few words about that. I think simplicity is the key here. And we think about people as they approach retirement accumulating their funds, accumulating ever more funds and really the point to think about is what will people's behaviour be? And we expect people will initially want to draw out their tax-free cash from an appropriate fund and then pursue a simple withdrawal of units per month, or more flexibly. And that feels to us a little bit like a bank account, populated by appropriate LGIM funds units, of course, but a little bit like a bank account and we should really help facilitate people drawing income flexibly, possibly with some system to manage their income tax bill.

Farhad Changazi - Nomura

Could you perhaps give some insight into what you're hearing from financial advisors and so on and whether they are onboard with the product development in terms of what you have in the pipeline and so on?

Kerrigan Procter

They're on board with the product developments. It was something that we discuss a lot. There's a lot of discussion in the market particularly around how the guidance and then the advice regime will shape what people do, and certainly they're onboard with the idea that people will accumulate, then start drawing down some, and then possibly later in life than currently start getting concerned about outliving their finances, and at that point look to pursue some kind of guaranteed income for life. That pattern I think is reasonably well agreed amongst advisers and other firms in the industry, I believe. Simplicity's got to be the key here though.

<u>Question 6</u>

Marcus Barnard - Oriel Securities

Mark, in your statement I think you said you thought the bulk purchase annuity market would be bigger. First of all, can I ask why you think that, have you got any evidence to back that up, because I can't see any reason why it would be bigger than it was previously?

And secondly, you said you were going to get more of it and this would make up for the shortfall in individual annuities. Are you serious here? You wrote £1.3bn last year, £1.3bn the year before, £3bn-odd of bulks last year, £1bn-odd of bulks for the year before. Are you really thinking you can make up for the shortfall of £1.3bn of individual annuities by writing more bulks and if so how do you think you're going to do that, are you going to cut prices? How are you going to make up that shortfall?

And finally, bulk purchase annuities tend to be a bit more volatile. I think if I remember back to 2008/09/10, there was so little business around that most of your competition went out of business, in fact I think you ended up buying one of them. So does that mean your trading results are going to be much more volatile going forward because you're dependent on a line of business that's much more volatile?

Mark Gregory

I think I'll give Kerrigan a break and I'll answer them. In terms of why the bulk market is growing, again I probably alluded to it in my speech, I think there's two big macro forces at play here. First and foremost most corporate CFOs don't much like having a DB pension scheme liability on their balance sheet and it does tend to wobble around a bit and occasionally needs extra contributions to go in etc. Most CFOs would rather talk about the trading of their business rather than the legacy issue of their defined benefit pension scheme. And clearly the adoption of IAS19, the pension scheme accounting standard, has forced corporates to face into this issue, it's no longer a kind of off balance sheet event. So that's been a trend that's been around for a while.

Again, in terms of a macro environment asset market, clearly the combination of decently high equity markets, because typically the schemes when they're not in any sort of buyout or buy-in phase have a higher equity participation than they would have when they move to a buyout effectively, and that's a good place to be in terms of the underlying asset transition costs, again it makes the headline for cost of transition to a buyout arrangement rather less expensive. So we do think there's a growing trend. Broadly DB schemes are now matured, there's a few open schemes in the UK but most have closed, and therefore I think that as an inevitable trend more and more of these arrangements will de-risk into some of sort of buyout arrangement going forwards.

Marcus Barnard

But there's nothing else that's changed that makes you think the DB market will be bigger other than equity markets have gone up and IAS19's come in?

Kerrigan Procter

You've also got deficit repair contributions going in at a record rate. And just in terms of the information we have, bear in mind that we manage DB pension assets on behalf of 40% of the potential clients in the corporate pensions universe through LGIM, and one of the main points of dialogue that we have is their de-risking journey, and if you look at some of the flows going into let's say LGI fixed income, as people transition down that journey, we know virtually everything that goes on in that market because we have such a comprehensive coverage of it, and so I'm very confident that we understand where the de-risking trend is, and of course we should do given we have by far the lion's share of that market.

Mark Gregory

And your point, Marcus, about why we think we can replace the £1.3bn of IA volume should the whole lot go, clearly we don't think the whole lot will go, but I take the point that that is a material amount of make up. The volume market is a very, very big market. I mentioned in my speech £1.8trn of total DB liabilities, of which £600bn represent pensions already in payment. Roughly in the UK about £50bn is currently moved to buyout, so something less than 10% of the total accessible DB pensions in payment market has moved to buyout already, so again there's a big slug still to go at. And there are significant barriers to entry, as Kerrigan said, in reality you've got to be good at this, and you mention the people who tried previously and gave it a go, you said it stopped because the volume has dried up, actually it stopped because they weren't good enough at what they were doing, ultimately they mispriced the risk they were taking on and that's why in the end they ended up effectively blowing up.

So I wouldn't accept the point that they went out of business because the volumes were volatile, it was a classic case that you need to really understand what you're doing, and not just on the longevity side, you need to do it on the asset side as well. Skills like asset transitioning from the old arrangement to the new one is a key skill and you get that wrong and you can lose a lot of money. So it is something that L&G with its integrated propositions is very good at doing, we utilise the LGIM skill set in that point as well.

Marcus Barnard

So you don't think your trading profits will be more volatile going forward?

Mark Gregory

Again fundamentally the actual profitability of course is primarily driven by the back book anyway, so at its core we've got a stock of £38bn of annuities and again provided that all behaves itself, that will throw off potential margins of profit and cash flow for the next 30 or 40 years in reality. So no.

Question 7

Ravi Tanna - Goldman Sachs

Just one question please on the bulk annuity space again, and it relates to the comments you have made in the release on DB to DC transfers and the idea that they wouldn't necessarily materially impact the bulk annuity market. I'm just curious to know number one, do you actually expect significant transfers of these types to take place going forwards?

And based on the discussions you've been having with employee benefit consultants and Trustees since the Budget, has customer behaviour changed or has awareness increased around the possibility to make these transfers? Thank you.

Kerrigan Procter

Just on the DB to DC transfers, I think as Mark said in the release that you've read, we have a central case if you like that DB to DC transfers will continue to be allowed. There'll be some sort of appropriate advice regime, I think Trustees will need to check that people have taken advice, and of course that directs a certain hurdle in that a gold-plated inflation linked from retirement and then inflation linked for your spouse at two-thirds of the rate of the individual, is a very significant benefit indeed and quite a hurdle for advisers to say to those people that they should take something different.

Having said that, I think there will be a slightly larger flow of DB to DC in that central case just pre-retirement, and there are some examples that would be appropriate, but only makes a small dent in the £1.8trn of liabilities, and actually in pound terms will make buyout tend to be more affordable. So I think that's a reasonably positive environment.

In terms of employee benefit consultants and consultants talking to their pension scheme trustee clients, we're obviously very well connected in that market given our presence in that market so have talked to all of them, and if they are raising awareness with their clients about the potential for making sure for those that it is right to transfer and should be able to transfer. I don't see anything as a significantly affecting the bulk market at all in any of that.

Question 8

Abid Hussain - Société Générale

I've got two questions both on the bulk annuity market. Firstly, of the £600bn of DB pensions in payment, what proportion can actually afford a bulk annuity buyout today?

The second question is, to what extent can you control the flow of bulk annuities being brokered around the market, especially at the larger end of the market?

Kerrigan Procter

The £600bn pensions in payment, so how much is affordable, that's an interesting question because a lot of the business that we see at the moment is actually buy-ins and you don't need to have 100% funded status to pursue a buy-in. If you subsequently want to pursue a buyout then you need to think about the balance of security between pensioners and non-pensioners, but that doesn't stop you from proceeding down the buy-in route. The ICI deal we did, £3bn, that was a buy-in deal.

Abid Hussain

But presumably the £3bn liability that you bought out for buy-in, that proportion of the total liabilities had to be well funded?

Kerrigan Procter

Well yes. We get the full premium from the clients in those circumstances, yeah, so we assess the £3bn buy-in value or liability value for that on a buy-in basis and we clearly got the full asset premium there. So I guess the point is that that remains an asset of the pension scheme rather than being directly paid to pensioners. So in theory all that £600bn could be in play, but I take your point that there's a wide range of funding levels across schemes, some more than 100% funded, but the average is probably more like 84%, 85% on an IAS basis and more like 70% on a buyout basis overall. But there's a wide variety within that and that keeps a happy control flow of the £1.8trn of liabilities. I mean £1.8trn is an intractable problem in itself and anything we can do it make it more tractable is a good thing for the market.

Your second point was controlling the flow from brokers. It's clearly a market that, as I said earlier, Trustees think about security first and then price second. Don't get me wrong, the price is a very important consideration for Trustees, and the brokers help the Trustees get a fair price for the security they get. But there is a benefit in engaging with clients early to help them construct a deal that's appropriate to them and you can help them find the best prices in your book, and so it's certainly a benefit that we have the LGIM link with this 40% of clients and we can be talking at an early stage about full path to de-risking. So whether that's moving into active fixed income, or pursuing an LGI mandate or longevity insurance or buy-in or buyout, but because we can offer all those paths along the way, we can engage with those clients and help them all the way along their journey, and that is a real benefit.

Question 9

Martin Alpena - Mediobanca

I have a question regarding also the bulk purchase annuities and the attached longevity risk. I'm just wondering how you see that, which percentage of longevity risk you are aiming to reinsure and whether that will change in a Solvency II environment, or maybe that you've taken that already into account?

Kerrigan Procter

On the longevity risk point of view we're comfortable with our stock of longevity risk, the more we think we have particular skills in underwriting given the depths of our historic data and other data that we've accessed in the market, so we like and we make profits out of that underwriting risk, so we like that. However, the reinsurance market for longevity risk has developed substantially over the last two or three years and of course we therefore take advantage of that market when the price is right. So we did a back book deal last year and when the price is right in certain segments of our book then we'll look to use that reinsurance market more substantially. But it's not really a question of risk appetite substantially at this point, more a question of the price is right.

Question 10

Andy Hughes - BNP Paribas

The first question is on the amount of LGIM assets that relate to the local government pension schemes please, could you give us a number?

The second question is about the bulk annuity market and I think you've given some clarification Mark on your comments about the economics of these transactions getting better, I must admit I kind of agree with Mark because I thought it was exactly the opposite. We had a survey yesterday from Mercer saying that the pension scheme deficits in the UK had increased substantially and I'm not really sure I understand the outlook in a quarter when you did basically no bulk annuities apart from ICI, so in theory the cost of these things is getting more expensive because inflation is picking up, interest rates are coming down and even in ICI's case for the deal you've done they had to pay an extra £150m into the pension scheme to enable this transaction so could you give us an idea about what you mean by the pipeline getting better because of the economics please? Thank you.

Mark Gregory

Okay the local government pension scheme Mark will pick up and maybe you can do the second one Kerrigan.

Mark Zinkula

Yes the vast majority of the assets in the pension space are for corporate pension clients so we are a major provider of fund management services for local authorities, as you can imagine primarily in our index tracking space in fixed income and equities. If what you're alluding to is the initiative underway for there to be reduced fees and potentially cooling of these mandates that is something that we would view as an opportunity since there'd be a movement towards passive mandates in that space that we think there's an opportunity then to potentially increase our market share and we're heavily engaged in that process.

Andy Hughes

I suppose it depends who manages that mandate though. I mean have you seen the outflows from the SIV for the local governments that are setting up in London?

Mark Zinkula

We haven't, have we seen outflows? No. There's a lot of debate and discussion going on right now it's like an event we expect to primarily play out next year and we're heavily engaged in that process.

Kerrigan Procter

Thanks for your questions Andy, just on those points addressing the Mercer survey first, just as a little technical point I think that went from on an IS basis 85% to 84% on average funded. That's a technical feature really of the tightening of credit spreads in the market which isn't really the feature that's replicated in let's say an economic funding level or a buyout funding level. So I've viewed that as really a technical feature of that particular measurement of funded status.

More broadly we do see a support of equity market, we have seen that, we have seen inflation lowering actually so it's potentially some improvement in radials but I think the crucial thing is pension schemes one way or another will get to fully funded because deficit repair contributions have to go in. They're now going in at a near record rate, I think the previous record was 2007 and they're pretty much at that level, so rapid pace of deficit repair contributions going in and of course I think, as Mark said, when CFOs put in substantial deficit repair contributions they don't want to then blow that on taking risk in the equity markets necessarily, they want to see a de-risking progress which is where you see the LDI mandates come in for example.

So I think the second point there is there's a wide disparity of funding levels between pension schemes, the ones let's say ICI have done as a substantial de-risking programme will often be in a better position to move to buyout and I'm certain we have a great visibility of that range of pension schemes there. So we're confident that the pipeline we're talking about is real and present.

Andy Hughes

And surely the narrowing credit spreads impacts the costs of these buyouts as well?

Kerrigan Procter

Yeah it does to some extent, you are right it's not quite the impact that tightening of the credit spreads, particularly double A credit spreads has on the IAS accounting measure. So it's far more marked in the IS spaces.

Andy Hughes

And going on the margins you're reporting today and profits in terms of net cash, as you know I'm not a fan of the net cash metric for the simple reason that today you're saying you've made £301m of net cash, a large chunk of which came from a £3bn bulk annuity that your competitors turned away, presumably because they couldn't get to the same level of profitability hurdles. Now I think on an economic capital basis if we looked at that bulk annuity we'd see a very different number in terms of capital generated in the period so how should we look at this going forward?

Mark Gregory

Just to be absolutely clear, Andy, the bulk of our net cash does not come from the new business we wrote in the quarter, the bulk of our net cash comes from the stock of assets and liabilities we've got on the books already and essentially it's a release of the potential margins we have locked up in the back book and we expect that to release nicely to profit and cash over time. So it's definitely wrong-minded to think that the net cash generation of £301m has been generated by a one-off.

Andy Hughes

No but there is a definite contribution from the £3bn bulk annuity though.

Mark Gregory

Well it's in the new business surplus number of the +£4m we've announced which clearly is not a huge percentage of the £301m but it's in there yes you're quite right Andy.

Andy Hughes

And on the Pillar 11 basis any idea what kind of capital this deal would have consumed?

Mark Gregory

Yes we do know because we've got our own economic capital model and that's primarily how we price these schemes in the first place, so we are very driven by that and clearly at this stage I mean to say the ICA process it's a private basis with the PRA but we will think about our economic capital disclosure which we try and help you understand the dynamics in their kind of two strokes Solvency II world do well going forwards.

Andy Hughes

And bulk data loadings, you used to apply those to these kind of transactions when they came on the books and that depressed the earnings or at least the strain initially from the bulk annuities, is there any bulk data loading here or not?

Mark Gregory

Do you know Kerrigan? I'm not aware there's anything in the number in the first quarter, certainly not in the pricing.

Kerrigan Proctor

No I don't have the points.

Mark Gregory

I don't think that's been a fact of this quarter Andy. And you're not last Andy.

<u>Question 11</u>

Alan Devin, Barclays

Hi guys, a couple of non annuity questions you'll be glad to hear. First of all just on corporate pensions the flow has picked up to net flows of £500m in the quarter I was wondering is there any one-off in that number or is that a good underlying run rate we can look to go forward?

And then obviously you've got £9.1bn of assets in that business now growing at £500m a quarter which is pretty close to your low double digit billion breakeven target you've discussed in the past so I was wondering if you could comment on how close you are and when we could see that?

Then a secondary question on retail protection, you had a very strong quarter there this quarter and actually that also contributed to the positive cash chain in the quarter so I was just wondering what's going on there? Is the cash chain and the positive chain in that business sustainable? Thanks guys.

John Pollock

Thanks Alan I'm pleased there's some interest in the LGAS business. So corporate pensions yeah as you're aware there's the staging dates for SMEs that come through this year and into next so the run rate of business we would hope to be able to maintain for as long as possible, our 50 basis point charge cap is an attractive offer in the market which we hope will bring more business to us. Clearly as we get towards the tail end of staging you're getting smaller and smaller and smaller schemes. So it's unlikely that we will see the kind of inflows that you've been seeing going off into the long term future but at least over the next couple of years we are continued to aim at scale.

We're at, as you said, just a little bit over £9bn. We are still aiming towards low teens, double digit assets under management to get to our breakeven point and grow from there. As the business is on the book so we get the increasing premiums as payrolls rise and ultimately as the government changes the contribution rates. So yeah pretty confident that over the next near term future you'll see flows continuing at this kind of level.

As far as retail protection is concerned the strain figure was changed if you remember as a consequence of I minus E which changed the accounting of the costs on the retail protection business. So for as long as the market competition will allow it I would expect strain to remain at the kind of levels that we're currently seeing but it is a competitive market but we won't see a return to the levels of strain that we saw a few years ago that's for sure.

Closing Comments

Mark Gregory

Thank you very much for your engaged questions this morning and we'll see you soon. Thank you.