## Q1 Interim Management Statement 2014

## Thursday 1 May 2014

### Clive Bannister, Group Chief Executive

Good morning everybody and thank you for attending today's call. I am Clive Bannister, Chief Executive of the Phoenix Group, and I welcome you to our first quarter Interim Management Statement call. I'm joined here today by Jim McConville, our Group Finance Director, and Sam Perowne, Head of Investor Relations.

I am pleased to report that the Group has generated a total of £235m of cash from the operating companies in the first quarter, and that we remain on track to meet all of the financial targets we set for 2014 and beyond. We will be very happy to answer your questions in a few minutes, but first I would like to take you through the highlights of our first quarter announcement which we have released this morning.

First, cash generation. Cash generated by the operating companies continues to be the metric by which we think is most useful in helping investors understand the long-term value and predictability of our business. In the three months to 31 March we distributed £235m of cash to the holding companies. The vast majority of these distributions were from the life companies made possible by the strong Phoenix Life free surplus at the year end, together with the completion of the sale of BA(GI) for £21m. The cash generation of £235m is in the context of our target for the full year of £500-550m, which we are on track to meet.

Second, turning to capital. We report our Group solvency position on two bases: IGD and the PLHL ICA. Our IGD surplus and IGD headroom, which is the excess over the IGD capital policy, have both remained stable since year end at £1.2bn and £0.5bn respectively as of 31 March. The impact of the Ignis divestment and debt pre-payment is estimated to be broadly neutral on these metrics. Our PLHL ICA surplus increased slightly by £0.1bn to £1.3bn as at 31 March. We aim to maintain a capital policy of £150m, and the PLHL ICA headroom over this policy was stable at £1.1bn. The impact of the Ignis divestment and debt pre-payment is estimated to reduce the PLHL ICA surplus and headroom by £0.1bn. And from an individual life company perspective we report the Phoenix Life free surplus. Following the distribution of cash to the holding companies the free surplus was £363m as of 31 March, which represents the excess capital over and above the life companies' own strong capital policies.

Third, Ignis. We announced the sale of Ignis to Standard Life for £390m at the time of our full year results. The regulatory change of control process is ongoing and we continue to anticipate completion of the transaction by the end of the second quarter. At completion we will make a debt pre-payment of £250m on our Impala bank facility. As we mentioned at the full year results, Ignis had a strong first quarter of third party sales. Ignis generated net new business from third parties of £1.1bn in the first three months to 31 March, excluding liquidity funds and Guardian assets. Overall Group assets under management were £69.3bn at 31 March, versus £68.6bn as of year end.

And then finally the recent regulatory announcements and changes. Following the confirmation that the FCA would be undertaking a thematic review of the fair treatment

of long-standing customers in life insurance as part of their 2014/2015 Business Plan, we have yet to receive any further details in relation to the scope of this review. However, we have been reassured by the clarification that has been provided by the FCA that the review will not consider the suitability of historic advice, nor will it require a review of individual policies, and we believe in addition that since Phoenix does not write new products other than vesting annuities, we do not believe that any review of cross-subsidisation, and I say any possible review of cross-subsidisation of new business, would be relevant to the Phoenix Group.

We remain fully focused on our policyholders with further actions taken during the first quarter aimed at the continued improvement of service and performance. We look forward to actively engaging with the FCA review on the fair treatment of long-standing customers in life insurance, and believe our initiatives demonstrate best practice in this area.

So to conclude, I am delighted by the progress we have made since the year end, and I remain confident of our ability to meet all our financial targets for 2014 and beyond.

**Question 1**

**Marcus Rivaldi, Morgan Stanley**

Good morning everybody. I've got a question actually away from the numbers but more thinking about the competitive dynamics within the closed block space prospectively post the Budget. Clearly there were discussions or newspaper reports around one of your competitors in the FT over the weekend, I'm just wondering what does this mean for the closed life arena going forward and how competitive it might become?

**Clive Bannister**

Marcus, thank you for your question. You made reference to the Budget so I assume you're speaking principally about annuities?

**Marcus Rivaldi**

Yes. But I think it's almost about what others may be thinking about changing the focus of their activity and suddenly maybe closed block becomes relatively more an attractive space to be playing in.

**Clive Bannister**

This is an evolving landscape, and the phrase I used when we announced our full year results in March is that the Budget changes as they related to annuities were going to change our industrial landscape as an insurance industry, and of that I am sure. I am not a believer that annuities will end overnight because that is not plausible, they have a role to play in any structured set of investment advice/guidance being given to retirees in the years of decumulation.

There are two components of impact on annuities; one of which is where you have GARs or guarantees; and one where there are no guarantees. Clearly the impact on the guaranteed portion is likely to be less negative or less dramatic than where there are no guarantees.

I'll speak about Phoenix for one second, we are confident that our guaranteed annuitants are well served at the moment, so if you are a 65 year old male your return will be around 11%. So we think there's a good deal of stability that will be ongoing in the guaranteed portion of the annuity world. On the annuity where there are no guarantees, this is clearly more challenged or likely to be more challenged going forward.

So if you are running a business today where you have a large percentage of your business committed to writing new annuities and/or have vesting annuities which don't have guarantees, clearly that line of your economic model is going to be more challenged or will be subject to changes, ie., the returns that you expected from that business are likely to be diminished from where they were before the announcements in the Budget. So we think that will, over time, force businesses to look at their capital allocations, and we think that may encourage more clarity between open and closed books and the emphasis between types of product. And if the first part of that statement is true, then again over time we think that will favour those organisations who are very focused on what they do, and we are very focused on the closed life sector.

**Marcus Rivaldi**

And can I just ask a follow up to that. With the Ignis deal coming to conclusion and the debt pay down, where do you think you are from a financial flexibility perspective to be pursuing transactions down the line?

**Clive Bannister**

I go back to what we said at the full year, the completion, and obviously it's subject to regulatory approval, so let me say that our target remains to complete the divestment of Ignis by the close of the first half to Standard Life. But what this does principally is allow us to pursue our stated strategy of being the UK's leading closed life consolidator. We believe it makes us more competitive as a closed life consolidator. In two ways we are a better counterparty. First we are clearly financially stronger, so there will be an accretion to our MCEV, we announced £2.4bn and we believe our EV will go up to £2.6bn, and that is a very useful, can I say, card at the table when it comes to discussions with possible vendors. And our debt comes down, our target leverage or gearing will come down to around 39% with the completion of the Ignis deal. So that is one reason why we'd be a more competitive counterparty.

The second is that we have entered into a strategic relationship with Standard Life which includes a synergy sharing arrangement on any assets that we bring to their table, bring to their business if we do a deal. So we think that Standard Life, because they are very good at asset management and because they understand how to manage books of long tail liability insurance businesses, if we were to find ourselves in discussions with a vendor, we go to that table with a counterparty and will be recognised as very able in that space, and we will also economically benefit through this synergy sharing agreement.

It was one of the underlying logics behind the divestment of Ignis because it was designed to make us a better counterparty in future transactions.

**<u>Question 2</u>**

**Marcus Barnard, Oriel Securities**

Morning all. Like the previous Marcus, I don't have any questions on the numbers, but I did have a question on the Budget again. The Chancellor announced the introduction of face-to-face advice/guidance for those reaching retirement, but was rather vague what this guidance would consist of or who was going to pay for it other than the industry. Presumably if you're in the industry and you don't have many retirees you might feel that those that do have retirees should pay rather more of it. I just wondered if as a business that has quite a lot of people retiring with policies, whether there's any implication that you should pay a greater share of that? Perhaps you could comment on that. Thank you.

**Clive Bannister**

Thank you for the question. We are unsighted. I know that's not the answer you wish to have. I think it is one of the most crucial aspects where there needs to be a greater clarity about what face-to-face actually means. It should be very straightforward to understand that when we think of telephones and computers, but face-to-face and the balance between what is guidance and what is advice. So we have to wait until that clarification comes out. But the burdens or the consequences of what guidance means and face-to-face has yet to be thought through.

Let me just emphasise that at the moment we have a very active relationship with our clients, and we make sure that when they are getting to annuities and to the point that they're divesting that they are contacted and made aware of their options, and this is done primarily electronically but then by post as well, and that is where we stand at the moment. So, there is no lack of communication; but we need to know what the new targets or what the new processes will involve before I can answer your question about a) its cost, and then b) who should be paying for it.

**Question 3**

**Jon Hocking – Morgan Stanley**

Firstly on Solvency II, I wonder if you could comment on your recent discussions with the PRA about the Solvency II implementation process and when you're expecting to get approval for your internal model.

And then secondly just on the FCA review. You mentioned clarification from the FCA in terms of the review; are you referring to the press release they put out on the afternoon of the day of the announcement? When do you expect to get further clarification from the FCA?

**Clive Bannister**

I'm going to answer your second question, Jon, and thank you for asking it, about the FCA. And then I'm going to ask Jim, on whose shoulders the burden of Solvency II development and delivery rests to answer the first.

Yes, I was making reference to what the FCA said on the afternoon, that they were not planning to review 30 million policies; that they did not intend to look at removing exit fees, so long as we had been compliant; and that they were going to not review in an antique way the sales practices for legacy customers. So, that is what they said.

It is up to the FCA to define the timetable, but my sense is that this is going to be a thematic review, so they are unlikely to publish in a sense a remit, but they are going to engage with the industry and take the necessary time to amass information and then reflect upon it etc. These reviews typically take nine months to a year and at the moment we have not been approached to participate or that has not been taken forward by the FCA. I think that is a question which is better directed towards them.

**Jon Hocking**

Do you think with this review outstanding it in any way precludes you from M&A in the meantime? Or do you think you could actually execute a transaction with this unresolved? It's hypothetical.

**Clive Bannister**

That's a second question and I'm very happy to address it. I think it makes life more difficult because I think you have the situation where both vendors are subject to saying, well what are the exam questions that we have to answer; and of course us as an acquirer. So, there is an added extra layer of complexity, and that maybe equates to difficulty. But does it mean that it's impossible? Of course not, because I think the FCA has an interest in ensuring that they are clear about the questions. It is a thematic review, and when other thematic reviews have taken place transactions have also taken place. So, I don't think it makes it impossible, but there is a layer of complexity that both vendors and acquirers have to think through.

Jim, do you want to go through Solvency II?

**Jim McConville**

As Clive says, I have the privilege of leading our Solvency II programme, which as I'm sure you can imagine is a very significant programme of work across Phoenix. That programme is on track. It's a very large programme and has many steps and involves very regular interaction with our colleagues at the PRA. We meet with them on a regular basis to share progress on the programme and so on. We would anticipate that our IMAP application will be during the first half of 2015. But as you know, it is a staged progress and information as part of that application will be submitted to the PRA regularly between now and then. So, we are very much on track.

**<u>Question 4</u>**

**Oliver Steele – Deutsche Bank**

I think I've got three questions; I'll work it out later on. The first is going back to Marcus' question about financial flexibility. You've got I think it's around about £500m of headroom on an IGD basis; how much of that is actually available to be used towards any acquisition? Or are you still talking principally about equity funded acquisitions?

Secondly, again on the financial flexibility question, I know it's only 24 hours since the EIOPA announcement, but any initial thoughts on that?

And then finally to the FCA review. Are you prepared to talk at all about the sort of shape of your charges, and I'm talking about the annual management charges, and the

exit penalties that you've got in place across your book, particularly I guess the unit linked book?

**Clive Bannister**

I'll take the last of those questions, so charges. Then we will go back to financial flexibility for Jim. Then we will come back to the EIOPA issue that you just posed.

I assume, Oliver, you're interested in our fee structure because of it being a possible line of enquiry with regards to what the FCA may look at. Is that the gist behind it?

**Oliver Steele**

Yes, and I take on board the comments that you make and other people have made that this is more about procedures rather than the actual level of charges. But I guess the fear that investors have is that it may go further.

**Clive Bannister**

Thank you for putting in that qualifier. At the moment it is slightly shooting into the dark because we don't know what the FCA will do; but there has been a question mark about exit charges and overall charges.

First of all, we're very comfortable, having participated in the Strachan review, that we have been compliant with the charges i.e. they have been applied as advertised.

The second observation just at the structural level we would make is that because of the book of our business is principally with profits we think that will be less subject to any possible investigation or part of this thematic review; and that the media have commented and analysts have commented, that it is more likely to be unit linked. So, our unit linked policies only make up about 20% of our policyholder liabilities. So, we are unusual in the industry because we are almost two thirds a with profits business. And a large majority of our book, being two thirds with profits, means that we have focused on thinking through the unit linked component. And there exit charges only apply to unit linked book are generally de minimis, especially where the policyholders have continued to pay in premiums.

So, if I was going to give you a statistic around the maths on our latest PRA returns they suggest that the average exit penalty across all of our UK unit linked business is not more than 1% of policyholder funds; and that the average policy size is around £13,500; and thus the average penalty per policy is unlikely to be more than £150. So, if that were to the exam question – and I think we are in the world of hypothesis here – we think that that on that maths that is not a threat to our business.

Then you had a second component which is the overall gross management charges. We understand why there is interest, and it may well be part of the thematic review; again we don't know about the overall charges. So, if I were going to talk about our gross management charges on our unit linked book, and this would include administration, investment management, surrender and exit charges and other contract fees, we think they are of the order of 1.5%. Now, there is clearly a bell curve and a spread, and those fees depend on the type of funds being managed, what generation i.e. how many years ago they were written etc. But that is my way of a sighting shot. We don't know what the exam question is; but when we have looked at our unit linked

business, both exit charges and general management charges, on average it is not something that has made our hair stand up on end. So, that is how I would answer your last question.

Can I go back to your first question, which is our financial flexibility? You are correct to notice that our headroom is £500m on IGD. And Jim the question was how much of that is available for M&A versus the other things we hold onto it for etc.

**Jim McConville**

In theory obviously we could use the whole of the headroom for whatever purpose we intended, including M&A. Clearly, as we've signalled in the past, we've always looked at that position on a prudent basis, and therefore I wouldn't like you to think we would run that down to an absolute bare minimum where we were out of the requirement and so on. So, we shouldn't think that that full £500m would be available in that sense.

We've also mentioned in the context of acquisitions that our preference would be for a larger acquisition than a series of smaller acquisitions, because the time involved in any acquisition is very considerable, and therefore there are some benefits of scale of thinking of larger acquisitions. In that context therefore any acquisition is likely to involve an element of equity funding, and therefore I don't think you should think of the available firepower as limited by the IGD headroom.

If I could move on to the EIOPA announcement yesterday. Clearly it is very early days, and I spent all of yesterday in a board meeting. So EIOPA announced new insurance tests for 2014, which will be carried out in conjunction with the National Supervisory Authorities. It is really too early for us to say whether we're going to be included in that test and how that will play through. We don't have that information through. However you will recall from our year-end announcement that we are relatively insensitive to various market movements, so we don't anticipate any particular difficulty with complying with that test requirement.

**<u>Question 5</u>**

**Jon Hocking – Morgan Stanley**

Just to come back on Oliver's question about the FCA review. You mentioned the 100 basis points average exit rate across the book, does that apply across the entire unit linked liabilities? If we take that number from the financials is that the correct liability number to apply that to?

**Clive Bannister**

The answer is yes, because it's £8.5bn?

**Sam Perowne**

I think it's about £11bn of liabilities at the year-end.

**Clive Bannister**

£11bn Jon, and I emphasise that this is an average and it's on our unit linked business.

**Jon Hocking**

That's very clear. Thank you very much.

## Closing Comments

**Clive Bannister**

I just want to wrap up by saying that I am pleased that the Group has generated £235m of cash from the operating companies in the first quarter of this year, and that we remain on track to meet all of our financial targets in 2014 and beyond. And this company is working very hard to fulfil all of its obligations to its policyholders.

So thank you very much for taking time today and you can follow up with Sam Perowne if you have any more individual questions.