Standard Life

Solvency II and Capital insight session

Friday, 19 February 2016

Luke Savage – Group Chief Financial Officer
Thank you for staying around for our Solvency II and Capital Insight Session. I am going to run through a presentation that tries to explain the dynamics between our real capital and our regulatory capital and so on. And then I am joined on the stage here by Stephen Percival and Jonathan Pears who are two of our real in-house experts and we have also got various other experts from Standard Life around the audience, including our CRO and people like Michael Kerr and so on. So hopefully between us we will be able to answer all of your questions.

Now before I dive into the presentation, one thing I would say is that the figures we are going to be talking to this morning, are our final 2015 year end numbers. And the reason I mention that is because one of the things a number of people haven't picked up on in the Solvency II world is the actual time we have to produce and report your Solvency II figures to the regulators, it changes significantly. So in an old Solvency I world, we had I think it was six months to 30 June to submit figures. So what tended to happen was people would focus on their IFRS results, get the Prelims out of the way and then they would spend months producing their regulatory capital numbers. At Standard Life, no thanks to me, it was work underway before I joined, we have been investing fairly heavily in our ability over a number of years now to actually do all of that work in parallel. So when we went to the Board and got our results approved, we also got all of our final Solvency II figures approved. And I think we are about the only big UK company that is in a position to do it to that kind of timescale.

So in terms of what I intend to cover this morning. I am going to run through the Solvency II position, at the headline level, going to touch a little bit more on its stability. And then I am going to start to unpack what it is that is driving that capital requirement and how that ties back to the kind of business we are writing. I will then walk through how our regulatory capital relates to our real equity capital which is after all what investors have entrusted to us. And then on to what that means for how we are managing the business day to day and indeed how it hasn't actually made any difference to the way we think about things like cash generation and our ability to support the progressive dividend policy.

So let's start where we have ended up under Solvency II. As we said earlier it is a Group surplus of some £2.1bn or a 162% ratio. Even at the Group level, never mind the extra surplus capital I will come onto in a moment. Even at the Group level we think that is a strong ratio given our fee based business model. And it is that confidence in our Solvency II position that made us confident last year that we could return £1.75bn to shareholders off the back of the Canadian sale. And indeed we also returned £300m to debt holders during the course of 2015 as well.

As I said, we have £5.5bn of capital that we recognise at the Group level. And if we break that down you can see that £4.9bn of that or 89% of the total is Tier 1. That on its own provides capital coverage to the SCR of 144% just from that Tier 1 capital.

And it is worth noting that we both applied for and attained permission to use transitionals. But there is only £100m worth of transitional in that Group number. But as I said, that is £5.5bn of capital at Group level is only part of the story. The structure of our business is such that most of the requirement for solvency capital originates within our principle entity Standard Life Assurance Limited. And if we look at the capital within Standard Life Assurance Limited, there is a further £1.2bn available within that entity that can absorb losses which are likely if they are going to arise to arise in Standard Life Assurance Limited by the definition of that relationship.

We don't recognise it at Group level. What is the reason for that? It is around fungibility constraints. When looking at the amount of capital we can recognise at the Group level coming up from SLAL, we end up taking the lower of the capital surplus from Solvency II perspective versus our distributable IFRS reserves. And in the case of SLAL it is the IFRS reserves that become the binding constraints on us bringing that up to Group. It doesn't mean it could never be recognised, but it does mean that in order to recognise more of that at the Group level we have to convince regulators that we could through management actions, turn that excess within SLAL into distributable reserves or be able to find another way of transferring up to the Group level.

But on that point let's just be clear, Standard Life Assurance Limited even with that constraint still has enough distributable reserves in its own right to cover several years of the order of magnitude of dividend flows that we see coming up from SLAL each year to Plc. So it is only a function of recognition of capital not a constraint on our ability to continue to dividend cash from SLAL up to Group.

But in effect it means that when we look at the Standard Life as a Group, we effectively have that Solvency ratio of 197% that we are thinking about rather than the 162% purely at the Plc level. And the impact of that on us is quite profound. I showed this slide in the earlier presentation. You can see that for each of these stress scenarios the total barely moves in aggregate let alone kind of at the individual level of the Group in isolation. Now it is fair to say that these are individual univariate stress scenarios so it is not assumed that all of these things happen at once. And if these things start happening in permutation there will be more volatility. But from what we have seen so far, they are very much in line with what a number of our peers have been disclosing. So in that sense it should provide a good reference point. And it is that extra £1.2bn that sits within SLAL that absorbs losses within SLAL that keeps the Group number stable.

So strong ratio, stable surplus and all underpinned by a high proportion of tier 1 capital. Let's look at what it is that drives out capital requirement in the first place. Now I don't want to teach your grandmother to suck eggs, but I was just going to start by being clear on what determines the amount of capital that we are required to hold. So we are required to calculate the amount of capital we need to ensure that we can still meet all of our liabilities under 99.5% of all possible scenarios that could come to pass over a one year time horizon. Now given that 99.5% is the same as saying 199 out of every 200 occasions and given we are looking over a one year time horizon, hence the reason people talk about as being the 1 in 200 year event. Now that 1 in 200 event could in theory be as a result of a single stress. And you can see across the bottom of the chart here we've put down examples of standalone examples of what we think would be a 1 in 200 movement. But in practice it is more likely to be a combination of the number of these happening at the same time, but to a lesser degree of individual severity. Either way we have to hold sufficient capital to meet all of the 99.5% of the worst outcomes that we could envisage.

Also worth being clear that what a 1 in 200 event would look like for any one of these, could change over time. So for example, if a miracle cure for a major killer was on the cards, then you might suddenly see a jump up in life expectancy, and so the 1 in 200 probability of an improvement in mortality could look like can vary over time. None of these things are set in stone.

So if that is what is determining the requirement, how do we calculate the figure? As I am sure you know there is more than one way you can come up with your 1 in 200 amount capital. For Standard Life it is primarily through the use of our internal model that the PRA approved back in Q4 last year. But there are other ways. So as you see here if you look at the top half of the slide, Standard Life Investments is captured under the BIPRU rules, so the capital there is calculated under BIPRU rules. And you can see that some of our entities where we use the standard formulas so for example China and Hong Kong where the complexity of applying a model just isn't worth it, versus the scale of that business.

What you can see at the top half here is both the way in which we calculate capital at the standalone entity level on the left hand side and on the right hand side you can see how that then feeds into the overall Solvency II Group position.

Now technically because we are using a range of different methodologies for different parts of the Group, the model itself is only applied to part of the Group. So if any of you were to bother to go online to the PRA website you would see that technically we have a partial model approval because we are not applying across the board. But for the avoidance of doubt, we applied for and we obtained approval for a model that covers all of the risks where we do apply. So it is not like a bit of our model was disallowed and that is why it is only partial, the model we applied for was fully allowed, but it just does not apply to the whole Group.

Now if we turn to the bottom half of the table here, you can see how both the capital and requirement figures I have been talking to up to this point break down by legal entity. And you can see that in the second row, our UK and European Pension and Savings business, which is through Standard Life Assurance Limited, is the dominant driver of that.

We have also been very clear and transparent here. In the footnote you can see that we said there is £1.1bn of transitionals within our available capital. Now transitionals will run down over a 16 year period, but if you think about the nature of our book, we are not a writer of spread/risk business nowadays. So currently we have both within our available capital an amount of transitionals, within our requirement we have capital arising on spread/risk business. What we will see over the next 16 years is those two will track down, not in absolute parallel, but materially in line with one and other. So what you won't see because of our fee based business, is any kind of reduction in that surplus over time as transitionals run off.

Now the different ways we can think about what is driving the capital requirement. Here you can see us breaking it down by conventional risk type. Now you can see areas on there that perhaps not surprising, longevity on the left at 18%. And you can see quite a big chunk of credit risk on the right hand side at 32%. Now given everything that is going on in the markets, I thought it was worth just touching that credit risk component. About 30% of that relates to capital requirements in respect of our pension scheme and with profits fund and I am going to come onto explain in subsequent slides why it is that the inclusion of capital and requirement in respect of those is a gross-up that really does make any kind of sense. The balance is our bond portfolio that is covering our genuine annuities, our subordinated debt liabilities and so on. And within that it is a good credit quality. So about 70% of the assets are rated at A or above.

I think this slide actually tells the story in a clearer fashion. So this is taking that same £3.4bn and breaking it down by the type of business that is driving the requirement and you can see three substantial components that I am going to talk to. We have got spread business on the top right at 32%. We have then got fee business of 26% which may, given that it is meant to be capital light, seem intriguing to people and I will explain what is behind that. And then we have got pension scheme with profits fund at 21% which I will come onto explain why that really does not make a great deal of sense.

I think the spread business is fairly obvious, it is longevity risk and it is credit risk on the assets. And the kind of things that drive both the requirement and the sensitivity are very much in line with a lot of our peers who are big writers of spread/risk type business. As I say, we are not and that requirement will trend down over time in line with the transitionals.

So what is it then that is driving the big 26% in our fee business given that we always talk about fee business being capital light. So what is happening there? I am afraid I could not think of a way of getting this message across without walking through an example. So this is homework time, I do apologise for teaching time. I will walk you through an example when you write fee business through a Solvency II regulated entity. So if we start at the top left hand corner, let’s assume that somebody gives us a premium of £1,000 that they are paying into a pension pot. It could be a one-off payment, it could be part of a monthly or annual steady recurring income premium. But assume you have got £1,000 and for the sake of simplicity, let’s assume that we forget the market appreciation of that asset over time, let’s assume we forget time, the value of money and discounting and so on. We just say that we make 50 basis points on that £1,000 net of expenses. So maybe we are charging 70 bps of income, 20 bps of cost, and we are making £5 per annum for administering that £1,000 on behalf of our customer. Let’s assume that this particular individual has got ten years we expect them to be with, because they are now 45, they are building a pension pot where they are going to retire at 55. So effectively we can anticipate that we are going to get £5 of income per annum for the next ten years. Now the way Solvency II works is you take that £50 of current and future projected income and you recognise that as capital, called value in-force or VIF. But at the same time you have to recognise that there may be lapses and that that customer might not stick with you for 10 years and therefore you calculate the risk of those lapses and you have to take a capital requirement against it. And this example in the bottom left, that is the £20 we put up here in the example. So by taking £1,000 of premium, we have made £5 of income now, we have created £50 of VIF and we have created £20 of requirement and we have generated a capital surplus of £30.

So even though this is fee based business, when you look at a Solvency II capital calculation, it is driving regulatory capital but from the perspective of our shareholders and the equity they have invested with us, it is not actually tying up any capital. So from an investor perspective it is capital light, it is anomaly of the Solvency II calculation.

Now you can see on the right hand side of the chart here that it is actually significant. It only arises on business written through Standard Life Assurance Limited because as I said, Standard Life Investments is covered under BIPRU rules. But you can see that within Standard Life Assurance Limited it is actually creating for us £2.9bn of capital versus a requirement of £0.9bn. So it is actually contributing £2bn of surplus but it only exists on a Solvency II balance sheet. It doesn't exist as hard cash. So as I say, it is entirely self-financing, from the regulatory balance sheet it ties up capital, but from a shareholder perspective it really is capital light.

Let's turn now to the third element of the pie I referenced, the with profits and pensions funds. I have used on this slide here an example that focuses just on the pension scheme, but the principle applies the same to our 100-0 with profits fund. So I think we are one of the few FTSE 100 companies that are actually running a pension scheme surplus. And thanks to the power of GARS over the past decade we are actually running a very substantial surplus. So we have a £900m surplus in our pension scheme.

When we look at that 1 in 200 scenario, the worst thing that could happen, 99.5% of outcomes, the worst thing that happens at that biting point is that we see about a £300m reduction in our pension scheme surplus. So on day one, £0.9bn surplus and shareholder capital at zero. The 1 in 200 scenario that surplus comes down by £300m, there is still a £600m surplus and exposure to shareholders capital is zero. So you think fine, great the shareholder capital is not at risk. But unfortunately it is not the way it works in Solvency II. The way it works in Solvency II is we have to take that £300m loss in value that you could see over a one year time horizon and we have to put that into our capital requirement. We then take £300m of the £900m surplus and we recognise that as available capital. So what we have just done is to say for something where there is no shareholder risk at that 1 in 200 event, we have just grossed up the numerator and the denominator of our solvency ratio by £300m. And in doing so we have diluted our Solvency II ratio in isolation to that by about I think 6% or 7% even though there is no shareholder risk there.

We also have 100-0 with profits fund, the old Heritage With Profit Fund. That runs a substantial surplus and the only risk to the shareholder from the Heritage With Profit Fund is the burnthrough risk that if the Heritage With Profits Fund blows up there is what is effectively a way out of the money guarantee by the shareholder to make good shortfalls. But that is already covered within the fee based capital requirement that I touched on on the earlier slide. So we have already recognised that there is a small amount of exposure to the shareholder. But again what we have to do from a Solvency II perspective is to go through it with exactly the same kind of gross up where we have to bring in the amount by which the fund could lose value, we recognise part of the surplus is capital and again we dilute that capital ratio.

In total, if you think back to the doughnut a couple of slides earlier, this gross up which does not present any investor risk is actually contributing 20% of our requirements and overall it is diluting our Solvency ratio by some 16%.

So the big three components of our capital are this gross up that is 20% of our requirement but does not pose any shareholder risk. It is the capital required to cover our fee business which is all self-financing through the creation of VIF and indeed not only is it self-financing, it actually creates surplus. And the only true driver or significant true driver of our real Solvency II capital is on our historic annuity book. But even a chunk of that can be financed by the surplus VIF that we have created on the fee based business. So bottom line is the amount of capital that the shareholder has at risk is a fraction of that Solvency II figure.

And here we just tried to show how we get between those various numbers. So you can see on the left hand side, we start at the £5.5bn. We then add on the £1.2bn that we don't recognise at Group level to recognise that the total Solvency II capital across the Group is £6.7 billion. From that in terms of what is it that the shareholder has at stake, back out subordinated debt, you can back out the components of our regulatory capital that comes from VIF. You can remove the gross up from the pensions and with profits. And then there are a number of things that in terms of the book equity of the investors you put back in, such as the total pension scheme surplus, which is how you then get back to the £4bn of book equity that you see across the Group.

But in terms of what is it that the investor really has at risk, you know in terms of tangible assets, even that is not the full story. Because you take that £4bn and then you say, yeah but £900m of that is the pension scheme surplus and that really belongs to the pension scheme, it is not part of shareholder's equity until decades down the line when the last pensioner has died. You do the same with DAC and DIR and so on and actually get to a point where you are saying in terms of hard, tangible, liquid assets that we have entrusted to us by investors that we are putting to work, it is actually about £1.7bn. So against that context you can probably see why it is we are sitting there saying regulatory capital is not a constraint on us, we actually work against that tangible equity capital. So it is that £1.7bn that we focus on. And we demonstrated that is underpinned by strong cash generation from our fee based business, 94% fee based. That drives the growth in IFRS profits, that growth in IFRS profits is strongly correlated with the cash that we are generating. And that cash that we are generating then gets dividended up from the subsidiaries to the Plc level. And is available as part of that £1.1bn that we have at Group level.

As you are familiar, we capitalise each our principle entities, SLI and SLAL in their own right. Everything else we try and dividend up to the Group and that is where the £1.1bn that we have at Group comes from. You can see here how that number has moved over recent times. So back in 2014 it took a dip when we acquired Ignis, you can see that in 2015 with the sale of Canada and the retention of proceeds, part of the proceeds from Canada, it is back up at around the £1bn level.

So why do we have £1bn of genuine capital at the Plc level? Well first of all, it will enable us to do things like complete on the acquisition of our Indian stake increase. You will remember we announced that last year. I think at the most recent exchange rate I looked at, that will take about £175m to increase that stake. It is something where we think it is a very valuable holding and hence the reason we will be looking to IPO once the stake increase has gone through.

What it also does is it gives us a strong buffer to underpin our progressive dividend policy. There has been a lot of talk in the press recently about volatile markets, tough times, are progressive dividend policies sustainable? We believe that ours is – in part underpinned by this buffer at Group level that will enable us over multiple year time horizon to ride out the ups and downs of the markets. And there is a question earlier and we can perhaps come back to that in the Q&A now. What it also does it means that in these current volatile times, it gives us a great deal of confidence in our financial strength against a backdrop of volatility, where that financial strength in turn gives us optionality. So Keith touched on the idea that you know predominantly our strategy is one of organic growth, but it is great to be in a position where opportunistically if things were to come along inorganically that complement the strategic direction of the business, we are well positioned to do that.

But let's not forget, you know in the event that we feel at any point in time that we don't envisage being able to put that capital to work effectively then we would of course consider returning it to shareholders. And we have a track record of doing so, a special dividend in 2013, the return of capital post the sale of Canada in 2015, and indeed the pay down of £300m of our sub debt in 2015 as well.

So I guess to conclude or almost conclude, what it means is that Solvency II capital is neither a constraint on our business, but nor is a lot of that capital a source of readily realisable tangible funds that is there as surplus to give back to our shareholders.

We believe that our fee based model serves us well and will continue to serve us well and isn't impacted by the Solvency II regime coming in. But as I said, we are not complacent. We are always looking for opportunities to make that capital work harder. And again there was a question in the main session that perhaps I could try and cover now, around, if you have got this VIF there, then why don't you look to put risk onto the balance sheet to take advantage of that? And the kind of asset liability management actions that we undertook in 2014, we did just that. We took £600m of credit risk out of the Heritage With Profits Fund, we brought into the shareholder environment, collaboration between Jonathan and the guys in the UK business working with their colleagues in SLI they reinvested that at much better yields creating value for the shareholder. And how did they do that? Well they did it by utilising that capital that is being driven from our fee based business. And we are always looking, subject to market conditions and pricing for ways to make that work harder.

So we are well capitalised under Solvency II. The headline ratio I believe does not tell the true story and I think one of the challenges that you as analysts and investors are going to have over the coming months is trying to unpick the different story from one insurer to another as to what the headline ratio really means. As we worked out how to tell today's story we realised that we think the nature of our business and shape of our balance sheet does not look like other peoples. The way we have capital at SLAL that we don't recognise at Group, does not look like other peoples. So I guess my request of you all is that you don't take the easy option and just look at the 162%, you get behind the numbers and you conclude as we have, that we think we are very well capitalised.

That's all I was going to say. I will now sit down and happy to take questions and answers. If it is an easy one I can do it, if it is not I have the real experts with me. Thank you for listening.

<u>Question and Answer Session</u>

<u>Question 1: Andy Hughes, Macquarie</u>
Hi, Andy from Macquarie. Basically a quick question about the pension scheme. Obviously you are closing the pension scheme to future accrual which will be positive for the surplus presumably. Does that affect the IFRS surplus and is that already in these numbers and does that further change this balance sheet disclosure?

Luke Savage
Given that Steven was at the heart of all those changes I am going to pass that one straight over to Stephen to answer.

Answer: Stephen Percival
Yes the defined benefit scheme is a career average scheme and closing it to future accrual is not going to change the accounting surplus or the funding surplus in the scheme.

Further question: Andy Hughes

It won't change the funding surplus in the scheme?

Answer: Stephen Percival
No it won't. It is a career average scheme and the benefits accrued to date will not be impacted by it.

Further question: Andy Hughes
But the actuarial valuation would presumably change?

Answer: Stephen Percival
No it would stay the same because it is career average.

Answer: Luke Savage
At any point in time the actuarial valuation takes into account what has happened in the past. It kind of almost assumes that everybody leaves today in a way. What it doesn't do is say well because Stephen was in the scheme and he doesn't look like it, but he has probably got another 20 or 30 years to go, he is that young. What it doesn't do is assume that he will stay in it and therefore project another 20 years of contributions. It is based on contributions up to this point.

Further question: Andy Hughes
And the second question was the question I asked before about M&A, so doing M&A using the £1.2bn, why can't you? You have answered the question about using annuities and you could use this to actually sell annuities or do a deal with the heritage with profits fund. But presumably you could use it for M&A as well, right. So you could buy another business using the surplus capital you have with the operating company, instead of the holding company. And I am not sure how I should view the Group's holding company's surplus position. Or whether I should look at this and say this is where you will do the M&A and the holding company stuff is free for shareholders? Thank you.

Answer: Luke Savage
I guess the way I would answer that question is to come back to the point I made earlier. We have got a total of £6.7bn of regulatory capital, but you can't do M&A deals based upon a transitional or VIF, it is not physical assets sitting in a bank. Which is why we focus on what is the amount of tangible assets we have because that is what you can use to fund M&A. There are people who sit there and say, if you have got all this VIF and the VIF is in effect the present value of the future fee business, can't you monetise that? Well you can, but that is going out and raising leverage and you could do that anyway, whether or not you want to call it VIF.

Further question: Andy Hughes
And a further question on cash flows. So you said that the cash flows going forward are kind of going to be like the IFRS profits which is pretty obvious because you have this distributable profit restriction, but would you be telling us what the actual economic benefit, i.e. how the £1.2bn is developing over time? Is the £1.2bn growing

basically as a result of the VIF you are adding, be more than the IFRS profits? So actually should we see this £1.2bn number growing over time for Standard Life because there has been more VIF added than actual IFRS?

Answer: Jonathan Pears
Actually when you look at it, it is probably fairly stable. What is happening is that VIF is being converted into IFRS profit which increases the distributable reserves, that they goes up to Plc as dividend and presumably out of the Group and so on. But as we write new business that then replenishes the £1.2bn. So in a kind of central scenario, actually it is a relatively stable position. Of course the £1.2bn moves with market movements as you see from the graph, but in terms of the business development, it is a pretty stable position, both on the distributable reserves and on the kind of capital within SLAL which isn't available to Group.

Further answer: Luke Savage
That is kind of a steady state situation. At the same time, if you assumed that we are going to continue to grow the business, then the amount of VIF on the balance sheet would grow as a function of the overall scale of the business growing obviously. I am looking to Jonathan?

Further answer: Jonathan Pears
If you grow lots of VIF then it will get bigger similarly if you didn't it wouldn't.

<u>Question 2: Trevor Moss, Berenberg Bank</u>
It's Trevor Moss from Berenberg. What is the reason for the low level of distributable reserves in Standard Life Assurance? Is that going back to the old mutual status, is that relevant?

Answer: Luke Savage
I don't think it is a particularly, it is actually quite a healthy distributable reserves position. You might find that companies distributable reserves are actually quite low relative to the profits they have generated in the previous years. We have actually got a fairly substantial £1bn distributable reserve position and part of it being a special reserve that was a function of the demutualisation. The particular issue we have is about then how much of SLAL surplus is available to Plc. And because of our relatively simple structure where you have got one insurance company with nearly all of the Solvency II interest within that insurance company, you know ideas of obviously being able stuff available by selling businesses, isn't something that is available to us. So our easiest way of demonstrating that money is available to Group is to say, actually you could distribute the full distributable reserves. But actually it is a healthy distributable reserve position.

<u>Question 3: John Hocking, Morgan Stanley</u>
It's John Hocking from Morgan Stanley, I have got three questions please. Just to clarify, the distributable reserves you are talking about are the Company's Act definition? And why are you talking about that rather than specifically the 9 month test that is Solvency II? Is the first question.

And secondly, the distributable reserves which are the constraint are these the SLAL distributable reserves, presumably not the Group ones?

And just finally, sort of taking everything together, the fee based business, you always have the advantage of creating capital when you write it, would you be better off with this business in or out of the Solvency II Group and are there any bits of the business with fees on platforms for example which are outside of the Solvency II Group? Thank you.

Answer: Luke Savage
I will take the last bit, yes there is lots of fee based business that is outside the Solvency II calculation. The obvious one being Standard Life Investments. So Standard Life Investments is over half our profit. But it does not fall into this regime, it doesn't create VIF. Now if we were in the business of trying to manufacture regulatory capital, then the answer is well write more business through SLAL and not less.

Further question: Jon Hocking
But are there bits of this life book like the group pensions book, do any of those fee streams sit outside of those Solvency II Balance Sheet or not?

Answer: Stephen Percival
The kind of main bit that would be outside Solvency II would be for example our mutual fund business that we write through our Wrap platform, that would be outside, but the core sort of retail and workplace business that we talked about earlier that is all within Solvency II.

Answer: Jonathan Pears
The 9 month test, yes so we do the 9 months test. We think we can make things available within 9 months. The issue then is can you get it to Plc? So you actually have to look at legal and regulatory constraints as well as availability within the 9 month period. And yes it is SLAL distributable reserves we are talking about rather than the Group.

Question 4: Gordon Aitken, RBC
Gordon Aitken from RBC. Just three questions. On the £1.7bn of equity that you talked about, I mean you seem to be quite positive about that slide and that number. It seems to me quite a low number relative to the market cap of the Group. Maybe that is just because I am thinking about other insurance companies and the multiples that they typically trade on. Are you thinking it is a good number because of asset management businesses where you are more similar to those these days?

Second question is on the pension fund. You said like a £0.9bn to a £0.6bn move, that would be a 1 in 200 year event. That seems like a really, like a normal move in any year. I am amazed that the 1 in 200 year isn't much more extreme than that, but if you could just explain that? Maybe it is just so tightly matched, I don't know.

And the third thing is, just on persistency, it seems quite key what the persistency assumptions are, I know there are different products and different persistency assumptions, can you just give us a feel for what those persistency assumptions are and which you are including in this model?

Answer: Luke Savage

Shall I just take the first part of that. The £1.7bn, all I was trying to illustrate there is actually you shouldn't be thinking about in terms of the £6.7bn of regulatory capital, the £4bn also includes items which aren't real shareholder money. So it is just trying to unpack the idea that the number, the amount of real cash that we are working with that is invested on behalf of our shareholders, it is just very different from anything you see in the books. So I wasn't trying to get people to latch on that to any great degree. Of the £1.7bn we have £1.1bn of that up at the Group level. So we are, we think, efficient in keeping the majority of the tangible shareholder equity up at Group where it can fund India, where it can underpin the dividend, where it can give us that optionality.

Further Answer: Stephen Percival
You asked about the stress on the pension scheme. Our pension scheme is invested in a GARS fund. And also has cashflow matching around it. And I think the very well diversified nature of GARS is reflected in the impact of the stress on the pension scheme.

Further answer: Luke Savage
And I think the other point to add on that is that we are not saying that the worst thing that could happen to the pension scheme in isolation is a £300m loss. When you look at it as I say, in reality your 1 in 200 event is a combination of things happening together. You refer to is as the biting scenario, the permutation of events that happening at any one time that creates a 1 in 200 event for the Company as a whole. And it is at that biting scenario that you see £300m come through. If you were to look at the pension scheme purely in isolation and try and come up with a 1 in 200 event for the Group, I am not sure if you could do with the pension scheme, I don't know.

Further answer: Jonathan Pears
In theory you could, but it is the incremental impact of the pension scheme on the SCR that counts in this.

And the final question I think was on persistency assumptions. So I mean these are basically it is the same assumptions that were effectively underlying our embedded value when we used to report embedded value. So there is nothing, the same processes and challenge around those assumptions as before. In terms of the stresses, I think we gave the stress to the long-term rates, just due to mis-estimation is both a strengthening and a reduction of persistency rates of 50% and then on aggregate about 31.5% going off in one go. Now that obviously varies between type of product where you have life bonds with a much higher off rate and then pensions which will be a bit more sticky.

<u>Question 5: Oliver Steele, Deutsche Bank</u>
Oliver Steele, Deutsche Bank. In view of the multitude of different balance sheet measures that you have shown us, how do you assess your debt leverage?

Secondly, can you just give us a little more detail on the sensitivities? You have given us 20% equity fall, would it have been materially different at 40%? You have given us 50 bps credit spread widening, what about 100bps?

And have you sort of tested yourself against a combination of all these events like most of your competitors for instance, who have been giving us what would have happened in the credit crunch?

Luke Savage
Steven do you want to take the leverage route and then talk about how we stress the surplus.

Answer: Stephen Percival
So leverage on an IFRS basis is 26% at the year end. And that is a level that we are comfortable with – obviously versus any kind of rating agency constraints, we have headroom against that level.

Further answer: Jonathan Pears
Yes so in terms of stress testing, we obviously do a wide range of stress testing. In terms of SLAL in deciding what is the right level of capitalisation within SLAL we are looking to first of all the plans that we have in terms of the use of the VIF and so on but then we also look at scenarios like the credit crisis at the same time as the impact of the low yield environment. Similarly a very low yield environment stress and also a high inflation stress. And we are satisfied that you know when we decide on the distribution to Group, it is around looking at the position under those scenarios to ensure that we are comfortable that we have a robust and sustainable business under those scenarios.

Further Answer: Luke Savage
So for example what we would want to do is we would want to be able to go through the likes of the financial crisis and be in the depths of that against a current low yield environment and still know that we are well capitalised and not going to find ourselves struggling to trade forward because we have seen that surplus destroyed.

Further question: Oliver Steele
You don't want to give us a figure for what the surplus might have fallen to in theory?

Answer: Luke Savage
We are not disclosing that, no. But we do actually have some questions that have come through online from Greig Paterson, if I could kick off a couple of those.

<u>Question 6: Greig Paterson [Online question read by Luke Savage]</u>
The pension fund, did the restrictions on the pension fund surplus have something to do with the IAS19 IFRIC14 restrictions? I think the short answer is no. It is just a function of the way the Solvency II calculation works that you bring in the requirement at the 1 in 200 biting point and then you only recognise the degree of the surplus and that is just a function of the rules.

There are two other questions. The Heritage With Profits Fund on a solo level what was the own funds and what was the SCR? I don't think we have put that into the public domain anywhere. And again off that he was saying how much of the VIF is coming from the Heritage With Profits Fund? And again we have disclosed the total VIF, we have disclosed the total transitionals. What we haven't done but we can give some thought to going forward, is whether we should provide more granular disclosure around that.

Back in the room.

<u>Question 7: Andy Sinclair, Merrill Lynch</u>
Thanks, it is Andy Sinclair from Merrill Lynch. Three questions and one request if that is okay. Firstly my three questions are kind of all trying to get around what you think is a suitable level of capital. And it feels that on a regulatory basis, on a Solvency II basis you are kind of looking at the kind of 197-198 number as where you consider yourself to be. Is there a range on where you want that to be longer term?

Then again I am sure you will point me towards the hold-co numbers as what you consider to be genuinely excess, what do you consider to be a sensible range for that to be sitting in? And that is linked to my question earlier about what you consider a sensible dividend buffer?

And then my third question would be, we've discussed M&A in a few questions around the room, what do you consider to be your fire power for M&A?

Answer: Luke Savage
Okay so in terms of a solvency ratio, one thing we want to try and get out of today's session is that thinking about it as a ratio, we don't think adds any real value. It is how big is that surplus in monetary amount and how sensitive is that surplus? And importantly, is that surplus that you can really do anything with or is it just surplus that exists in a Solvency II balance sheet? Internally when we think about capital and we are looking at things that could happen in terms of stressing the balance sheet, we look against a whole number of moving parts. One is what does it do to regulatory capital? But importantly what does it do to tangible assets and physical cash? What does it do to IFRS earnings? So that Solvency II capital erosion is just one of a number of metrics that we look at which isn't a binding constraint on us.

For the reasons around things like the gross-up because of the dilution impact of Heritage With Profits and pension scheme, you know putting out a ratio and a target ratio I think is kind of meaningless. If we grow our fee based business then this surplus goes up. But it is VIF it is not tangible cash. If we had a £2bn or £3bn pension scheme surplus, and the pensions trustees decided they want to take more risk appetite, then the £300m would go up, the amount we would bring in would go up. The dilution effect would be bigger, but again it makes no difference whatsoever to the real capital that investors have entrusted to us that we have exposed. And that is why looking at that headline ratio we just think is the wrong measure. And is why we certainly wouldn't want to put out any kind of target range, it is just not a constraint.

In terms of the holding company, the £1.1bn we have there. You could, if you remember from the graph that I showed earlier, it has been in the kind of high hundreds for some time now. Once we have gone through the completion of the Indian stake increase, it will come down to about £0.9bn, it will be very much in the range we have been at. In terms of what that does, as I said, it gives us the ability we believe under both stress and severe stress scenarios to maintain our progressive dividend policy over a number of years and it gives us optionality. What we are not in the business of doing is saying, here is how the £1.1bn breaks down, it is X hundred for this, X hundred for that, X hundred for something else.

What I would say, and again I said it earlier, is if that any point in time we think we have got more capital there than we envisage being able to put to work to drive improved shareholder returns then we would, as we have done in the past, look at some kind of capital return.

Was there a third part I had missed out there?

Further question: Andy Sinclair
Just looking at how much fire power, what do you think is the biggest M&A transaction effectively you could reach for?

Answer: Luke Savage
Well then you know, what I would say is that as well as surplus that we have at that Group level within the £1.1bn that gives us optionality, as Stephen said, we have got 26% leverage so we have capacity there to increase fire power if something came along that were appropriate.

Further question: Andy Sinclair
One final request. The breakdown by business unit level that you have given, could you please give that on an ongoing basis, that would be much appreciated?

Answer: Luke Savage
Sorry?

Further question: Andy Sinclair
The disclosure by business unit level for the capital requirements and surpluses, if you could give that on an ongoing basis that would be much appreciated.

Answer: Luke Savage
Okay, we will take that request on board.

<u>Question 8 : Andy Hughes, Macquarie</u>
Andy Hughes from Macquarie. A couple of other questions based on slides 12 and 13, just trying to compare the two slides. I guess the numbers that jump out at me on slide 12 are the fact that you have got 9% of your required capital which is about £300m, relates to sovereign debt and you only have £9bn of annuity assets. You must think the UK Government is not a great credit risk. So could you basically, and also on the annuity side you talk about having 32% of your risk for £9bn of annuities

which comes to about 10% for the SCR in terms of annuity reserves. I mean do you think you are using a basis that is much more conservative than your peer group or do you think this is par for the course? And does this include the longevity swap? Is that why it is relatively high even after transitionals.

Luke Savage
I think they are all questions for Jonathan.

Answer: Jonathan Pears
Yes I can answer those. In respect of the sovereign debt, this arises from gilt-swaps basis risk. So you know I think personally in our economic capital view, we wouldn't view gilt-swaps basis risk as being a sort of genuine risk to customers. So it is not saying we have lack of faith in the UK Government. Nearly all of that 9% sits within the bit which is the With Profits Fund gross up rather than being in the genuine kind of rest of company shareholder part of the balance sheet.

In terms of the credit risk, I think as Luke said in the presentation, about a third of the credit risk again comes from the gross-up. That then leaves I think about £850m or so again in the rest of company. And there are a number of things that contribute to that. It is not just the annuities, there is also assets backing shareholder free surplus, which some of which is invested in credit assets which does not benefit from the matching adjustment so therefore gets a disproportionate capital compared with annuities. And also things like reinsurance recovery risk, external fund links. So there is quite a big bucket in credit, so I would not put it all down to annuities.

In terms of the reinsurance between the Heritage Fund and the Proprietary Business Fund, it does reflect the credit risk on the bits where we have actually moved the assets through, but it does not really reflect the bit on the residual because that is within the With Profits Fund and invested in Government Bonds, hence the gilts-swaps risk.

Further question: Andy Hughes
I was thinking more about slide 13 where you show 32% of the capital requirement in respect of about £9bn of annuities which looks like it is about £1bn on £9bn liabilities i.e. 10% and so is that a reasonable number for annuity portfolio or is that distorted.

Answer: Luke Savage
I don't think we are in a position to comment on how the capital that we put up for our portfolio compares to others. I think you need to ask others how they arrive at their figures.

Further question: Andy Hughes
I am just curious as to whether other people would have a lower capital requirement and you put a buffer in here basically because it is not a core business of yours?

Answer: Jonathan Pears

No we are satisfied with where we have ended up with the strength of our internal model stresses for the things that feed into that business.

Further question: Andy Hughes
But the expenses and persistency don't show up on your chart very highly in terms of the mix on Slide 13 sorry Slide 12. Persistency is only 6%. And even though you have got quite a high fee business and expenses. So if you were to cut the expenses or grow the business, would the capital grow significantly or much higher than implied by these charts basically?

Answer: Jonathan Pears
These charts are post diversification so persistency risk is correlated to other risks. But it is not hugely strongly correlated to the market and credit risk which makes up a large element of the diversified capital, part of this is effectively diversification against longevity and market risks which makes it a small proportion. Obviously if we do grow the VIF very significantly then persistency risk does grow over time.

Further answer: Luke Savage
And if I could just come back and add a comment about the capital against the basis risk between governments and swaps. One of the things a lot of people were pushing us for over the past 12-18 months is what is the ratio going to be? How much capital are you going to need to tie up? And we are very, very steadfast in saying, we are not going to talk about it until the plane lands, because there are just too many moving parts. And this is an example of something where in the middle of last year, about summer last year, all of a sudden out of the blue this whole concept of sovereign credit risk gets thrown into the equation. So with hindsight, I am actually very comfortable with the fact that we have not said a lot until today. But hopefully today as you can see, we are trying to be very transparent about what we are doing now.

<u>Question 9: Oliver Steele, Deutsche Bank</u>
On diversification have you shown us what the gross of diversification total capital requirement?

Answer: Luke Savage
No we haven't.

Answer: Jonathan Pears
There's a sense in which it doesn't really make sense to talk about a gross of diversification because it depends how many buckets you split your risk up into. So what we do is we simulate over many, many scenarios what happens to our capital position and take the 99.5th.

<u>Question 10: Ashik Musaddi, JP Morgan</u>
Hi, Ashik Musaddi from JP Morgan. Just a couple of questions. First of all Luke you mentioned that £900m is the cash buffer where you are comfortable with as this was

in the case in the past as well. However if I remember correctly, I mean in the past you had a massive Canadian business with massive duration mismatch with the big credit risk exposure, as well as the outlook for annuities business in UK was still positive. I mean would you agree that the risk has gone down materially in your business units now compared to what was the case in say 2012/13/14? I.e. you actually don't need to hold £900m of buffer at the holding company. Would you agree with that comment?

Answer: Luke Savage

I guess what I would say is that you know Standard Life has always capitalised each of their businesses in their own right. So yes Canada represented a significant amount of spread risk for us. But at the same time it had capital that enabled it to operate with the risk levels it was taking within the Canadian entity. So that did not have a direct impact on the amount we felt we needed to hold at the centre, other than at the margin.

Further Question: Ashik Musaddi

Secondly, I mean if you think about your hard capital, the way you describe £1.7bn as equity, £1.5bn is debt which is still like hard capital in some sense. So you have £3.2bn capital. Is it fair to believe that as annuities portfolio roll over because it looks like you are not growing annuities book any more, you don't need this much hard capital because if I look at for example Hargreaves Lansdowne, they have a hundred billion of AUA on the balance sheet and they have got £200m of capital so how do you think about like the structure of the business at the moment and how it will look like as annuities roll over. The thing I am trying to understand is, is it possible for you to release this capital, be it debt release, be it equity release, over time or do you still need to hold this much capital even in that scenario?

Answer: Luke Savage

I think you are absolutely right, over time the annuities book will run down, over time the transitionals that go against that will run down. In terms of the hard cash underlying it, you know that will again move over time. One of the things we are trying to get that we are working on at the moment now the dust is starting to settle, is we are looking at projecting out into the future in order to make sure that we continue to hold the right amount of capital in the right place. It is not something which we are in a position to go into today, but it is an initiative which Stephen is actually driving in order to project out where that requirement will shift and what if anything it will do to the amount of cash we feel we need to hold in various parts of the Group.

Further question: Ashik Musaddi

Very clear, thank you. And sorry, just one more last thing is can you give us some scenarios of where this £1.2bn will really burn through and is it related to the Heritage With Profits burn-through as well? So what scenarios I mean this may go down to zero? Any sort of hypothetical scenarios you want to give?

Answer: Jonathan Pears
First of all it is worth saying that anything that moves SLAL's IFRS distributable reserves of course immediately affects the Group ratios, so things like changes in longevity assumptions would do that anyway. I don't think we are going to go into specifics in terms of you know market events and so on. I refer to my earlier answer, we look at a range of stress tests and we are satisfied that the insurance company is adequately capitalised on that basis.

Question 11: Abid Hussain, Société Générale
Hi, it's Abid Hussain from Soc.Gen. Just a quick question on the pension scheme. I was just wondering if you have thought about purchasing a bulk annuity to remove the scheme off your balance sheet, especially given that it is in surplus?

Answer: Luke Savage
As I said earlier, we spend, not our entire life, but we spend a lot of time looking at ways that we can make the balance sheet work more effectively. And that includes looking at our pension scheme, it includes looking at the Heritage With Profits book be that annuities or guarantees. There is a whole range of things that we work on in the background, none of which I think is really appropriate to comment on in detail today.

Question 12: Gordon Aitken, RBC
Just remembering back in 2008, you reinsured, well a sell of half the annuity book to Great West, but it wasn't a complete sell was it, it was, was it not some sort of reinsurance? I was just wondering if that still reflected in the SCR in any way? That is the first thing.

Second thing is so the Heritage With Profit Fund, the Scheme of Demutualisation was quite a bit different to everyone else's in that there was, it was going to be multiple years until the shareholders are going to be asked to, just can you talk about how that benefits and what is the SCR for the Heritage With Profits Fund?

And the final thing is can you tell us what the benefit of the matching adjustment is?

Answer: Stephen Percival
I will pick up your last point about the With Profits Fund. As Luke explained in his presentation, it contributes an SCR to the overall figure but that is matched by own funds within the With Profits Fund of an equal amount and that amount is about £400m.

Answer: Luke Savage
Although that is not real exposure to the shareholder. As I also mentioned within the fee based business we do take a capital charge there for potential burn through which is very modest in the context of the total.

Answer: Jonathan Pears

Shall I talk about the Scheme and how it fits in which I think was part of your question, Gordon. So as you say the Scheme of Demutualisation includes a set of transfers to shareholders according to a formula which is set out in the Scheme. That effectively continues into Solvency II. We will be making some changes to that to update it for Solvency II, but in principle it remains the same in terms of its operation. So within the VIF that we talked about, that includes the value of those transfers from the With Profits Fund and we include in our capital requirements the burn through risk to those transfers. So that is all kind of included. So that is the real way the With Profits Fund interacts with the surplus and then there is the gross up in addition which Luke talked about. What was your first question Gordon, sorry?

Further question: Gordon Aitken
It is about the sale of half the UK annuity book to Great West?

Answer: Jonathan Pears
Yes so the reinsurance, yes that is still in place, it was a deposit backed reinsurance. So it was a single premium reinsurance, it is collateralised and deposit backed. So within credit risk we include the credit risk that arises from the collateral and effectively we stress the collateral and so on in working out the credit risk position. So it is fully included and we take credit for the longevity reinsurance.

Luke Savage
We are just about out of time. We have kept you here for three hours this morning, which I am amazed at your patience. Maybe if we just take one last question?

Question 13: Andy Hughes, Macquarie
Hi very quick question on the burn through, the point you just made. As I remember it you allocate VIF to the Heritage With Profit Fund in a stress scenario. So I am a bit surprised there is any burn through at all given you have got the £1.2bn that is written off. Why isn't the £1.2bn first get allocated to the With Profit Fund and you not have any burn through at all? Thanks.

Answer: Jonathan Pears
Well at the Group level yes, you are right, nothing will come through because of the £1.2bn which is in SLAL, But within SLAL itself, clearly within there is an effect to that. So the SCR does not take into account that Group restriction. So the Group SCR is calculated without applying any availability restrictions, so without saying the £1.2bn is trapped within SLAL. So it is in the Group SCR and the value is in own funds up to the level of the SCR then it is capped.

Luke Savage
Might I suggest you follow up on that in detail afterwards.

Thank you very much indeed everybody, I hope that has provided I would hope a great deal of transparency into our Solvency II position. I would just ask you please, please go away and look at other peoples' in similar detail, look at how their transitionals work, look at how their gross-ups and dilutions work and so on, because if you just start looking at a headline ratio you are going to get it wrong.

So thank you very much indeed for your time everybody.

End