Institute and Faculty of Actuaries

Cash, capital and returns – how Solvency II impacts the investor story

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The insurance investor story to date

What are investors looking for?

Returns

Growth

Sustainability

No dilution risk

- Progressive dividends

Supported by

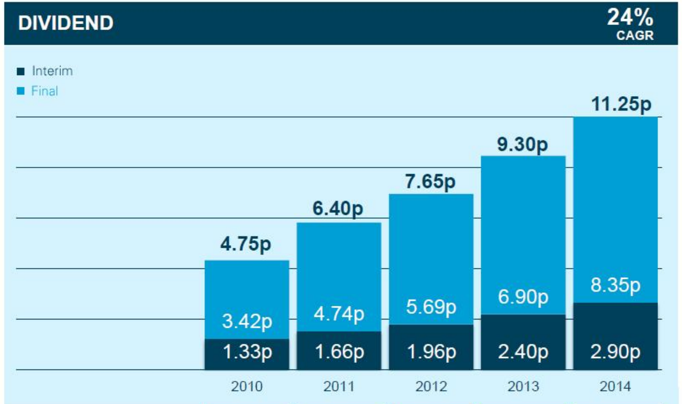
- Earnings
- Cash generation

Unconstrained by

- Capital adequacy
- RoE

Delivering on the ask (1): L&G

Full year dividend up 21% to 11.25p



	2010	2011	2012	2013	2014
NET CASH (£m)	760	846	865	1,002	1,104
DIVIDEND (£m)	279	375	452	550	668
DIVIDEND COVERAGE[1]	2.72	2.26	1.91	1.82	1.65

1 Dividend coverage based on net cash generation.

LEGAL & GENERAL GROUP PLC | YEAR END RESULTS | MARCH 2015

MARK GREGORY: GROUP CHIEF FINANCIAL OFFICER 8

Consistent delivery: strong results

Growth

	2014	2013	GROWTH
Annuity assets (£bn)	44.2	34.4	28%
LGIM assets (£bn)	708.5	611.6	16%
LGAS savings assets (£bn)	124.2	113.4	10%
UK protection and GI gross premiums (£m)	1,784	1,701	5%
Direct investments (£m)	5,703	2,879	98%

Earnings

	2014	2013	GROWTH
Operational cash generation (£m)	1,101	1,042	6%
Net cash generation (£m)	1,104	1,002	10%
Operating profit (£m)	1,275	1,158	10%
IFRS profit before tax (£m)	1,238	1,144	8%
Earnings per share (pence)	16.70	15.20	10%

Capital

	2014	2013
IGD surplus (£bn)	3.9	4.0
IGD coverage ratio (%)	201	221
Economic capital surplus (£bn)	7.0	6.9
Economic capital 1-in-200 coverage ratio (%)	229	251
Return on equity (%)	16.9	16.1

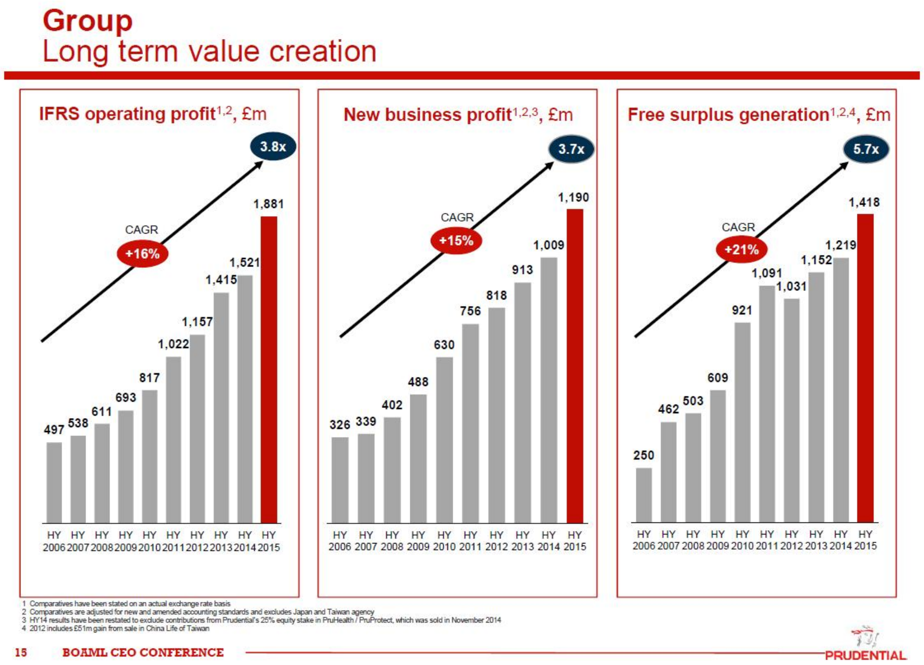
LEGAL & GENERAL GROUP PLC | YEAR END RESULTS | MARCH 2015

Source: company presentations

Delivering on the ask (2): Prudential

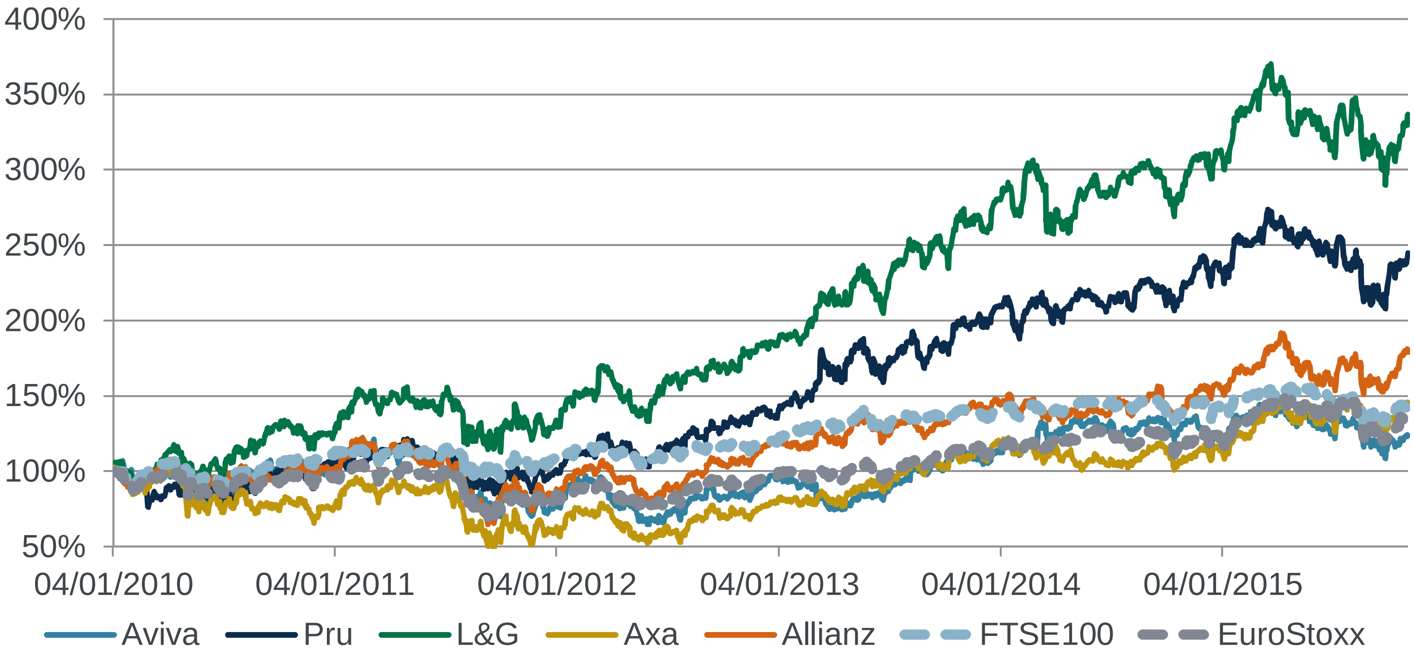
2014 full year financial headlines
Strong performance on all key metrics

	£m	FY 2014	FY 2013	Change CER[1] (%)
Growth	**IFRS operating profit**	**3,186**	2,954	+14%
	New business profit[2]	**2,126**	2,082	+10%
	EEV operating profit[2]	**4,096**	4,204	+4%
Cash	**Free surplus generation**	**2,579**	2,462	+9%
	Dividend per share[3] (pence)	**36.93**	33.57	+10%
Capital	**IGD** (£bn)	**4.7**	5.1	
	EEV per share (pence)	**1,136**	971	+17%
	Economic capital ratio[4] (%)	**218**	257	



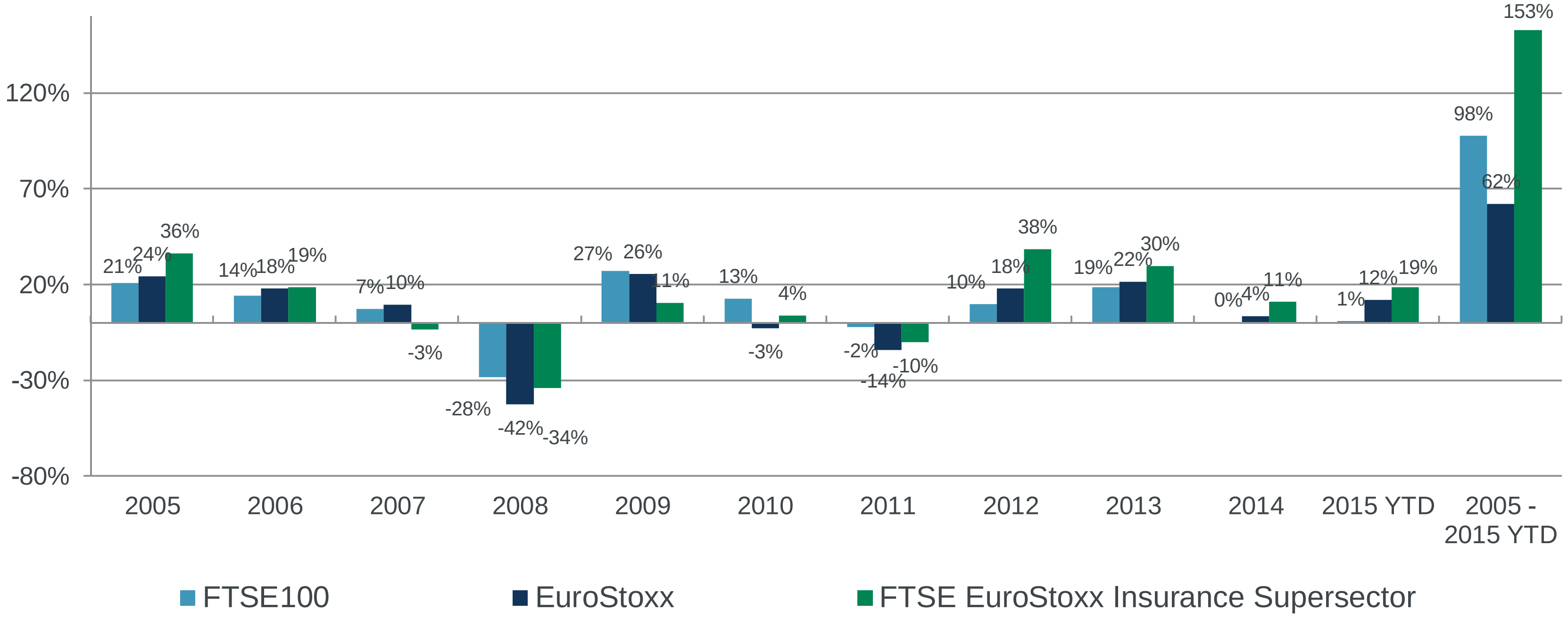
Source: company presentations

Translating into stock specific outperformance



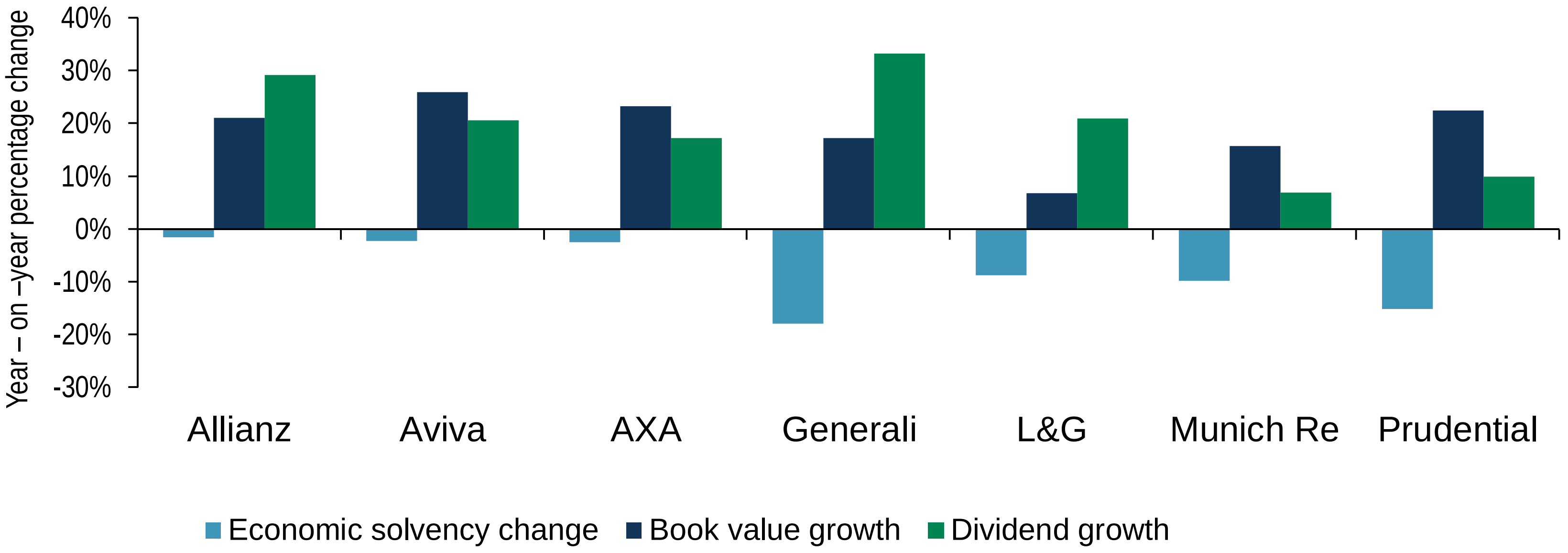
Source: Bloomberg

Sector as a whole has also benefitted



Source: Bloomberg, EY analysis

Do the 2014 results represent a high water mark?



Source: Company results, EY analysis

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How Solvency II challenges the story

Questions raised on the investor story

• Progressive dividends	Do dividends need to be rebased?
Supported by	
• Earnings	Pressure from low growth, low yields
• Cash generation	Capital generation in Solvency II?
Unconstrained by	
• Capital adequacy	What's the new rule of thumb?
• RoE	Can insurers earn their cost of capital?

Top-line growth is anaemic

Growth ratios (2010-14)

	Aegon	Allianz	Aviva	AXA	Generali	Old Mutual	Prudential	Zurich	AIG	Metlife	China Life	QBE
Revenue growth ratios 2014												
5-y CAGR	(1.2%)	3.5%	(3.7%)	0.7%	(0.7%)	(6.0%)	6.0%	1.7%	(4.8%)	8.8%	3.4%	5.5%
y-o-y	1.2%	10.4%	25.5%	0.7%	5.2%	(21.9%)	14.8%	0.7%	(6.5%)	7.5%	5.5%	(6.2%)
3-y avrg	1.4%	7.2%	2.9%	1.0%	1.4%	(11.6%)	5.5%	1.5%	(4.9%)	3.8%	9.0%	(6.7%)
Gross written premiums (GWP) growth ratios 2014												
5-y CAGR	(1.5%)	1.9%	(12.1%)	0.4%	0.7%	(1.9%)	8.6%	2.3%	(4.8%)	9.6%	1.0%	4.6%
y-o-y	(0.4%)	2.5%	(8.3%)	0.9%	6.9%	(13.3%)	7.6%	0.2%	(0.7%)	3.8%	1.4%	(9.1%)
3-y avrg	2.1%	1.2%	(2.2%)	1.0%	3.6%	(7.0%)	6.2%	0.8%	(1.2%)	1.5%	1.3%	(5.8%)
Business operating profit (BOP) growth ratios 2014												
5-y CAGR	0.3%	6.0%	1.8%	7.5%	2.5%	4.0%	14.9%	(1.2%)	(14.5%)	16.4%	(1.0%)	(10.9%)
y-o-y	(3.2%)	3.3%	6.1%	4.7%	10.7%	(0.4%)	7.9%	(0.9%)	12.1%	4.8%	37.8%	27.7%
3-y avrg	0.2%	5.6%	6.2%	11.5%	6.3%	(0.2%)	12.5%	6.8%	118.1%	7.8%	103.0%	(2.8%)
Net income growth ratios 2014												
5-y CAGR	(7.3%)	6.1%	(2.5%)	16.3%	(2.1%)	n/a	13.7%	4.4%	(11.5%)	24.2%	(1.0%)	(12.8%)
y-o-y	38.4%	4.1%	(19.2%)	12.1%	(13.5%)	(13.3%)	64.6%	(2.0%)	(17.2%)	86.7%	30.0%	(407.0%)
3-y avrg	(5.2%)	9.1%	(22.9%)	11.3%	231.9%	(23.4%)	13.4%	2.6%	64.2%	117.9%	75.9%	(269.1%)

Source: Company results, EY analysis

Question 1: what is the min. acceptable S2 ratio?

- Few datapoints
- Sample bias to stronger names
- Legacy of existing disclosures
  - S1: rule of thumb 175-200%
  - EC: most large groups >200%
- Opening balance sheets still being negotiated
- Group vs sub. solo ratios

Dividend policy

Allianz

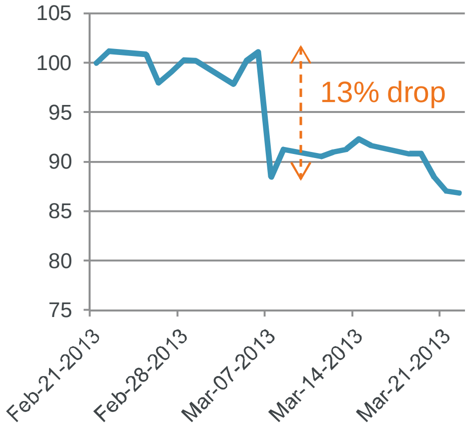
The dividend policy is subject to a sustainable **Solvency II ratio above 160%.**

Storebrand

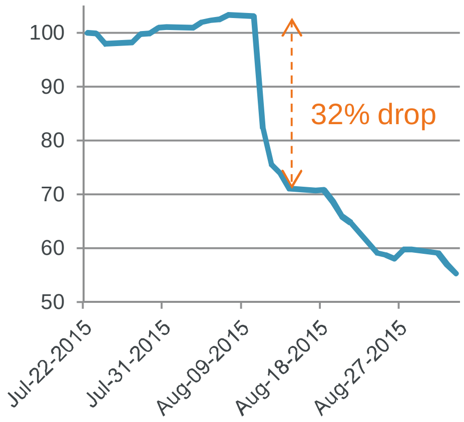
The target is a Solvency II margin of at least 130 per cent, including the use of transitional rules

Why investors worry

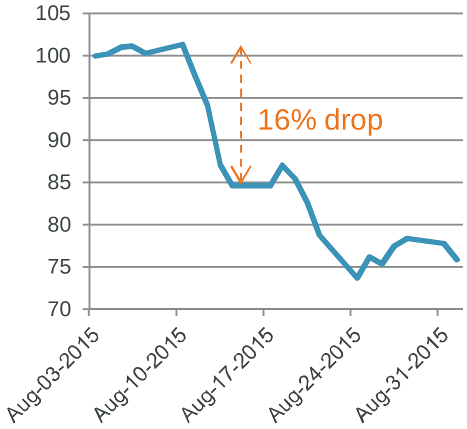
Aviva cuts its dividend at FY 2012 results



Delta Lloyd indicates S2 ratio < 140%



Aegon rebases S2 range to 140-170%



Devil is in the detail

Methodology

- Internal model vs standard formula
- Consolidation vs D&A vs mixed
- Third country equivalence

“Soft” capital

- Transitional provisions
- Ultimate forward rate
- MA / VA
- VIF

Fungibility

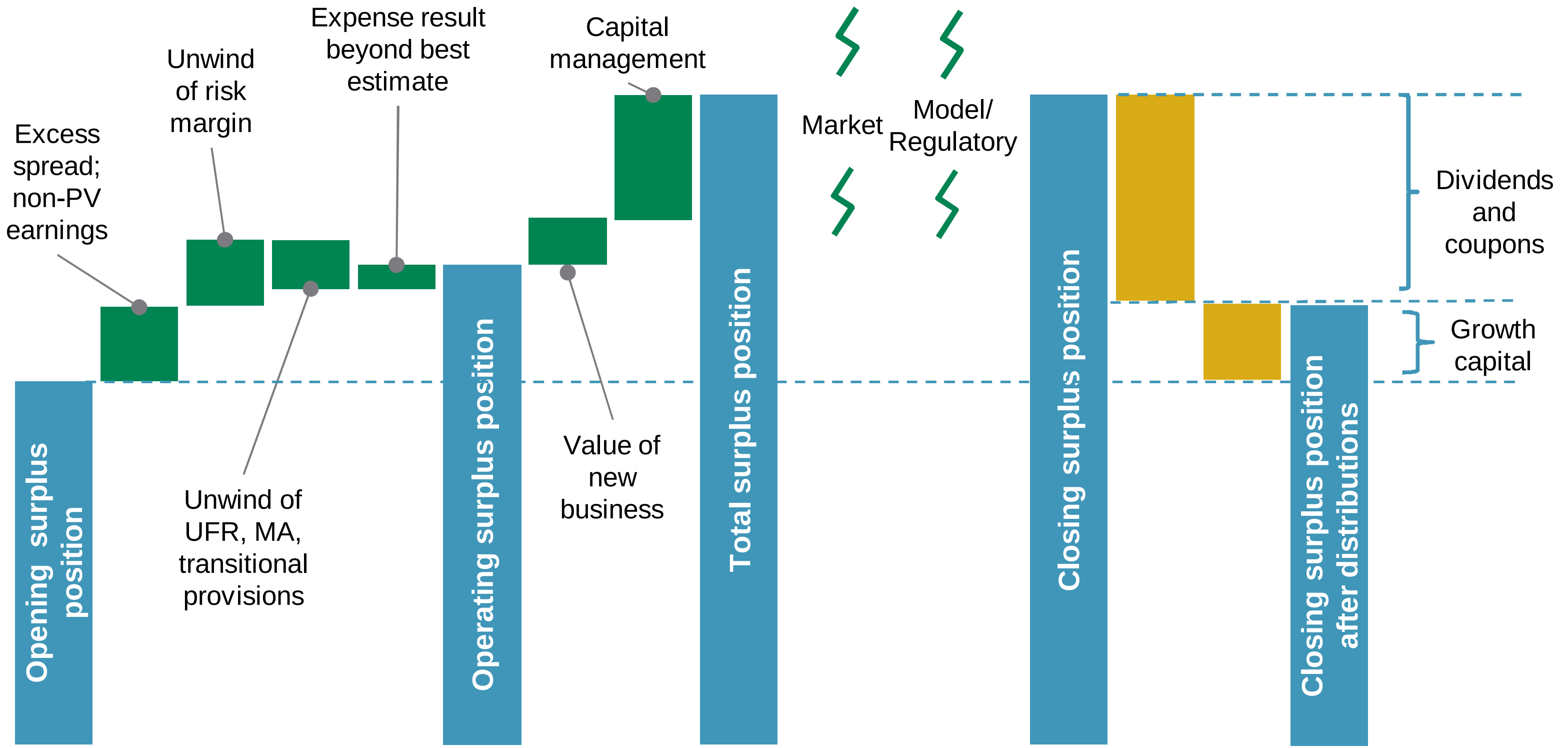
- Own Funds must be available within 9 months to support risks elsewhere in the group
- MA portfolios, ring-fenced funds

Question 2: are dividends sustainable?

Necessary conditions for dividends to be paid:

Accounting earnings	• Need for distributable funds • Investors focused on dividend cover
S2 capital generation	• Free surplus generation in excess of opening capital position
Liquidity	• Central liquidity to finance cash payment • S2 own funds are not necessarily cash

Capital generation in Solvency II



Further reflections

PV vs accrual

- Trade off between day 1 capital and capital generation
- How is VNB measured (and tracked)?

Adding value

- Ongoing search for yield
- Cost savings drop to the bottom line
- Capital management will become a core competency

Volatility

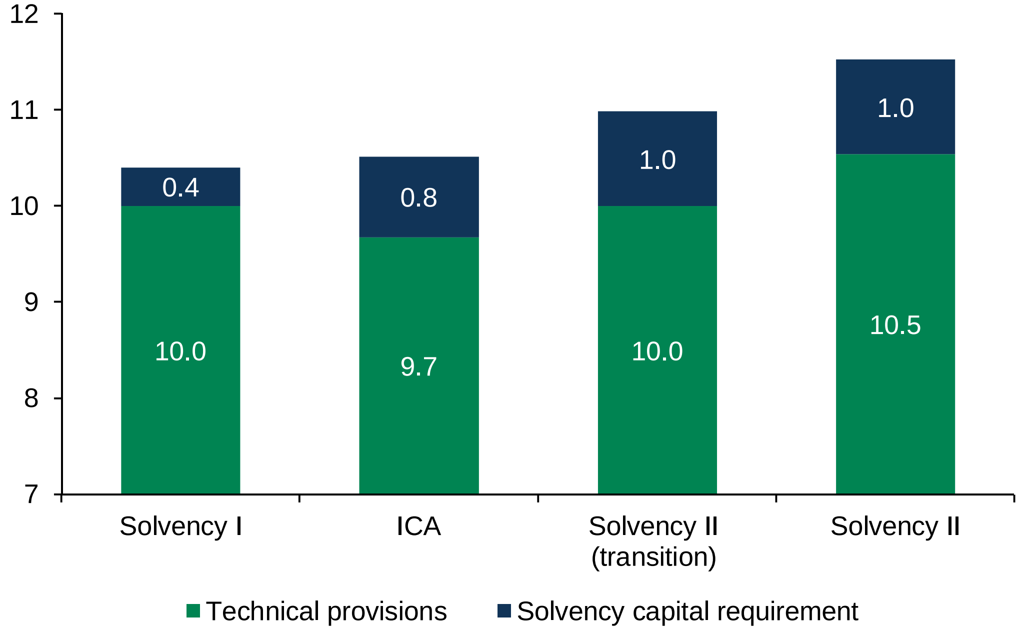
- Now matters – can't be taken below the line
- Not fully understood
- Explicit view needed on cost of, and appetite for, it

Question 3: can insurers generate ROE > COE?

In-force portfolios	• Significant increase in capital requirements for guaranteed life
Current economic environment	• Low growth = intense competition • Low yields further drag returns
Cost of equity	• Will expected S2 volatility increase beta and therefore the cost of capital?

UK annuities: a case in point

- Significant increases in capital deployed, especially when risk margin is included
- Transitionals soften the back-book pain but drag future returns
- Ability to re-price new business is unproven



Source: EY estimates using a representative annuity portfolio of £10 bn Solvency reserves.
Solvency II technical provisions include matching adjustment and risk margin.
Capital requirements shown at 100%.

Disclosure and metrics

Pillar 3 will disclose far more than currently

May 17	June 17	Contents of Annual Public Solvency Financial Condition Report
Solo	Group	Market consistent balance sheet
Solo	Group	Premiums, claims and total expenses by line of business and country
Solo		Technical provisions life summary per line of business
Solo		Technical provisions non-life summary per line of business
Solo		Non-life loss triangles gross claims paid and gross undiscounted best estimate reserves
Solo	Group	Impact of Long Term Guarantee Measures and transitional provisions
Solo	Group	Own funds – including variation over period analysis
Solo	Group	SCR Standard Formula, Partial Internal Model, Full Internal Model
Solo		MCR
	Group	Entities in scope of the group

Existing metrics being reappraised

Embedded value	• Already dropped by some companies • Investors do use aspects of EV, eg VNB
“Cash”	• Usually based on Solvency I surplus • Shift to remittance from generation
GAAP / IFRS	• Local GAAP still drives profit sharing in many continental European countries • Impact of IFRS 9 and IFRS 4 phase 2

Conclusions

Navigating into the unknown

- The sector has performed strongly, driven by strong, growing dividends underpinned by a cash generation story
- Solvency II raises significant questions
  - Capital adequacy
  - Capital generation
  - Return on capital
- Setting the right strategy, delivering against representative metrics, while communicating clearly and consistently will underpin success

Questions

Comments

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