Prudential: Full Year 2008 New Business Results
Conference call (for analysts & investors)
20th February 2009

Management team participating on call:
Mark Tucker (Group Chief Executive)
Tidjane Thiam (Chief Financial Officer)
Clark Manning (President & CEO, Jackson National Life Insurance Company (Jackson))

Duration: 01:06:41

Introduction

Mark Tucker

Good morning and welcome to Prudential's Quarter 4 teleconference. This morning I'm joined by Tidjane Thiam, our Chief Financial Officer, and Clark Manning, CEO of Jackson.

Today, as you can see from the figures this morning we have a very good sales performance across all our businesses and, clearly increasingly more important in this environment, we are reporting very strong capital figures. Despite the extremely challenging conditions, both in the financial markets and the world economy, which clearly have intensified significantly in the fourth quarter, the group has again demonstrated the tremendous power of its retirement focused strategy and the resilience of its operating model. We believe we have benefited from a clear flight to quality based on the trust and heritage in our brand and the significant strength of our investment performances.

The figures I will use in this presentation are based on growth in Sterling unless specified otherwise. Getting back to the figures, the group achieved headline growth in life new business of five per cent and our asset management business has achieved excellent net inflows of £4.3 billion. As you know we are absolutely committed to increase levels of disclosure with the aim of improving market understanding, comparability and real clarity on the key drivers of our business. Today we are therefore taking the opportunity of this new business announcement to provide an update on our capital position on credit and liquidity. Our IGD capital surplus is estimated at £1.7 billion and means that the group remains in a very strong position.

You will have also seen this morning that we announced an agreement with China Life Insurance Company of Taiwan to transfer to them our legacy agency book and agency force in Taiwan, subject to regulatory approval. This business, as I know you all know well, contains the legacy negative spread products written in Taiwan. On completion of this transaction, and again to anticipate a question which we expect to be in two or three months' time, there will be a net increase in the IGD surplus of around £800 million which would further improve the already robust IGD position we reported this morning. Clearly a total of £1.7 billion and £800 million (i.e. £2.5 billion) with the sensitivities that we've shown, and which Tidjane will go into later, places us in a very strong capital position. There is an IFRS write down, which has no cash or dividend consequences, of around £595 million.

To be clear we remain very excited about the prospects for a focused bancassurance and direct business in Taiwan. We have some excellent relationships in Taiwan, we have the bancassurance relationships, as you know, with Standard Chartered, with E.Sun Bank - we saw in the last half of the year, particularly the last quarter, those sales go to new levels and overall sales were around a quarter from those channels and that moved up significantly in the last quarter of the year. So we remain excited about that business. I will also talk, a little later on, about our business in Asia and the great progress that Barry and his team are making, the Asian element of our strategy clearly remains central to the group's strategy overall.

Much as I know you like listening to my dulcet tones, you'd probably much prefer to listen to Tidjane and Clark and therefore what I'd like to do now is hand over to Tidjane to discuss capital, dividends, cash, etc. before coming back to talking about the trading performance.

Tidjane Thiam

Thank you Mark, good morning. As Mark has said, the group's capital position has remained strong and robust during 2008 in what was an extraordinary year of equity market declines and volatility, falling interest rates and high corporate spreads. We entered this period in a defensive position; we have remained prudent and taken a proactive approach to managing our risks and capital base. As Mark told you, on the regulatory measures we estimate our capital surplus at £1.7 billion before allowing for the 2008 final dividend, I should say a few words about how we reach that number.

At 31 December 2008 our IGD surplus was estimated at £1.4 billion, the total economic interest of the shareholders in the future transfers from the UK with-profits fund was estimated at £1.7 billion at that date. During February, as result of an innovative structure we have developed, the FSA has allowed us to recognise £300 million of capital from that shareholders' interest in the future transfers from the UK with-profits fund into our IGD surplus taking it from £1.4 billion to £1.7 billion. There is the opportunity to recognise more of the residual £1.4 billion of shareholder interest.

I would also like to give you some sense of the bridge, because the last number we disclosed at Q3 for the IGD was £1.2 billion as you remember but had an accrued dividend. If I add back the accrued dividend it goes back to £1.4 billion. So we need to bridge that £1.4 billion which is comparable to the £1.7 billion we have given you now and it's a combination of negative movements and positive movements, which will not surprise you. On the negative side you get about £600 million for credit, part of that is strengthening the annuity credit reserve in the UK, part of that is the impairments in the US and various market movements for another £300 million which takes you to a negative £900 million. So from the £1.4 billion, which is the £1.2 billion with the dividend added back, the £1.4 billion minus £900 million you are down to £500 million and when you get the shareholder interest and the recognition of that which we have disclosed for about £300 million, it takes you back up to £800 million and then you get about £900 million and that's a combination of the forex impact on earnings, the SSAP 86 in the US (I will come back to that later) and management actions, for again a total £900 million.

So £800 million plus £900 million equals about £1.7 billion. As Mark said earlier, the agreement we have reached in Taiwan to transfer the legacy book to China Life Taiwan will give us a further £800 million of IGD surplus on completion, taking our IGD position to £2.5 billion.

In considering our capital strength, it is important to remind you that we have set aside significant credit reserves in the UK annuity business of £1.4 billion for future defaults. In 2008 alone we have increased that reserve by £800 million, so it is now equivalent to 80 basis points per annum over the lifetime of the assets. The fund could withstand a repeat of the average default experience during the Great Depression every year. Going further, talking about the key sensitivities which we have disclosed, our equity sensitivities for a 40 per cent fall in the market, from the end of 2008, is £350 million.

We have also provided today some further commentary on how we manage the equity risk in our US variable annuity book, I'm sure that Clark will be happy to talk to you about that. There are many factors that we believe differentiate our approach in the market, these include the channels and customers we target, the benefits of transparency we get from selling unbundled guarantees, our disciplined pricing and the comprehensive dynamic hedging strategies that we utilise. The proof ultimately is in the results. During 2008 our equity hedging gains more than offset the near 40 per cent fall in the S&P index on a statutory capital basis. In addition, we have actively reduced our equity exposure in Asia to manage down our global equity sensitivity.

Moving on to interest rates, we said at the interims that the main sensitivities were in Asia and in the US. The sensitivity to a further fall of 150 basis points is now £300 million versus £550 million as indicated at the interims. A major element of the US sensitivity related to a need to mark to market our hedges, during the fourth quarter we worked with our US regulator to move the statutory valuation on to an economic basis. This has eliminated some of the negative mark to markets that were impacting our IGD position because a lot of those hedges were swaps where we pay fixed and received floating and when the floating rates decreased effectively you were faced with significant negative mark to markets. The majority of the sensitivity going forward is in Asia, relating to guarantees and asset liability mismatches. However, the downside is limited as interest rates in some territories are at historically low levels. Our interest rates sensitivity is well within our risk appetite and in Asia the sensitivity will reduce further after completion of the Taiwan transaction. In the UK there is also some sensitivity to mismatches in the UK annuity book at very low levels of interest rates.

Moving on now to credit, as you are well aware the two main areas of shareholder exposure are through the UK shareholder annuity fund and the General Account in the US. So I would like to focus my comments now on these two items. In the UK shareholder annuity fund, we have taken actual defaults of £93 million in 2008 or about 0.5 per cent of the book. As I set out a few moments ago, remember that we have a £1.4 billion credit reserve in that fund to allow for future defaults so we are in a strong position. In addition, the group's exposure to Lloyds, Barclays and RBS Tier 1 instruments is £160 million.

Moving to the US where we have provided significant disclosure in the release today. The level of actual defaults in 2008 was £78 million, that is 0.3 per cent of the portfolio and the default in Q4 was £5 million. We have managed the book actively selling down bonds which we felt may come under some pressure and, as a result, we saw realised net losses of £127 million in the year and £67 million in Q4. We have also undertaken a rigorous and prudent review of every bond and security in the portfolio and impairments were £419 million for the year and £228 million in Q4.

In our view the accounting rules are not always consistent with the underlying economic reality and we would not expect to see all of these impairments result in defaults, our US team manage the portfolio very actively and, as I said, we will sell down where we think that is appropriate as we did with Lehman and Washington Mutual. Ninety three per cent of the corporate portfolio is investment grade and concentration levels are low, for instance, our top 10 holdings represent only five per cent of the portfolio and the size of our average high yield holding is £8 million, we are also well diversified across sectors.

Moving on to structured securities and the RMBS portfolio in particular, 50 per cent is agency and therefore guaranteed; an additional 25 per cent is pre-2006 vintage and has performed very well. Our exposure to the more problematic 2006 and 2007 vintages is £946 million overall of which two-thirds are in well protected senior tranches. To be prudent we have written down the remaining securities from these two vintages to a significant extent, the same base portfolio has performed well (85 per cent is AAA and we materially reduced non AAA purchases after 2004); the average credit enhancement is 30 per cent giving us excellent protection. Not surprisingly, given the movement in price observed in the US, and we talked about that at Q3, it's been amplified in Q4, with unrealised losses increased to £3.2 billion. It is important to remember that we have both the intent and the ability to hold these securities to maturity which in economic terms limits the impact of the current market dislocation.

Finally, on liquidity, we remain very comfortable with our position; we have significant internal sources of liquidity which are sufficient to meet our requirements for the foreseeable future. In addition, we have recently renewed for three years, £1.9 billion of committed banking facilities which remain undrawn.

To summarise, our base IGD surplus is strong and robust, we have a profitable business that generates capital as we go, there will be an additional £800 million on completion of the transfer in Taiwan to the IGD surplus, our sensitivities to equity and interest rate movements are low and our hedging has worked well. There is scope for further access to shareholder economic value in the with-profits fund if required. We have £1.4 billion credit reserve in the UK, the risk in the credit book in the US is containable, there remain more options to generate additional IGD capital should we need them, and therefore we feel very comfortable with our capital position. I will stop here and hand back to Mark.

Mark Tucker

Thanks, Tidjane, I am sure there'll be questions a bit later. Let me just take you briefly through the geographies. In Asia new business grew by six per cent in the year, our spread of businesses within the region from the developed to the rapidly growing markets, our broad and flexible product range and out multi-distribution capabilities have delivered underlying growth and ensured resilience in a challenging economic environment.

In the year we achieved strong growth across a number of markets, sales in Indonesia were up 45 per cent as we extended our distribution capability and launched Prudential

Shariah compliant products, the Islamic compliant products, which puts us in the number one position in both traditional and the Islamic products within Indonesia today. Malaysia was up 24 per cent, driven by higher agency activity and the continued momentum behind our Shariah products there as well. Again, we are number one in both, we heard yesterday that it was confirmed by the Life Insurance Association of Malaysia that we ended 2008 as number one in the country and we're number one both on traditional and Shariah, which is a tremendous achievement. Hong Kong sales were up 23 per cent, importantly and significantly, and certainly competitively and comparatively, we saw pretty tough conditions there but to be up at that sort of level is a tremendous performance.

Our joint venture businesses continue to perform strongly. In China we are the largest foreign joint venture in APE terms and increased new business by 31 per cent. We are the largest in India as well but the Indian economy clearly experienced some elements of market dislocation in the final quarter with very sharp declines in equities coupled with the broader anxiety caused by the Mumbai terrorist attacks and as a result the fourth quarter sales were down. Yet despite all of this and despite the tough year we were able to grow by 16 per cent for the year overall. Again, a very credible performance.

In Taiwan our sales were down 12 per cent against a tough comparator in 2007 but what we saw significantly was a strong launch of our agreement with Standard Chartered. Standard Chartered, if you remember, bought the bank Hsinchu there and the joint venture or the co-operation there' the bancassurance agreement has really begun to motor. In Taiwan we did see some competitors offering short term interest rate sensitive products and we chose not to compete in that market. We saw similar action in Korea and, again, as we said to you significantly on many occasions in the UK, we said to you in the US and we said in Asia, we're not playing the game of competing for volume not value. We're sticking hard on value wherever it is across the world.

Singapore new business was down 11 per cent, due largely to the impact of changes in the Central Provident Fund (CPF) rules, affecting the single premium market and Singapore overall, with its dependency on inter-regional trade particularly financial services, was badly effected and hit by the economic crisis in the second half. Encouragingly though, in all of that it's a key trend through the region, our regular premium business grew by 17 per cent with a significantly increased proportion of higher margin health products. On a regional basis the economic environment has had an impact on customer behaviour but we were able to respond to this change in sentiment by really emphasizing our regular premium products which grew by 10 per cent.

Understandably sales of our mainly unit linked single premium products fell in the second half of the year, however - and again it's really good news and something we've been focusing on for the last couple of years - our sales of health and protection products, which is a major growth initiative across the region, grew by 34 per cent and the with-profits product also performed well. We also saw the benefit of our multi-distribution approach based on agency and bank as well as direct sales partnerships through the region. Agency activity encouragingly remained in line so the number of cases sold in 2008 was pretty much in line with that of 2007. The case size was lower, due in part to our shift in emphasis to lower premium but higher margin health and protection, and that's material. Additionally, we were delighted to extend our partnership agreements with Standard Chartered in the region during the year.

Overall we had a very strong final quarter relative to the market benefiting from emphasis on regular premium products and tied agency. We believe that we were the leading foreign company or joint venture in seven of our 12 markets and the overall leader in four markets, i.e. number one in four markets. A tremendous position and no other company stands in that position.

Turning now to the US where Jackson achieved new business growth of seven per cent and retail sales which were three per cent ahead, again as we know, in tremendously difficult market conditions. We have referred at previous 2008 briefings to the trend towards an increase in FA sales compared with VA sales as consumers have become more risk averse in volatile equity markets. We were able to respond to that change in demand very quickly and it's important - clearly important - in these conditions to ensure flexibility in annuity offerings. For the full year FA sales grew by some 200 per cent and VA sales were down a credible 23 per cent. As well as the impact of the general market environment there was also intense price competition in the VA market, particularly through the first three quarters. But, as elsewhere, we maintain strong economic discipline and have not and indeed will not sacrifice value for volume. Having said that, in dollar terms VA sales declined six per cent in the fourth quarter but then let's look at the industry there with Jackson outperforming against an estimated 14 per cent decline in the market overall. So Jackson actually took share in the VA market in the fourth quarter. Jackson remained fourth in VA net flows through to September and overall net annuity flows were six per cent up on the year.

Moving to the UK, the UK had a very strong year both in absolute terms and relative to the market, particularly on the retail sales side. We will come out of 2008 being the best performing in terms of retail sales across the UK industry. Overall increase of four per cent, clearly including the wholesale side. Again, a very credible and good result. With-profits continue to show excellent growth in market conditions where customers are more cautious and looking for products with smooth exposure to volatile equity markets. Sales of with-profit bonds increased by 139 per cent. Individual annuity sales were in line with 2007 with new business from internal maturing pension customers growing by 14 per cent. There was also continuing growth from lifetime mortgages offshore bonds and we began to see some traction from our factory gate offering in individual pensions market where we have backed away, as you know, from up front commission sales. This time around we have included PruHealth for the first time in these numbers and in the comparatives. The business continues to expand with covered lives increasing by 32 per cent to £187,000 over the year and new business sales up 23 per cent. In the wholesale market and the wholesale business, we completed one small transaction in the fourth quarter to add to the larger Rothesay Life and Cable & Wireless transactions earlier in the year. So overall in the UK the work that Nick and his team have done has really produced an excellent result.

That moves on again to outstanding performances in our asset management businesses. The success continues to be based on strong investment performance in M&G in particular, it's one and three year track record across most asset classes is truly spectacular and we see new fund launches across our Asian asset management markets. M&G have achieved record gross inflows and £3.4 billion of net inflows of which £2.1 billion was in the retail market and £1.3 billion of institutional funds. It's worth noting with M&G, to give you a sense of the flows and the flight to quality, we saw in the last month in December 2008 record net retail sales in M&G, the highest in its 80 plus year history, which gives a sense of what defines a flight to quality. In Asia net inflows were £900 million, nearly £1 billion, into a mix of equity bond and money market funds.

So let me summarise before moving to Q&As. Overall a very good performance, both in terms of operating performance and capital in a period of unprecedented volatility. All of our businesses grew in 2008 and the group capital position, as Tidjane has described in some detail, is resilient and strong. In 2009, we will again look to balance new business with a focus on cash generation and capital preservation but we should also continue to position ourselves to take advantage of any market upturn and increasingly, as Tidjane has explained before, our focus is very much on capital, on cash, on statutory profit to ensure that we were looking at those metrics and managing against them.

Finally, we believe very strongly that Prudential is uniquely positioned to outperform over the cycle and we remain confident and committed to our stated dividend policy. Let's just move to Q&As, we will leave clearly as much time as you would like, just remember that Clark's average question time is 40 minutes so just work on that basis!

Q&A

Jon Hocking (Morgan Stanley):

(i) Could you give a little more of a breakdown of the £900 million of offsetting positive movements in the IGD? I think Tidjane mentioned FX, management actions and SSAP 86, if you could break those out that would be very helpful.

(ii) On the UK with-profits transfer, could you give us a little bit more colour about the exact nature of the structure?

(iii) Finally, on the CMBS portfolio in the US I think the sort of marks you've taken there seem a little bit less aggressive than some of your US Life peers. I wonder if you could comment on how you are valuing that chunk of assets, thank you.

Mark Tucker:
Let's move to Tidjane to take the first question on IGD, although we are limited in what we can say at this time.

Tidjane Thiam:
Effectively as I mentioned in the £900 million forex, management actions, SSAP 86 but also there are earnings - we'll have to wait a few weeks before we can give you more information there.

Jon Hocking (Morgan Stanley):
Are earnings the dominant number there?

Mark Tucker:
Jon, I think that's a great question and you know you're not going to get an answer to it. I think whichever figures we give you, you will be able to balance out; you will have to be a little patient.

Tidjane Thiam:
Yes, I've given you as much as I can today.

Jon Hocking (Morgan Stanley):
Okay.

Tidjane Thiam:
UK with-profits transfer, fundamentally it's something equivalent to a time deferred stop loss situation on the book where you remove a tranche of liabilities and set up a swap for your counterparty and get some capital recognition for that. That is the basic structure.

Jon Hocking (Morgan Stanley):
So is this a reinsurance style contract?

Tidjane Thiam:
Yes, but I don't want to discuss too much on it but that's the general idea because we've done quite a bit of work on that and the FSA has approved it and is very comfortable with the concept. You've heard me say several times in the past that the IGD did not allow us take into account sufficiently the shareholder interest and we were very happy that we found a way to realise that.

Jon Hocking (Morgan Stanley):
And is there any embedded value or IFRS impact to that structure?

Tidjane Thiam:
No.

Jon Hocking (Morgan Stanley):
Okay, thank you.

Mark Tucker:
We'll move to Clark.

Clark Manning:
Okay, the question related to write downs on CMBS. The things to consider on our write downs on the CMBS is that it's first of all a very high quality portfolio, the average credit enhancement on the CMBS portfolio is about 30 per cent, and if you look at the make-up of that portfolio, as Tidjane said during his remarks, post 2004 we definitely went very much up in credit quality - we have c$35 million of our 2006-07 CMBS, this is in dollars, that is non AAA and about $35 million of 2005 that is non AAA. Pre-2005 we have about $475 million that is non AAA but if you think about how that would have performed, first it was put on before the late stages of the market and, second, there has been time for substantial credit enhancement build up on that. I think the other thing to think about is that about 81 per cent of the AAA is super senior. So even to the extent that there was principal loss, the principal loss is going to be greatly mitigated because you are the last tranche in line.

At this point the default levels on CMBS or the delinquency levels, it's still very early. Delinquency level latest figures are 88 basis points, Fitch is predicting that there will be two per cent delinquencies by the end of 2009 so it's going to increase but exactly where it's going to go no one knows yet, but the effect of the credit enhancement, if you think about it, if you've got 30 per cent credit enhancement and say, LTV ratios at the 75 per cent level - you need extraordinary levels of defaults combined with very significant severity on those defaults to run through the protection that you have. So, while we haven't taken much in the way of write downs on that portfolio it's because we still feel very good about that portfolio and feel that there is substantial value there.

Jon Hocking (Morgan Stanley):
And is it mark to market or is it mark to model?

Clark Manning:
It is some of both on the CMBS and I don't remember the splits on that.

Jon Hocking (Morgan Stanley):
Okay, thank you very much.

Greig Paterson (KBW):
(i) On Taiwan, I just wonder if you could just give us a steer what that would mean for the holding company cash flow and was Taiwan capital consumptive or not in terms of holding company cash flow and obviously the impact on the dividend policy.
(ii) Taiwan had an £800 million IGD release but a £600 million hit on the IFRS. I just wonder if you could reconcile those two numbers for me; that would be useful.

(iii) Just to clarify, when you spoke about the £900 million on the IGD you mentioned SSAP86, and then you said you would talk about it later, when you were talking about the agreement that you had reached with the regulator about taking your liability from book to mark to market so as to match the hedges. Is that what you're referring to with the SSAP86?

Mark Tucker:
Let me get Tidjane perhaps to start on the Taiwan position and cash flow.

Tidjane Thiam:
I have become very boring for my colleagues here, because I am very cash flow obsessed but let's say that Taiwan is a good transaction from that perspective because we have all these spreads which have a cash cost for us in the past so there will be a positive impact from not having the business any more, from a cash flow perspective. And as far as dividend policy is concerned the IFRS cover is intact because that hit is going to go below the line. On the IGD and IFRS loss, fundamentally you had significant net assets in that business that basically goes away and you take a one-off hit. But we think that the balance of the IGD gain at £800 million plus the positive cash flow impact more than justifies the transaction going forward.

Mark Tucker:
Yes, I think the £595 million comes about from clearly writing off the shareholder funds plus some goodwill, plus some restructuring, it's a combination.

Greig Paterson (KBW):
What I'm saying is if you start off with a £600 million hit that means there's a release of capital requirement to the tune of £1.4 million?

Mark Tucker:
You can't actually work it out that way, Greig, it's not a symmetrical relationship.

Greig Paterson (KBW):
Yes, well the reason I asked the question was I had a query from an investor saying, "You better check what's going on here?" So if you could, off line, give me a recon of some sort that would be useful.

Tidjane Thiam:
Very happy to do that, it is to do with the completely different nature of the IGD number and the IFRS.

Greig Paterson (KBW):
I understand. And then just on the swap.

Tidjane Thiam:
The short answer is yes.

Blair Stewart (Merrill Lynch):
A couple of questions:

(i) On the US business perhaps Clark can talk about the potential reserve risk in the US. We've seen that with other companies, the regulators moving up the reserves. Does the SSAP86 concession you had in the US business affect the reserving as well?

(ii) Secondly, the with-profits VIF has gone down, probably not surprisingly. I just wondered what implications that has for cash flow going forwards? And the structure you've put in place in the UK to get the credit for the £300 million so far, you talk about potential for more, what would be the trigger for taking more credit for that?

Clark Manning:
The reserving risk in the US is reflected in our capital numbers, the SSAP86 wasn't a reserving item per se it was more in the nature of part floating rate institutional contracts, we have interest rate swaps to match the assets to the liabilities and those swaps - it's a case of not marking those swaps to market without marking the liabilities to market. There has been strengthening of US statutory reserving requirements over the course of the last couple of years, our results though do reflect that. We have something called CARVM coming in this year, that's not in effect yet and I think there's still some discussions going on between the ACCI and the NAIC regarding some of the elements of that calculation.

Tidjane Thiam:
Could you just repeat for me your second question it was about VIF and cash flow but I'm afraid I missed some of it?

Blair Stewart (Merrill Lynch):
Yes, it will be the Scottish accent that's probably doing it, Tidjane. Just talking about the size of the with-profits VIF that you quoted, I think £1.7 billion, that's obviously lower than you've quoted in the past, perhaps unsurprisingly, but a lot of the holding company transfer comes from the with-profits fund, I just wonder if you could just comment on the cash flow implications of that.

Tidjane Thiam:
That's true, Blair, it has gone down, I think the last number we quoted was £2.7 billion in Q3 and it's £1.7 billion this time. As you say, unsurprisingly due to the mechanics of inherited estate and the way that the transfer works. At this point, as we said before, we think that the transfer itself from the with-profits fund of the shareholder interest in those surpluses is very safe, it's not sensitive at this stage to equity market levels.

Mark Tucker:
Yes, we've just had a board meeting this week on PAC, which we can't give you the figures, but we know what the cash flows are coming out of that and we are comfortable they remain strong.

Tidjane Thiam:
The trigger for additional access to shareholder interest in the with-profits fund - what we wanted to do was really kind of proof of concept with the £300 million. We did and, we're very happy that it got recognised and we got the credit in the IGD, we don't feel the need to do more at this point. We're frankly quite happy with where the IGD is in absolute terms, it's going to go up further and really we're really focused on the sensitivities that is where we've invested most of our effort in the last three months. Equity markets have gone down 40 per cent in 2008 and to make sure that we were protected we have indicated £350 million down for another 40 per cent. We've had to work quite hard. We've made a number of decisions and we feel that our absolute level of IGD with the level of volatility we have achieved is a comfortable position, so we don't feel the need to do more.

Blair Stewart (Merrill Lynch):
Okay, can I just ask one further question. You talked about the sensitivity to interest rates going down further ex-Taiwan, could you comment on what the number would be at this stage?

Tidjane Thiam:
Yes, let's say you could knock £50 million off, so from 300 you go to 250. But remember the interest rates in Taiwan are very, very low so I'm not giving you necessarily a total indication of the sensitivity of Taiwan. It's just that we've gone so low but what's left is 50 if you remove Taiwan.

Blair Stewart (Merrill Lynch):
Thanks.

Raghu Hariharan (Fox-Pitt, Kelton):
I just have two questions and a clarification:

(i) To follow up on what Blair was asking on the UK structure, the way I understand it is the £1.7 billion is the value of the discounted value of the shareholder transfers so the way I understood it was you're swapping cash flows for capital. So I'm not clear how you'll still be able to extract cash flow while keeping the capital intact, i.e. would you need to reduce the capital and take it out of capital to get the cash flows out to the holding company? So a clarification on that would be great.

(ii) The second question was on Asia - you mentioned that you're seeing a flight to quality on new business, I was just wondering if for the inforce you can give us a sense of lapses? I guess, persistency behaviour on the inforce and the impact that you're facing from the market dislocation?

(iii) The third question was just for Clark on the RBC ratio in the US, if you could confirm to us what the RBC ratio was at year end?

Mark Tucker:
Let's go first to Clark, which I think is RBC at year end.

Clark Manning:
RBC at year end in the US was 420 per cent, Michigan is considering a permitted practice to increase the period for consideration of the deferred tax asset reversals from one year to three years if they go in line with what other states are doing there and do that extension then our RBC ratio would increase to about 438 per cent.

Tidjane Thiam:
That would also increase the IGD.

Mark Tucker:
Okay, then let's come back in reverse order. I think in terms of Asia, again, clearly the experience variances you'll see through the results and you'll see that in four weeks' time. Let me give you a clear steer there that performance has been on the business side quite strong, we have seen no deterioration. Let's come back to Tidjane on the final one.

Tidjane Thiam:
Yes, I think it's quite a well known structure - you remove a tranche of liabilities far in the future and against that you have your shareholder transfer and your payment coming out and you swap the two, and because you remove liabilities you have a capital benefit. So that's how you create the situation of your capital credit in the IGD. That is the concept, there are all kinds of technicalities around it but that is the concept.

Mark Tucker:
But it doesn't, as you suggest, take out capital, it's a technique that avoids doing that by tranching annuities.

Raghu Hariharan (Fox-Pitt, Kelton):
Okay, got it. Just a quick follow up, if you don't mind - the IGD increase, which you said if you were to get to that 18 points boost in the US, would you have a number for it?

Tidjane Thiam:
Clark?

Clark Manning:
It would be £100 million roughly.

Raghu Hariharan (Fox-Pitt, Kelton):
Okay, thank you, gentlemen.

Andy Hughes (JP Morgan):
Hello, I like the brilliant idea of the with-profits virtual capital! Given that I wrote a note on 26 January, I just wondered if you were going to pay me some commission for the idea or whether you kind of dreamt it up yourself?

Tidjane Thiam:
This was absolutely fascinating, I read your note with great pleasure, it was a very funny moment – you could say that it was a meeting of the minds!

Andy Hughes (JP Morgan):
The questions I had were:

(i) How come you've only got £300 million in terms of the buffer, is that because of the timing or what was the reason for only £300 million of coverage on the virtual capital transaction?

(ii) The second question was just to understand the implications of the cram down in the US, because I know you talked about super senior today but obviously a lot of people are quite worried about what could happen with cram down coming in potentially and loan renegotiations of AAA slices of certain structured products?

(iii) The third question was relating to the UK credit provision, which I think you've announced is sort of 80 or so basis points, is there also a cap on the yield that you use. So, for example, you could create an example of the Lloyds TSB tier 1 debt which was yielding a lot now. Would you still take the yield on those less 80 basis points or would you cap that yield in calculating in your reserves?

Tidjane Thiam:
Right, I have referred to proof of concept, it was more proving that it was doable. We chose that size because it was convenient, we could have done more. It was just really

proving the value and the recognition by the FSA as a signal for all the people in the market who were concerned about our position.

Clark Manning:
Cram down - some background for everyone on the call:

- Legislation is being considered in the US which would allow bankruptcy judges to essentially write off first lien mortgages to the property's value.
- This hasn't been permitted in the US since the early 1990s.
- From a policy standpoint I don't understand why they want to do this to what already is stressed paper in many cases, but we do think there is a good probability that some form of this will pass.

The impact on the RMBS deals is that certain deals have language that allow mortgage losses from these bankruptcy adjustments to be distributed pro rata across the structure rather than going through the typical waterfall. Meaning that senior tranches could be affected by this. We think the economic effect of these bankruptcies in tranches for prime non agency and Alt-A is quite small so we don't think this is an economic issue. The issue is that it subjects the senior bonds, senior RMBS bonds to risk of downgrades because of the increased effect of the defaults. It does not affect the subprime securitisations that we hold in the portfolio so we're talking about non agency prime and we're talking Alt-A.

We've looked at our portfolio to see how much downgrade risk we might have and what we've got is 46 per cent of our senior prime non agency and Alt-A portfolio would allow the cram downs to be distributed pro rata. That is US$1.1 billion. So then the question is if that were to happen what might the ratings effect be. Based on Moody's current guidelines, we believe that a single B rating would be most likely to come out of that. So then the question is if they're all downgraded to single B, you know, again from a policy standpoint we're talking about taking AAA paper and making it single B, I don't understand this at all. If you do that the RBC impact of that would be 23 per cent. If you look at the 2005-07 vintages which we actually think have the most risk for being effected by this, that's $764 million worth of at risk book value and the impact of downgrading all of that to single B would be 15 per cent on our RBC ratio. There are things to be done to mitigate this that we're looking at, such as re-remic the structures and other possible solutions. But those are the numbers if the whole thing just got downgraded.

Tidjane Thiam:
The question on do we cap? No, we said at the half year we were taking about a 75/25 proportion between liquidity and credit and increasing for corporate spreads. You saw that Q3 translated into 65 basis points and I have had quite a few discussions with David Belsham (Actuarial Director, UK & Europe) on how much we should put for Q4. We decided not to cap and to continue to take 25 per cent of the entirety into credit, which took us to the 80 basis points. We are announcing now to give a sense of conservatism of that. In the 80 basis points expected defaults are about 15, there is about 11 basis points for what we call the credit risk premium so there is a risk of volatility in the default, and then the 54 that will take you to 80 for the credit contingency reserve. The Great Depression was 78 basis points which is why we say that 80 for the average duration of a portfolio gives you a Great Depression every single year. And the final point is that we have a very high quality portfolio. We have a lot of AAA so we feel that this is really an adequate level of protection.

Andy Hughes (JP Morgan):
So just to clarify a point on the cap - if, for example, on a Lloyds tier 1 instrument of £160 million where the yield is probably something like 13-14 per cent, you're taking the yield of 13 per cent, 14 per cent less 80 basis points to calculate the backing proportion of liabilities. You are not capping that at say eight per cent or something?

Tidjane Thiam:
No.

Andy Hughes (JP Morgan):
Okay, thank you.

Andrew Crean (Citigroup):
Good morning, a couple of things I just wanted to talk to you about.

(i) Firstly, a very eloquent discussion of how well you're doing in Asia from an organic perspective, you know, winning business and winning market share. Why, therefore, do you feel the need to augment that possibly with an acquisition strategy?

(ii) The second question is just as clarification. You've given us the splits of your fixed interest portfolios, UK, US and Asia, in Asia I think you were saying it is £11 billion of which £7 billion is linked with-profits funds. Is the other £4 billion all in corporate? And as part of that I just wanted to understand, you've given us the default provision for the UK of £1.4 billion, could you give us the default provisions which you are carrying in your Asian and US businesses?

Mark Tucker:
In terms of your first question which was related to inorganic attitudes given the strengthen of our organic business, I think I just repeat what I have said before, namely that we are seeing a lot of opportunities in the marketplace in both the ordinary course of business and arising specifically out of the current dislocation. We look at a number of things - our financial and economic discipline is immensely tight and immensely hard and what we look at is seeing what makes sense for our business and for shareholders. There are two particular elements that are always attractive to us, which is cash and stat (i.e. statutory, IFRS profits). If businesses can produce cash and stat then that's clearly of benefit.

So the combination of the two is important, we have a tremendous business in Asia which is going well. We don't have a requirement to buy anything but if there are opportunities at prices that we think are attractive to shareholders and meet our conditions then they are things that we should look at. I genuinely don't put it stronger than that.

Andrew Crean (Citigroup):
Okay, can I just follow up on that because last time that Prudential talked about wanting to do an acquisition, and particularly it was talking about the virtues of American General's cash generative abilities, and then that passed through to the AIG Group. There was a point then where the market turned around and said, "Obviously you needed the cash because you were short yourself" and then that led through to a dividend cut in the fullness of time, the rights issue. That is the concern that the market has, are you doing this from a position of weak cash generation relative to your dividend?

Mark Tucker:
No, absolutely not, what we said is we're going to be holding company cash positive this year, we have delivered that. You've seen the trend over the years and that will continue. You see continued cash coming off the Asian portfolio, off the UK and off the US and you see great cash coming off M&G on the asset management side so I think it's just in terms of value going forward, it's not in terms of any need now.

Tidjane Thiam:
To be specific, we were being a bit diplomatic when we said balance new business with capital and cash, we've built the 2009 budget from the cash line up. It is built to make sure that we generate an adequate level of cash to go through this cycle. So it is really a very high degree of focus on cash. On Asia, Andrew, it's mostly government, the balance.

Andrew Crean (Citigroup):
Okay, yes.

Clark Manning:
Well, the impairments taken in the US would have been about $300 million of RMBS, mostly Alt-A, about $500 million of corporates which are the big names there (i.e. Lehman, Wamu, GMAC, Capmark, Genworth, iStar) and about $100 million of preferred and others, mostly preferred. Big names there obviously Fanny and Freddie.

Andrew Crean (Citigroup):
And those are dollars?

Clark Manning:
I'm sorry, those are dollars, I should qualify.

Andrew Crean (Citigroup):
Could be the same thing practically! Thanks.

James Pearce (Cazenove):
Just following up Andrew's question about Asian acquisitions:

(i) How much surplus capital you've got after magically doubling your IGD number and what you think your cost of capital is? If I look at your share price the earnings yield is sort of 14 or 25 depending on what accounting method I use. Is that a reasonable thing to look at and how high a return would you be looking for?

(ii) Secondly, you've been reinsuring your GMIB exposure, what would you do if that cover fell away and how secure is that reinsurance capacity that you're using at the moment, please?

Clark Manning:
On the reinsurance, it is getting increasingly more difficult to get reinsurance on GMIBs, we're not willing to issue GMIBs without reinsurance and in fact we will be pulling our GMIB benefit. It represented 11 per cent of the VA sales last year so that, we don't think will have a significant impact on our sales and other people with GMIBs are either repricing them or pulling them. Ace Tempest has the reinsurance and it's all fully collateralised so we feel good about that.

James Pearce (Cazenove):
Okay.

Tidjane Thiam:
I think the question you're asking more or less is what kind of return on capital are we looking for?

James Pearce (Cazenove):
And how much surplus capital do you now think you have?

Tidjane Thiam:
I think really as far as returns are concerned we will talk about them on 19 March and that will give you a sense of the kind of profitability we are after.

Mark Tucker:
On 19 March we will give full results, James, and we will take you through all the detail.

James Pearce (Cazenove):
Okay, and how much surplus capital do you have? I mean, if you were adequate at £1.4 billion presumably at £2.5 billion you've got £1.1 billion, is it as simple as that?

Mark Tucker:
James, as I say, we'll take this on 19 March, we will go through this in detail. It's all connected to returns so we will take this through to the 19 March.

James Pearce (Cazenove):
Okay, thank you.

Tidjane Thiam:
James, just one thing, using the figure you gave me: we have said that we were working on disclosures and we're going to talk about free surplus in a much greater level of detail on 19 March too so that should give you more visibility on capital generation and cash generation.

James Pearce (Cazenove):
Okay, thanks.

Greig Paterson (KBW):
Three questions:

(i) One is bulk annuities, L&G was particularly aggressive in the fourth quarter, now it's had some problems so it's backing off. Does that mean you can expect to tick up in 2009 with your capital strength?

(ii) The second question is in the UK as well: you've been put on a negative watch by the two rating agencies around your with-profits book, I was just wondering how the mechanics work as that's a core strength of your business so if it gets downgraded does the underlying group's financial strength rating get hit and potentially could have sort of a contagion impact into the US? I'd be interested to know what, if you did have a downgrade, the impact would be for sales and for the general rating of the group.

(iii) If you give us a number, what is your exposure in Sterling assets to the toxic UK banks tier 2 and upper tier 1 and prefs?

Mark Tucker:
Okay, let me deal with bulks first, we did a very small deal, a deal that we term internally as a ‘capital light’ deal in the last quarter, this was the only deal that we did and I think we are staying very focused. If there are opportunities out there that we think we are getting the returns that we want, we’ll certainly look at these but we are cautious and careful and are looking for more return in this environment given the volatility. So we have the ability to do that business and we are looking at opportunities but, we’re looking at these very carefully. We have no intention to go out and buy the market.

Tidjane Thiam:
Yes, on the rating agencies. First of all, PAC is extremely strongly rated but fundamentally behind that there is a debate about strategy. The rating agency, if you look at the words they’ve used when they’ve put us on negative watch: they recognise that we have good strategies, they recognise that the strategy is delivering, they recognise that we have the highest margins in the UK, the challenge is around the structure of our model with a premium on diversification. Every time we have a discussion with them around does it make sense to be diversified into value destroying segments of the market? Our answer is no clearly. The models of rating agencies put a premium on it.

Greig Paterson (KBW):
Just on that point, in their note they actually mention that you’re restricted. The changes around your with-profits fund would inhibit your strategy to move out of annuities. I don’t recognise you having a strategy to move out of annuities. Is that they just misinterpreting your strategy?

Tidjane Thiam:
I think it is a misinterpretation. Overall we think we have a very strong rating, even a downgrade would not have any contagion to any other part of the group because it’s going down from a very high and a very strong basis. On the UK banks, total Tier 1 exposure is £360 million (of which £160 million relates to Barclays, Lloyds / HBOS and RBS), we feel that these are the most relevant numbers.

Greig Paterson (KBW):
Thank you very much.

Jon Hocking (Morgan Stanley):
Yes, hi, just to follow up quickly. Can I just check my maths is correct? On the 420 per cent RBC that you’ve got in the US at the end of the year, did you say that effectively the difference between 420 and 438 was £100 million? So can I then interpret you’ve got sort of £390 million of surplus over the 350 RBC at the end of the year? And also can you just confirm that that is fungible around the group and that you could move that to the UK if necessary? Finally, can I just clarify that the 10 per cent stake you’re taking in China Life is in China Life Taiwan rather than China Life Group?

Mark Tucker:
Yes, I think if we could do that for £45 million we would take it!

Jon Hocking (Morgan Stanley):
Just checking!

Clark Manning:
The 420 RBC level in US dollars that gives us excess of $637 million over 350 per cent RBC level, fungibility it obviously consolidates upward. There are statutory limitations in terms of how much you can move in a given time period without approval from the Michigan Commissioner. But ultimately it's all fungible, yes.

Mark Tucker:
The FSA treat it as fungible.

Jon Hocking (Morgan Stanley):
Okay, thank you very much.

Mark Tucker:
Okay, before we terminate the call, thank you for listening. We have hopefully demonstrated that we have a very strong story, both in operating and capital positioning both on a relative and absolute basis and we look forward to continuing to build this business in 2009. Thanks again for listening and have a good weekend.

[END]