Check Against Delivery

Morgan Stanley Conference 26 March 2014

Slide 1 – Title: Legal & General - multiple opportunities and manageable risks.

Good Morning,

Today’s question is this: did everything change for Legal & General at about twenty past one last Wednesday?

The answer is “probably not”.

The end of, effectively, compulsory annuitisation at retirement for most people in defined contribution pensions <u>will</u> mean adjustments to our Legal & General Retirement business, but not as many as some observers might think...

…but it creates opportunities too: including for LGIM, and for our Savings and Retirement businesses.

That’s why we were able to publicly score the Budget at four out of five…

…pretty good economics…very clever politics…and an element of Schumpeterian “creative destruction”. But for us the creative opportunities outweigh the challenges.

I’ll start with a reminder of the financial highlights from our Prelims earlier this month.

Slide 2 – Financial Highlights

It is easier to deal with change if you have a strong base….

Net cash and Op cash up 16% and 9% respectively, with Net cash above £1bn for the first time…Operating profit up 7%, PBT and Profit after tax up 10% and 12% respectively… a further improvement to RoE at over 16%...

EPS was up 10%, and DPS up 22%, with a full year dividend of 9.3p per share. We also gave new guidance on the dividend: cash cover in 2013 was 1.8 times, we will move towards 1.5 times over the next two years.

That is a strong base…but just for clarity, following the Budget we reiterated that 2014 Op cash guidance for L&G Retirement is unchanged at £290m versus £260m for the prior year. Dividend guidance is similarly unchanged.

Slide 3 – Strategic and Financial evolution

These results were part of a consistent direction of travel. Over the last five years we have taken Legal & General on a journey over three stages: from focusing on cash, to cash plus organic growth, to cash plus organic growth plus selective acquisitions.

Since 2008, Net cash has grown by 213%, from £320m to £1002m….while dividends have grown 129% from 4.06p to 9.30p.

In the course of that journey, we have delivered strong operational results…executed well, including through six bolt on acquisitions in the last twelve months…and simplified our management structure to focus on five major profit centres.

Many of the actions we have taken position us well for the changes now under way in the retirement market. LGIM is now increasingly international, and a leader in the Liability Driven Investment, LDI, market with £70bn AUM in that segment…Savings assets are now £109bn and Cofunds, with £64bn is the biggest UK savings platform…this matters because individuals will now be encouraged to save more both through ISAs and Unit Trusts, and through workplace savings where we are also a leader.

Last year we wrote £5bn of longevity insurance and £4.1bn of annuity premiums. £2.8bn, or more than two-thirds of those annuity premiums were from bulk purchase transactions…and this morning you will have seen we have announced the UK's largest ever BPA deal: £3bn for the ICI pension fund…. with more to follow.

To misquote Mark Twain: if you are in, bulk business, LDI business, longevity business, then rumours of the demise of annuities are definitely exaggerated.

Slide 4 – Creative Destruction
"No one will have to buy an annuity"…that's what the Chancellor said.
It is a perfectly fair idea to open up choice for consumers, to let the market flourish.

We have no problem with that, but let's dig a bit deeper into the effects for Legal & General, the market and the broader economy.

We predict more saving. Our research indicates that DC should grow at 12% per annum. Once the political euphoria about pensioner choice dies down, it will become apparent that however much choice you have about how you extract money from your pension pot, you can still only have it once.
That was, I think what Steve Webb meant when he spoke about pensioners buying Lamborghinis.

The challenge is to save more in the first place…and the incentive to do so is now improved. So savings will grow: retail savings on platforms like Cofunds, pension savings in Defined Contribution Schemes, and in Workplace.

DC fund management opportunities will expand, and this is good for LGIM, whose capabilities in DC will be extended by the acquisition of GIA, who provide market-leading DC strategies.

There are potentially new opportunities to enter new decumulation product areas, like drawdown. More personal ownership of retirement planning could encourage equity release: another area we plan to enter.

Of course annuities will remain right for many people: and with the continued secular expansion of the Bulks market, we are extremely confident that we will write more annuity business in 2014 than in 2013…possibly substantially more.

An at-retirement world of freer choices also has to be a world where good quality advice is more accessible. We cannot make people wiser…but we can help them be better-informed. This is going to be crucial, and the government recognises it as such. This advice question is a much bigger challenge for the market and the government than the issue of product development or adaptation. Guidance and advice (both small and capital ‘A’) must be available, and it must be good. But it should not create an open-ended liability or cost for the industry.

There will be economic effects as a result of liberating money. The Treasury’s expectation that it will take more in tax tells you this. I believe, and the Australian evidence supports this, that most people are sensible with their money, even if they do tend to underestimate their own longevity. But government does need to be careful about fuelling a consumption-led boom, and about making government debt harder to finance as a result of these changes.

Slide 5 – Government Proposals DC Market

Here is a snapshot – the simpler schematic on the right shows what we expect to happen: a broad three-way split between full withdrawal, annuities to provide certainty of income, and drawdown and new products.

Respectively, we estimate the likely sizes of these segments at £4.9bn, £2.8bn and £5.8bn, of a £13.5bn market in 2015. These are estimates at a market level. Reality for individuals will be more complicated as some will take a mix, or use different products at different times. This is part of the complexity of the advice issue. Advice given at retirement is all very well, but what if more advice is needed at different stages of retirement as the ideal product mix changes? For the adviser and more importantly for the individual, it will be about hitting a moving target as retirement progresses.

Slide 6 – Impact of Proposals for DC

So here is what we expect. We do expect individual annuity sales to go down, including for internal vestings, which have been the subject of regulatory intention, and enhanced annuities: if you have a short life expectancy, you are more likely to take cash.

Slide 7 – Pensions Market

The slide demonstrates how we have analysed the market.

In total, we expect the IA market to drop from £11.9bn to £2.8bn of premium.

We certainly expect to see more cash being taken out, either singly for small pots or across several years, and we expect to see more use of the housing asset as pots get depleted more quickly.

If you have a small pot, less than £10k, you will likely cash it in, in its entirety. £10-£30k pots which currently deliver £2.2bn in premium, will only produce £0.4bn as they will be split across cash, drawdown and annuities. Even for pots above £80k, we are predicting a market fall of more than two-thirds, from £5bn in premium to £1.5bn.

We expect an increase in drawdown and new products: lower margin, but also less capital-intensive for providers. More flexible products are likely to mean shorter duration or more liquid investments, which could impact gilt funding at the long end, and corporate bonds.

Slide 8 Pensions market Structure

Now let’s broaden out to look at the DB market.

A major topic of the Treasury’s consultation is whether the new freedom for DC pensions should be made available to DB scheme members, by the simple expedient of taking a transfer value into a DC scheme and then extracting their money as they like.

The government has already moved fast to prevent this happening to its own funded schemes, worth around £210bn. That is right – the outflows could be very damaging – but it gives a clue as to just how far the rhetoric about freedom versus paternalism is likely to be extended.

The £1.1trn of assets and £1.8trn of liabilities in private sector DB funds tell us two things.

First, that structurally a huge amount of de-risking is still required, through a growing bulks market, like the £3bn deal we have announced today, longevity insurance like the £5bn we did last year, and LDI, where LGIM are global leaders. This is positive for Legal & General.

The second thing it tells us is that moves to encourage members to head for the exit would be seriously disruptive to markets, including gilts. For this reason I believe that allowing more than very limited exits from DB – for example only for those schemes that are in surplus – is unlikely. It is of course unlikely anyway: most rational people lucky enough to be in a corporate DB scheme would be unwilling to expose themselves to the uncertainty of giving up a firm promise for the vagaries of acting, in effect, as their own investment manager and their own actuary in DC-world.

Slide 9 – Impact of proposals for DB market

The government accordingly is offering a series of five possible approaches in its consultation paper. My hunch is that there will be a nod to flexibility, but that in practice transfers will be tightly controlled – most likely choices (2) of (3), and then perhaps dependent also on the surplus or deficit of the fund. One thing is therefore absolutely certain: DB, and DB de-risking, will be with us for a long time, and in size.

This is a particular advantage for Legal & General. The history of the BPA market shows us that it is a market where scale, investment management and longevity expertise are essential prerequisites for success….not an easy market to enter and to thrive in…One of our best acquisitions last year was

Lucida, and I daresay Paternoster is working the same way for its new owners, Goldman Sachs.

Slide 10 LGR, LGIM and LGAS: substantial growth

It is not the only advantage I can see as we look at the likely impact of the new proposals for Legal & General. If we look down the list here of five levers of growth, we can see the scale of the existing business and therefore the headstart we have when we look at the opportunity…

- a UK bulk annuity business with already £23.7bn in stock of assets…
- expertise already in longevity insurance with £5bn completed last year…
- a set of businesses designed to help individuals with pension accumulation and decumulation – Cofunds the UK's largest savings platform, Suffolk Life with £6bn in SIPPs, a leading position with £8.7bn in workplace savings and of course an individual annuities business with £13bn…
- an investment management capability in LGIM with over £100bn already across DC and LDI investment
- and the ability to internationalise our asset management and de-risking businesses.

This is a valuable portfolio of businesses, and it gives us broad optionality in a world where there will be more options available to savers and pensioners.

Slide 11 – Clear Strategy, Outstanding Results

One reason why we have outperformed since the credit crisis has been that we have identified five macro-trends which drive growth in our business, and we have set our strategy accordingly. These five trends are:

- increasingly homogenous asset markets, which create attractive opportunities to grow and internationalise our investment management business

- ageing populations, which create a growth market for providers of individual and corporate retirement solutions
- welfare reform, where as state funding shrinks, private protection can step in
- bank retrenchment, which create opportunities for insurers and other institutions to invest long-term in assets like infrastructure and housing
- and increasingly digital lifestyles, which favour scale, automation and low unit-cost production.

With a strong balance sheet and a strategy based on these trends, which are hard to argue against, we have been able to ride through short-term economic fluctuations and deliver strong performance across the economic cycle.

You can see from the right hand side of the slide how the focus on these five themes has delivered operational successes: in each case, the trend is our friend: annuity premiums, principally driven by bulks and workplace pension assets up 78% and 45% respectively…£64bn on-platform savings assets…protection premiums up 7%...37% growth in international AUM…and rapid progress in direct investments…and another £1.1bn completed in the 11 weeks since January 1st – that's £100m a week.

Slide 12 – Driving Growth: Increasing Stock

Through this presentation, I have tried to emphasise the importance of stock of business. This is what ultimately drives cash and profit. Here as a snapshot you see the progress made in thee years in building stock across four businesses: investment management, insurance, annuities and savings.

That is the growth – principally organic - which drives our rising cash and ultimately rising dividend. Given the spread of our business, there is nothing in these budget announcements that I see as interrupting that progression…

Slide 13 - Acquisitions

But we have said that we would augment organic growth with bolt-on acquisitions, where they fitted our strategic objectives. The six deals done in the last twelve months have been well-executed…we have been disciplined about what we have done and what we have chosen not to do…and they have strengthened us financially and competitively.

We know what we want to do next…this is a dynamic process where we will look in the UK for annuity opportunities post-budget…for promising digital opportunities…for opportunities to internationalise…and potentially to take profit, for example an IPO of an enlarged housing business.

Slide 14 – UK pre-election boom

Turning to outlook, I want to offer a few brief comments.

First, the UK economy. The data in the budget confirmed our view that we are in pre-election boom of the traditional British type: consumption and house-price led, with other data lagging, and stubborn budget and trade deficits.

We are vulnerable to interest rate rises in 2015 – there is a close correlation in the UK between rates going up and GDP going down.

Slide 15 - Persistent macro economics

The global situation still looks fragile, with China and the QE unwind the major potentially destabilising influences. One knock-on effect may be that the UK may find its deficit harder to finance in international markets – it was a key achievement of the current government to restore the credibility of gilts and it may be harder to maintain this credibility, and access to cheap funding, in future. This of course takes us back to the current reforms…it is an argument for not destabilizing the DB pension sector, which could have knock-on effects for gilts and corporate bonds.

Slide 16 – Fast and slow money: what happened

Looking at the impact of QE is interesting. This is a very clear and graphic illustration of the way in which creating narrow money coincided with the destruction of broad money: if indebtedness was the cause of the 2009 crash, QE was never going to be the solution.

I do think however that back in 2008-9 the authorities, meaning essentially the Fed and the BoE, with Japan following a bit later, took the right decision. Nobody had a better idea and the patient was probably saved by this intervention. But there were huge side-effects which still remain to be unwound. The QE drug was massive, but we seem to have become hooked on the monetary methadone and weaning off it will be tough.

Here on the slide you see narrow money being created via QE…and the almost mirror-image of broad money, in this case sterling M4, shrinking. What happens through the money creation process is that we get two-speed money. The old sort of slow money – the money that Adam Smith, JM Keynes and Milton Friedman understood – becomes even slower and stickier on bank or corporate balance sheets while the fast money becomes ever-faster as it trades digitally and chases yield, creating new winners and losers and arguably a less stable and sustainable recovery.

Slide 17 – Fast and Slow Money: Winners and Losers

Looking at the winners and losers from QE gives a good snapshot of how the policy has worked.

It has been a policy first of all devised by the rich, for the rich. Inequality has widened, asset prices have risen and real wages have fallen. This also makes it inter-generationally unfair, older people generally have more assets. The assets that have benefitted have been mainly financial assets: stocks and bonds, there has been a backward move in corporate investment in capital goods.

Spenders have done better than Savers: those saving for a pension or buying an annuity have suffered from negligible returns in low-risk assets. Moreover, going back to annuities, it was the prolonged period of low interest rates, and of course some sales practices, which made them ostensibly an unattractive product, rather than problems with the product itself. As rates rise, we may see some re-evaluation of the value of an income for life.

It has been a mixed blessing for politicians. Countries that control their own monetary policy could adopt QE to ensure survival or re-election. But where there is no local control of the levers of monetary policy, and no QE, unmitigated austerity guaranteed unpopularity: look at the series of collapsed governments across the EU.

QE has also moved the focus of economics to the monetary side: it is easy to ignore the supply side when interest rates and QE are the only game in town. So it was a good recession for monetary policy experts, a dull one for supply-side specialists.

The numbers tell you it was also a good recession for Legal & General. This is a business with huge resilience – partly thanks to our strong balance sheet, partly because we are diversified, the quality and capability of my colleagues and partly because we set our strategy by the five macro-trends, rather than in response to short-term events.

What this means in very practical terms is that as interest rates rise next year, and as individuals have to save more in response to these latest reforms, there are opportunities for us grow…in savings, in digital and in investment management.

Slide 18 – 2014: Further Progress in all areas

We will be ready to take advantage of these developments. At prelims we set out a series of actions – and progress already just in this quarter has been good across our five major profit centres. Today’s transaction has delivered £3bn in BPA…..we have invested £800m of LGR annuity funds directly to enhance risk-adjusted returns….acquired GIA and Banner….driven forward digital growth in protection….and made £1bn of direct investments through LGC…just since the New Year. The guidance for operating cash still stands. As you know we have tight control of costs, and a very clean and disciplined approach to dividending cash up to Group – almost 90% is available for reinvestment, balance sheet strengthening and, naturally, dividends to shareholders.

Slide 19 – 2014 Dividend up 22%

So here is dividend progression since 2009: from 3.84p to 9.3p in four years, with the net cash coverage ratio falling to 1.82 times over the period. We guided at the prelims that we will reduce coverage further, towards 1.5 times over the next two years.

We therefore have two variables to work with:

- First, cash generation, working through from an operating cash number, many parts of which are predictable
- Second the pace at which we want to deliver the reduction in cash cover.

Neither of these factors are particularly affected by the budget changes for annuities. The business mix that we have, our diversification as illustrated by the ICI transaction today, and our close alignment with the main five drivers of the economy mean that we are well-placed to benefit from these changes to UK pensions.

As the dust settles, we will be seen as a winner from these reforms: that is why I was confident in giving the Chancellor four out of five for his budget.

Thank you for listening.